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FEATURE

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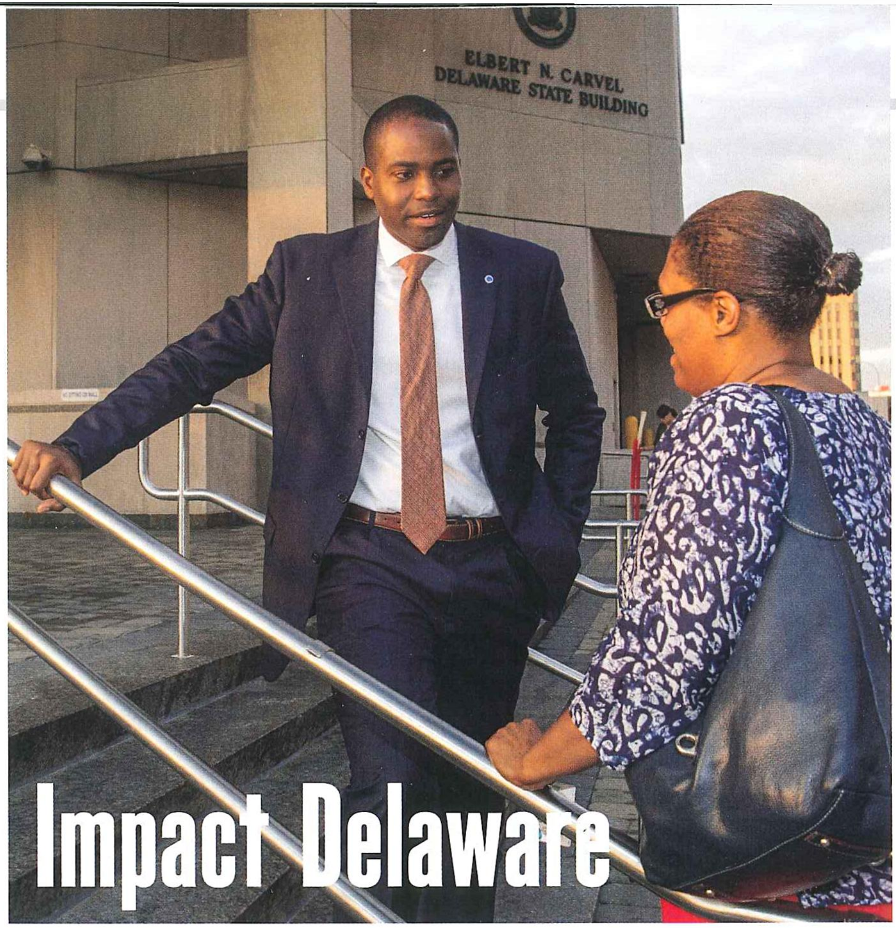
How the Federal Tax Law Will Impact Delaware



With state taxes linked to federal rules, changes in Washington have a direct effect on local citizens.

On December 22, 2017, the Tax Cuts and Jobs Act of 2017 was enacted into law. This Act is hereafter sometimes referred to as "the Bill."

The changes made by the Bill to the Internal Revenue Code of 1986, as amended (the "Code"), are sweeping and numerous. Many articles, news stories and pamphlets have been written and published that detail the changes implemented by the Bill. The purpose of this article is not to summarize or explain those changes, but rather to explain the legislation's effect on the State of Delaware and its taxpayers.

Delaware, like many states, has a state income tax that piggybacks on federal income tax, with modifications. This is true of both the Delaware personal income tax[1] and the Delaware corporate income tax.[2] Accordingly, whenever the income tax provisions of the Code are amended, the amendments are likely to have an effect on the State of Delaware.

Congress rarely considers the impact of income tax changes on state revenues. This forces the states to react — and often makes states look bad when they have to pass legislation that may be perceived as a tax increase, even if the legislation is merely intended to preserve the status quo in tax revenues.

The Bill is perhaps more burdensome than most, since its enactment occurred at the end of a calendar year, with only a handful of days before it took effect.

Many of the Bill's provisions change the amount of deductions of certain types of business expenses by limiting the amount of current deductions, by eliminating them, or by increasing them, as noted below. Many provisions of the Bill also change individual income tax deductions, some of which are noted below.

The Delaware Department of Finance has the ability to analyze the aggregate of individual and corporate income tax returns filed in the state to estimate how this type of change will affect Delaware's coffers, and is no doubt performing that analysis. The authors of this article do not have access to that type of information and therefore cannot predict whether the overall effect of these changes will increase or decrease Delaware's 2018 income tax. However, our state, unlike the federal government, must operate under a balanced budget, so changes to Delaware law may be inevitable.

Section 11001 of the Bill, which changes federal income tax rates, will have no effect on the State of Delaware income tax, since the Delaware Code defines its own set of rates. One might initially think that section 11011 of the Bill, which adds new Code section 199A, will have a potentially significant impact on Delaware tax revenues. This is the provision that permits individuals and pass-through entities to claim a deduction of up to 20 percent of certain qualified business income.

The Delaware Code defines taxable income as "the federal adjusted gross income as defined in the laws of the United States as the same are or shall become effective for any taxable year with the modifications and less the deductions and personal exemptions provided in this subchapter."[3]

However, new Code section 199A(e) states that "taxable income shall be computed without regard to the deduction allowable under this section." Because this deduction is one not enumerated in the Code as being allowed in computing "adjusted gross income," the Division of Revenue is likely to take the position that this deduction will not effectively flow through for Delaware State income tax purposes because it will not effectively reduce federal adjusted gross income.

Section 11021 of the Bill, which increases the standard deduction under section 63 of the Code for 2018 through 2025, will have no direct effect on Delaware income tax collections, since the Delaware Code has its own definition of standard deduction, and permits itemizing for State income tax purposes even when a taxpayer does not do so for federal income tax purposes.

However, section 11041 of the Bill, which eliminates the deduction of personal exemptions allowed by section 151 of the Code for years 2018 through 2025, by redefining the exemption amount as zero, could have a significant effect on Delaware income tax. The Delaware Code specifies the amount of a resident's personal tax credit as $110 for each personal exemption to which such individual is entitled for the taxable year for federal income tax purposes, plus an additional $110 for each resident individual aged 60 or older.[4]

Section 13001 of the Bill, which reduces the corporate income tax rate to 21 percent, will have no direct effect on the Delaware corporate income tax, which specifies its own rate.

It is, at minimum, arguable that the federal statutory language that makes the exemption amount zero effectively eliminates the Delaware personal credit. The Code statutory language, however, probably means that the Delaware Division of Revenue will interpret the Delaware Code to mean that the personal tax credit is still in force.

An individual's total deduction for state and local taxes previously was unlimited in amount, but now will be limited to $10,000 ($5,000 for married taxpayers filing separately).[5] Many higher-income Delaware taxpayers pay Delaware income tax, ad valorem property tax, and in some cases Wilmington city wage tax, which together exceed the threshold. This change will increase the resident's federal income tax liability unless deductions were already limited by other reasons, such as the phase-out of itemized deductions or the alternative minimum tax.

The change will not always increase the Delaware income tax liability, however, since the state income tax itself is not deductible for Delaware state income tax purposes.[6] For example, a Delaware resident who pays $7,000 in Delaware state income tax, $4,000 in property taxes, and $1,000 in Wilmington City wage tax, both under present and future law will not be able to deduct the state income tax on his Delaware state income tax return, and will only have $5,000 in other state taxes, which should still be deductible.

On the other hand, a Delaware resident who pays $12,000 in property taxes alone, as well as any amount in state income tax plus $1,000 in Wilmington City wage tax will have the $13,000 deduction reduced to $10,000 on his Delaware income tax return.

Section 11061 of the Bill doubles the federal estate tax exemption from $5,000,000 to $10,000,000, indexed for cost of living increases, for 2018 through 2026. The Delaware estate tax exemption tracks the federal exemption.[7] However, since Delaware's estate tax has been repealed effective for decedents dying on or after January 1, 2018, this change has no effect on Delaware.[8]

Section 13001 of the Bill, which reduces the corporate income tax rate to 21 percent, will have no direct effect on the Delaware corporate income tax, which specifies its own rate. However, changes such as in section 13101, increasing the expensing deduction from $500,000 to $1,000,000 in section 179 and changes in certain depreciation schedules, will flow through to Delaware corporate, partnership and individual returns in a way that will reduce Delaware taxable income.

Do you want to hire a tax attorney or a CPA to help you figure all this out? If it is not a trade or business expense, the tax professional's fee that you pay will no longer be deductible, since under section 11045 of the Bill, miscellaneous itemized deductions will no longer be allowed for 2018 through 2025. Previously, fees for tax planning expenses were deductible as a miscellaneous itemized deduction under Code section 67.

Happy New Tax Year! ◆

NOTES

1. 30 *Del. C.* §1101 *et seq.*
2. 30 *Del. C.* §1901 *et seq.*
3. 30 *Del. C.* §1105
4. 12 *Del. C.* §1110
5. Section 11042 of the Bill, Section 164(b) of the Internal Revenue Code.
6. 2 *Del. C.* §1109(a)(1)a.
7. 12 *Del. C.* §1501(3)c.
8. 81 Del. Laws ch. 52 (2017).