Changes in federal tax law will cut taxes for many Rhode Islanders; wealthiest families and corporations benefit the most

In December, Congress passed, and the President signed into law, the Tax Cuts and Jobs Act ("the Act") which includes changes to both the federal personal income tax and the federal corporate income tax. The Act results in very large tax cuts for higher-income earners, foreign investors, and corporations. The resulting loss of an almost $1.5 trillion in federal revenue is likely to lead to cuts in federal support for programs that are important to people in Rhode Island and to the state budget.¹

While generalizations for such a complex piece of legislation are challenging, we know that the Act will (at least initially) provide tax cuts for many Rhode Islanders. The benefits of the tax cuts will, however, accrue disproportionately to Rhode Island’s wealthiest families, as seen in Figure 1.²

The wealthiest five percent of Rhode Island families will see nearly half—47 percent—of the total tax reduction resulting from the bill, while the bottom 60 percent of families will see just 14 percent of the total. While the richest one percent of Rhode Island families will see their taxes reduced by $43,400, middle income families (those in the middle twenty percent of the population) will see their taxes cut by $710 annually (about $59 a month) and Rhode Island’s poorest families in the bottom 20 percent of the population will see a tax change of $70 (less than $6 a month).³

Because corporations (both C-Corps and pass-through entities) pass a portion of their tax savings on to consumers, most Rhode Island families benefit modestly from cuts to corporations (and pass-through entities) in addition to the cuts they will see from changes to the individual income tax. For the bottom 60 percent of families, nearly four-fifths (78 percent) of the tax change they will see in 2019 will be from changes to the personal income tax. In contrast, the majority of tax cuts that the top 1 percent of Rhode Island filers will see result from changes in the tax treatment of corporations and pass-through entities.

![Figure 1: Distribution of Tax Changes in 2019.](image)

2. These estimates come from the Institute for Taxation and Economic Policy (ITEP). Their microsimulation model is able to break out the final impact of all tax changes, determining the actual ‘incidence’ of taxes (i.e., who pays, or benefits, at the end of the day). For example, a $100 reduction in taxes owed by a C-corporation might result in $40 savings for consumers, $40 in additional profits to be distributed to shareholders, and $20 increase in compensation for the CEO.
Figure 2 highlights the differences in the impact of the tax changes on high and low-moderate income Rhode Islanders.

**Figure 2: Components of the Act affect the wealthiest differently than most Rhode Islanders**

### Personal income tax changes

The tax changes that affect families and individuals most directly are a mixed bag for low- and middle-income Rhode Island families. Importantly, most of the provisions in the Act affecting personal income taxes expire December 31, 2025. The key provisions of the Act affecting individuals and families include the following:5

- **Rates and Brackets**: The Act changes the income tax brackets, retaining seven different rates, reducing the rates for most filers (see Table 1 below).

- **Standard Deduction**: The Standard Deduction is nearly doubled (from $13,000 to $24,000 for married filing jointly and from $6,500 to $12,000 for single filers).

- **Personal Exemption**: The value of the personal exemption—previously set at $4,150 per person for 2018—that taxpayers can claim for each family member is set to $0, effectively eliminating it.

- **Child Tax Credit**: The child tax credit is increased to $2,000 for each child from $1,000 per child, and taxpayers are newly able to claim a $500 credit for each non-child dependent.

- **Mortgage Interest Deduction**: The Act caps the value of mortgages—the interest payments of which can be claimed as an income tax deduction at $750,000 (down from the previous limit of $1M) on homes purchased between December 14, 2017 and December 31, 2026. The Act also eliminates the tax deductibility of home equity loans4 and retains (subject to the $750,000 cap) the tax deductibility of second homes (a provision that benefits higher income earners who can afford to own and maintain two homes).

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State and Local Tax Deduction: The Act limits the amount of state and local taxes that are deductible on federal income to a combined $10,000 for income, sales, and property taxes.

### Table 1: Changes in tax rates and brackets under the Act

<table>
<thead>
<tr>
<th>Married Filing Jointly</th>
<th>Single Filer</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Previous Rates &amp; Brackets</strong></td>
<td><strong>Tax Rates &amp; Brackets under the Tax Cuts and Jobs Act</strong></td>
</tr>
<tr>
<td>Tax Rate</td>
<td>Tax Bracket</td>
</tr>
<tr>
<td>10%</td>
<td>$0-$19,050</td>
</tr>
<tr>
<td>15%</td>
<td>$19,050-$77,400</td>
</tr>
<tr>
<td>25%</td>
<td>$77,400-$156,150</td>
</tr>
<tr>
<td>28%</td>
<td>$156,150-$237,950</td>
</tr>
<tr>
<td>33%</td>
<td>$237,950-$424,950</td>
</tr>
<tr>
<td>35%</td>
<td>$424,950-$480,050</td>
</tr>
<tr>
<td>39.60%</td>
<td>$480,050+</td>
</tr>
</tbody>
</table>


### Impact of changes in the Act on Rhode Island’s income tax code

State tax codes are linked to the federal tax code in various ways. For some states, the Act will have significant impacts. For others, including Rhode Island, the impact is relatively modest.

Rhode Island is among the 18 states (plus DC) that have “rolling conformity”, meaning changes at the federal level are automatically implemented at the state level, unless the state specifically decouples from the federal provision. Rhode Island is one of the 29 states that use federal adjusted gross income (AGI) as the starting point for determining state income tax. These states are affected much less by the Act than are those that use federal taxable income as their starting point.6

Rhode Island’s personal exemption is currently linked to the federal personal exemption (though its amount is not coupled to the federal exemption and is specified in Rhode Island’s tax laws). Officials with the Rhode Island Department of Revenue have determined that because the federal exemption is not eliminated, but rather its amount is set at zero, that no action is required at the state level to retain the Rhode Island personal exemption as is.

### A closer look at the state and local tax deduction (“SALT”)

For most families who benefit from itemizing their deductions rather than using the standard deduction (because their itemized deduction amount is greater than the standard deduction), the deduction for state and local taxes paid is one of the largest components of their itemized deduction. In Rhode Island, in TY2015, for example, the SALT components of all itemized deductions included 27 percent for state income taxes and 20 percent for real estate taxes. Non-SALT components included 24 percent for home mortgage interest payments and 11 percent were for charitable contributions. Clustered together as “other” were deductions accounting for 17 percent of all itemized deductions (In Rhode Island, this category would include the motor vehicle tax, which would be included under the $10,000 cap on SALT deductions).7

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6 Those starting with federal AGI are largely unaffected by federal changes to the standard deduction, personal exemption, or the new deduction for pass-through entities.

7 US Internal Revenue Service, Statistics of Income, Table 2, Individual Tax Data, by State.
Among all filers, one third (33 percent) itemized their deductions in TY2015. For high income families, that number is much larger, as seen in Figure 3. Nearly all filers (98 percent) earning $200,000 or more itemize their deductions.

Rhode Island is among the states—most of which are concentrated in the Northeast and West Coast regions—with the highest relative value for state and local taxes deducted from federal income. These states are relatively wealthy (and therefore residents pay more in state taxes) and have relatively high property taxes. In every state, it will be families with quite high incomes who will see their itemized deductions limited by capping the SALT deduction at $10,000. Among the 33 percent of Rhode Island families who had been using itemized deductions, most (especially middle income families) will now opt to claim the standard deduction, as a result of the combined effect of limiting the SALT deduction, AND nearly doubling the standard deduction.

The SALT provisions of the Act have received a lot of attention in the media and among policy makers, with extensive analysis by organizations such as The Tax Foundation and the Center on Budget and Policy Priorities. Legislators in many states are exploring options that would shelter residents from the SALT provisions in the Act.

There are two mechanisms being most widely considered. The first involves allowing residents to make “charitable donations” to government bodies, in exchange for a tax credit on state income taxes. In Rhode Island, bills have been filed “that would create the Rhode Island Ocean State Fund, which would accept federally tax-deductible contributions and funnel them straight into state coffers.”8 State tax experts generally believe that such an approach will not pass scrutiny of the IRS.

The second mechanism involves shifting some amount of employee income to the employer as a payroll tax (an amount by which the employer would in turn reduce the employee’s compensation). Such an option would detrimentally impact employees’ Social Security contributions, hurting both the Social Security Trust fund, and the income base for calculating employees’ Social Security benefits.

In February, the Governor of New York introduced budget amendments to shield New York residents from the federal SALT limitations, with provisions incorporating both of the alternatives discussed above.

ITEP Executive Director, Alan Essig, suggests that the SALT provisions be looked at in the broader context of the Act, writing “It’s important to keep in mind that most taxpayers affected by SALT will still receive significant tax cuts under the federal bill.”

Figure 3: Rhode Island tax filers claiming itemized deductions

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For Rhode Island’s highest-income households—those with annual incomes over $1 million—the average tax cuts from other federal changes in the law ($105,000) are more than twice the average size of the impact from the loss of SALT deductibility ($45,600). After accounting for the effects of the SALT changes, the average tax cut for these taxpayers will be $59,400 (Figure 4).

Impact of the Act on Rhode Island businesses

For Rhode Island businesses collectively, the bill represents a massive tax cut. However, C-Corps (disproportionately comprising large corporate entities) will fare much better in the long run than will pass-through corporations, the income of which is passed through to individuals who file that income with their personal income taxes. This discrepancy is the result of two factors.

First, and most importantly, the biggest component of the “tax cut” for corporations is the permanent reduction in the federal corporate income tax from 35 percent to 21 percent, a substantial reduction with the expressed intention of making US businesses more globally competitive. (As an example, Rhode Island based CVS estimates they will reap $1.2 billion in tax savings as a result of the bill).  

By contrast, many LLCs, LLPs, Partnerships, Limited Partnerships, and other “pass through” entities will enjoy a temporary 20 percent deduction on qualified business income. When individual tax changes expire in 2025, the tax benefits for these pass-through entities will be significantly reduced. One financial expert emphasizes the different treatment of C-corps and pass-throughs: “corporate America got a 40% effective rate reduction in the form of a permanent tax cut [for C-Corps], while “qualified” small businesses got about a 9% effective rate reduction – and even those crumbs expire after 2025”.

The second factor limiting the tax benefit of the Act for pass-through entities is that there are substantial limits on which business income will qualify as deductible income that will prevent many pass-through entities from being able to claim the deduction.

Because of the very different treatment of C-Corps and pass-through entities in the Act, tax experts anticipate that some businesses will choose to change their corporate status, with pass-through entities potentially adopting C-Corp status to enjoy the permanent tax cuts or C-Corps choosing to become pass-through entities to take advantage (at least temporarily) of the deduction of qualified business income. Whether it makes sense to change their status is something that will be determined on a case by case basis, in consultation with their respective tax advisors and/or accountants. Rhode Island, like other states, would be impacted by corporate entities changing their corporate status. It is too early to speculate whether that impact would be positive or negative for state coffers.

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Benefits of tax changes fade away for most Rhode Islanders and businesses

While the initial impact of the Act will be to reduce the federal taxes of a majority of Rhode Islanders in every income category (while raising taxes on a small number of families\(^\text{11}\)), when most of the components of the Act expire, the average Rhode Island family will see an annual tax reduction of just $40 ($3.33/month). If looking just at the impact of income tax provisions directly impacting individuals and families, Rhode Islanders will annually pay, on average, $130 more in taxes. The aggregate impact of the changes resulting from the Act can be seen in Figure 5.

In tax year 2019, when the changes are fully implemented, changes to the personal income tax will result in Rhode Island families and individuals paying $466.4 million less in taxes than they would have under the previous law, while pass-through entities (disproportionately “small businesses”) would pay $189.2 million less, and C-Corps would pay $255.8 less.

By 2027, when the individual tax changes have expired, affecting pass-through businesses as well as Rhode Island families, we see a very different picture, with families and individuals paying $74.3 million more in taxes, and pass-through entities paying $53.9 million more. Rhode Island businesses filing as C-Corps would continue to see a substantial tax reduction, paying $187.6 million less in 2027 than they would have paid in 2017 under federal tax law in effect prior to passage of the Act.

What does it all mean for state governments and Rhode Island specifically?

For starters, it is important to acknowledge that there remain a lot of “moving parts” to this federal/state tax puzzle. There are many things that we won’t know for certain until the details of the new tax provisions are hammered out, within the IRS, state departments of revenue, and, quite likely, the courts.

Rhode Island policy makers will decide in the coming months whether to implement provisions such as proposed in New York to shield its residents from the SALT provisions of the Act.

Probably the most significant impact of the Act will not be seen until the “next shoe drops”, with the next shoe being the budget changes that will be pursued in the name of preventing the $1.5 trillion tax cuts in the Act to cause the deficit to balloon. If the resulting federal budget is anywhere close to the President’s recently released budget proposal—which slashes spending on Medicare, Medicaid, SNAP, transportation, and other essential government services—Rhode Island residents will suffer, and Rhode Island’s budget, which currently relies on federal funds for one third of its total income, will take a substantial hit.

\(^{11}\) ITEP analysis shows that in 2019, 8 percent of Rhode Island families will see a tax increase, 81 percent will see a tax decrease, and the balance—11 percent—will see no change in their federal taxes.