Federal Tax Reform and the Oklahoma Income Tax

Sheppard F. Miers, Jr.

May 15, 2017

Tax reform is being proposed in Congress and by President Trump to make major changes to the federal income tax imposed under the Internal Revenue Code. Oklahoma imposes a state income tax on individuals, corporations, and estates and trusts. The Oklahoma state income tax generally "conforms" to the federal income tax imposed under the Internal Revenue Code. Income and expenditures are generally treated the same for Oklahoma income tax purposes as for federal income tax purposes. Because of this conformity, the federal income tax reform changes being proposed, if enacted, could also change the Oklahoma income tax and affect taxpayers subject to it.

Federal Tax Reform Proposals

The federal tax reform proposals include the House GOP "A Better Way" blueprint for tax reform released in June, 2016, and the President's tax reform proposal released during the campaign in September, 2016, and later announced in broad terms by the White House on April 26, 2017. Another more detailed federal tax reform proposal was introduced in 2014 by Representative Dave Camp, then Chairman of the House Committee on Ways and Means, as the Tax Reform Act of 2014. These proposals are described in Congressional Research Service Report, *An Overview of Recent Tax Reform Proposals*, February 28, 2017 (https://fas.org/sgp/crs/misc/R44771). Other tax reform proposals are discussed in Congressional Research Service Report, *Tax Reform in the 114th Congress: An Overview of Proposals*, dated March 18, 2016 (https://fas.org/sgp/crs/misc/R43060.pdf). The President's proposals announced on April 26, 2017, are described in a Tax Foundation article, *Details of the Trump Administration Tax Proposal Released Today*, April 26, 2017 (https://taxfoundation.org/trump-adminstration-tax-proposal/).

The House GOP tax reform proposals for individual taxpayers would consolidate and lower the federal income tax rates to 10%, 20% and 25%; reduce rates on active pass-through business income, dividends, and capital gains; increase the standard deduction; repeal all itemized deductions, except the deduction for charitable contributions and mortgage interest; repeal personal exemptions; repeal the alternative minimum tax; repeal Affordable Care Act tax-related provisions; and repeal what is referred to as various "tax expenditures."

The House GOP proposals for corporate income tax would reduce the maximum rate to 20%; allow immediate expensing of capital investment; limit deduction of interest expense; and repeal the corporate alternative minimum tax. The proposals would implement a territorial tax system and border adjustment under which exports from the U. S. would not be subject to tax, and imports would be subject to tax; and subject currently held untaxed overseas earnings to a deemed repatriation tax of 8.75%, on cash and cash-equivalents, and 3.5% on earnings held in other forms. The proposals would repeal most corporate income tax provisions, except for net operating loss carryforwards, last-in-first-out accounting, and the research and development tax credit. The proposals have been described as replacing the current form of federal corporate income tax with a new "destination-based cash-flow tax."

The President's proposals for tax reform are comparable to the House GOP proposals with some differences. The proposals, as announced on April 26, 2017, would provide, as to individual taxpayers, for reducing the 7 tax brackets to 3 tax brackets of 10%, 25% and 35%; doubling the standard deduction; providing tax relief for families with child and dependent care expenses; tax simplification; elimination of targeted tax breaks that mainly benefit the wealthiest taxpayers; protection of the home ownership (mortgage interest) and charitable gift tax deductions, and by implication, eliminating other itemized deductions; repeal the alternative minimum tax, and the 3.8% tax that affects small businesses and investment income. For corporations, the President's proposals include reduction of the corporate maximum federal income tax rate to 15%; enacting a territorial tax system to level the playing field for American companies, imposing a one-time tax on dollars held overseas, and eliminating tax breaks for special interests. The proposals provide that a 15% maximum federal income tax rate would also apply to business income of owners from pass-through entities taxed as S corporations and partnerships, including limited liability companies taxed as partnerships.

The provisions of the Tax Reform Act of 2014, introduced earlier in 2014, include those said to be intended to simplify the federal tax code and make it fairer for a large majority of taxpayers. It would provide a significantly larger standard deduction so that more taxpayers would not need to itemize deductions to pay the lowest amount of income tax. The standard deduction would be increased similar to the House GOP and President's proposals. The Act would also reduce and collapse the individual tax brackets into two regular brackets of 10% and 25%, and a third bracket of 35% for individuals with significantly higher income. The Act would reduce the maximum corporate rate to 25%; would eliminate the alternative minimum tax for individual and corporate taxpayers; and also make numerous other tax simplification changes for individuals and business taxpayers.

Oklahoma Income Tax Conformity with Federal Income Tax

As indicated, the Oklahoma state income tax generally follows or "conforms" to the federal income tax. This is because the Oklahoma Income Tax Act contains provisions that conform them to corresponding provisions of the Internal Revenue Code, subject to certain exceptions and adjustments. Terms used in Oklahoma's law have the same meaning as when used in a comparable context in the Internal Revenue Code, unless a different meaning is clearly required. A taxpayer's Oklahoma taxable income is generally computed based on amounts of income and deductions used to determine the taxpayer's taxable income subject to federal income tax. Oklahoma income tax taxpayer status and elections are generally regarded to be the same as they are for federal income tax purposes except when the Oklahoma Income Tax Act specifically provides otherwise. Specified adjustments subtract or add particular items to determine a taxpayer's Oklahoma taxable income subject to the Oklahoma income tax. Oklahoma individual income tax rates do not conform to federal individual income tax rates and there is a maximum Oklahoma individual income tax rate of 5%. The Oklahoma corporate income tax rate is 6%, and does not conform to federal corporate income tax rates. This conformity of the Oklahoma income tax to federal income tax continues from year to year, with the term "Internal Revenue Code" defined in the Oklahoma Income Tax Act as the federal Internal Revenue Code, as amended, effective for the taxable year to which the current Oklahoma law applies. As a result, changes in the Internal Revenue Code resulting from enactment of the proposed federal tax reform changes would likely be effective for purposes of determining Oklahoma state income tax unless the Oklahoma Income Tax Act was amended to prevent that result.

Federal Tax Reform Proposals / Possible Oklahoma Income Tax Effects

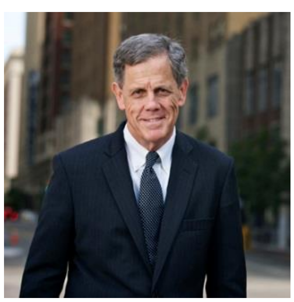
Because the Oklahoma income tax is based on and tied to federal income tax under the Internal Revenue Code in this way, the federal tax reform changes that have been proposed, if enacted, could also affect how Oklahoma state income tax is imposed on individuals and corporations, unless the Oklahoma law was amended to provide otherwise. The federal tax reform proposal for repeal of itemized deductions other than charitable contribution and mortgage interest deductions could result in fewer deductions and increased Oklahoma taxable income for some individual taxpayers. The federal tax reform proposals to significantly increase the federal standard deduction would presumably also increase the Oklahoma standard deduction for many individual taxpayers so as to reduce their Oklahoma taxable income, if the Oklahoma income tax conformed to the federal income tax. However, Oklahoma has recently enacted HB 2348 in 2017, a change in the Oklahoma Income Tax Act that appears to prevent and discontinue conformity of the Oklahoma income tax standard deduction for individuals with the federal standard deduction allowed under the Internal Revenue Code, effective January 1, 2017; and as a result, it appears that enactment of a major increase, such as doubling, of the federal standard deduction would not have the effect of also doubling the Oklahoma standard deduction. For corporations federal tax reform allowing immediate expensing of capital investment might reduce Oklahoma taxable income, while the proposal for "repeal of most federal corporate income tax provisions" could increase Oklahoma income taxable income compared to the present law. For an Oklahoma taxpayer with international operations and transactions, federal tax reform that included such a "territorial tax system," a "border adjustment" or one-time tax on dollars held overseas, as part of the Internal Revenue Code, could affect the taxpayer's Oklahoma tax liability if it continued to be based on conformity with the Internal Revenue Code. The establishment of a new maximum federal income tax rate for pass-through entity business income would not appear to change the Oklahoma income tax rates on such income for owners without a change in the Oklahoma law. The federal tax reform proposals described could have varying effects for different taxpayers subject to the Oklahoma income tax. Discussion of the proposals here is a general overview. Actual effect for a particular taxpayer would be dependent upon the federal tax reform changes finally enacted, and the nature and amount of the taxpayer's income and expenses. It could involve and result from various changes, and increases or decreases of amounts that would then determine the taxpayer's Oklahoma taxable income and Oklahoma income tax.

"Decoupling" of Oklahoma Income Tax from the Internal Revenue Code?

If the federal tax reform proposals were enacted the State of Oklahoma could possibly amend the Oklahoma Income Tax Act to "decouple" it from the Internal Revenue Code. This would be by amendment to provide that the Oklahoma income tax would no longer follow or conform to the Internal Revenue Code as to some or all federal tax reform changes enacted. An example of decoupling is the recently enacted amendment of the Oklahoma Income Tax Act that appears to provide that the Oklahoma individual income tax standard deduction is no longer to be the same as the standard deduction provided under the Internal Revenue Code. That and other and more extensive decoupling changes could require computation of Oklahoma income tax more as a separately structured state tax, not as much related to and based upon a taxpayer's federal tax determined under the Internal Revenue Code. This could add complexity and expense to tax reporting and compliance for taxpayers subject to Oklahoma income tax and tax professionals providing services to them.

Federal Tax Reform Could Change the Oklahoma Income Tax

The enactment of the federal tax reform proposals and the ultimate form it might take is not certain at this point. However, if significant federal tax reform of the kind being proposed was enacted it would seem likely to have effects on the Oklahoma income tax for the State and taxpayers subject to it.



Sheppard F. Miers, Jr.
Gable Gotwals
100 West Fifth Street, Suite 1100
Tulsa, Oklahoma 74103-4217
918-595-4834
Fax 918-595-4990
smiers@gablelaw.com