



SENATE FISCAL OFFICE  
REPORT

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**RHODE ISLAND SPECIAL LEGISLATIVE COMMISSION TO  
STUDY INSTALLATION AND IMPLICATIONS OF ITEMIZING  
STATE INCOME TAX REFUNDS AS FEDERAL  
DEDUCTIONS**

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FEBRUARY 5, 2014

## Commission Members

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**Senator Michael J. McCaffrey**

*Chairperson*

**Senator William A. Walaska**

*Senator*

**Representative Deborah L. Ruggerio**

*Representative*

**Representative Scott Slater**

*Representative*

**David Sullivan**

*Tax Administrator*

**Grafton Willey**

*Representing Rhode Island Society of Certified Public Accountants*

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## Report

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A Special Legislative Commission to Study the Installation and Implications of Itemizing State Income Tax Refunds (Commission) was created by 2013-S-0831 Substitute A, and enacted on July 22, 2013. The purpose of the Commission is to conduct a comprehensive study of the implications of allowing individuals to reduce their federal adjusted gross income (AGI) by subtracting state income tax refunds on Rhode Island tax returns.

The Commission met on January 30, 2013, and examined the current filing requirements and fiscal impacts of enacting legislation that would add this modification to State tax laws. Senator Michael J. McCaffrey (D-District 29, Warwick) served as Chairman of the Commission.

The Commission heard testimony from Mr. David Sullivan, Tax Administrator, who outlined how tax refunds are treated on the state income tax return and provided an overview of the impact of the 2010 Personal Income Tax Reform. Mr. Grafton “Cap” Willey served as designee of the Rhode Island Society of Certified Public Accountants. He testified that the current system amounts to double-taxation of income that is refunded from state taxes. Dr. Paul L. Dion, Chief of the Office of Revenue Analysis, explained the fiscal impacts of modifying current statutes. According to Dr. Dion, permitting taxpayers to modify income amounts to exempt prior year refunds would reduce state revenues by an estimated \$12.3 million to \$13.3 million in FY2014.

### FINDINGS OF THE COMMISSION

- Prior to TY2011, Rhode Island taxpayers could itemize deductions. Income taxes paid were an allowable deduction. Therefore, any state income tax refund received where the individual claimed a deduction for state income tax paid in a prior year should be included in taxable income.
- Under the 2010 Personal Income Tax Reform, itemized deductions were eliminated. Standard deduction amounts were increased to offset the elimination of itemized deductions. The Personal Income Tax reform took effect in TY2011.
- The Division of Taxation would not be able to immediately verify state income tax refund modification amounts. The Division would have to cross-reference taxpayer information with federal tax files. This information is generally received 12-18 months after the close of a tax year.
- Allowing a modification to subtract state tax refunds from federal adjusted gross income would make the personal income tax return more complex. There are currently 23 modifications allowed under current state law, however, these are specific to certain cases. This would be a broad-based modification that would apply to all personal income tax filers.
- Allowing a modification to subtract state tax refunds from federal adjusted gross income would reduce estimated revenue collections by between \$12.3 million and \$13.3 million in FY2014.

## SUMMARY

### *Division of Taxation*

Mr. David Sullivan, Tax Administrator for the State of Rhode Island, testified on behalf of the Division of Taxation.

Under the federal Internal Revenue Code (IRC), state and local tax income refunds are taxable in a given year if an individual took the state and local income as an itemized deduction on their federal tax return in the prior year. Taxpayers that itemize deductions on their prior year federal income tax returns must include the prior year's state income tax refund in the current tax year.

Rhode Island personal income tax is calculated based on federal AGI, therefore, any state and local refund taxable at the federal level is also taxable for Rhode Island. The 2010 personal income tax reform eliminated itemized deductions beginning in TY2011. Standard deductions were increased when itemized deductions were disallowed.

Mr. Sullivan outlined an example that illustrates the impact of a state tax return in TY2011, and the implications for TY2012 liability.

### *Rhode Island Society of Certified Public Accountants*

Mr. Grafton "Cap" Willey, designee of the Rhode Island Society of Certified Public Accountants (RISCPA), testified that the current system is unfair and unsound tax policy. He noted that too often policymakers are focused on the potential revenue impact of making a change, rather than sound tax policy.

Mr. Willey indicated that he was one of the central architects of the 2010 personal income tax reforms, and that these reforms have improved Rhode Island's tax burden relative to other states. He said that these changes, however, have had some unintended consequences for taxpayers. Taxpayers that itemize state income tax refunds on federal tax returns essentially are taxed twice on income equivalent to the refund amount at the state level.

As a matter of tax policy, Mr. Willey contends that Rhode Island should not tax state income tax refund income for which there was no state tax deduction. He proposed adding a provision to tax laws that would allow the Tax Administrator to adjust or modify Rhode Island taxable income to account for items for which taxpayers received no tax benefits.

Mr. Willey said that a group of attorneys are considering a class-action lawsuit against the State. The premise is that current tax laws treat income differently for taxpayers, depending upon how taxpayers report items on federal tax returns.

### *Office of Revenue Analysis*

Dr. Paul L. Dion, Chief of the Office of Revenue Analysis (ORA), presented an analysis estimating the potential impacts of allowing taxpayers to modify income to reflect prior year state tax refunds. To estimate the impact of this modification, ORA modeled a simulation based on TY2010 personal income taxes. ORA provided a range of potential revenue losses for fiscal years 2014 through 2016, based on TY2010 and TY2011 taxpayer files. Revenue losses over the three-year period range from \$12.3 million, to \$14.4 million.

Revenue Loss	FY2014	FY2015	FY2016
2010 Tax File	(\$12,293,627)	(\$12,657,817)	(\$13,286,834)
2011 Tax File	(\$13,335,113)	(\$13,730,157)	(\$14,412,462)

## 2010 PERSONAL INCOME TAX REFORM

Enacted in June 2010, 2010-S-2921, reformed the State's Personal Income Tax beginning in tax year 2011. The reforms:

- Based Rhode Island's personal income tax on federal Adjusted Gross Income (AGI)
- Permitted only a standard deduction to determine Rhode Island taxable income, and thus no longer permits taxpayers to itemize their deductions. Deductions phase out between taxable adjusted gross income levels of \$180,000 and \$200,000
- Established exemption amount of \$3,500 for each tax filer and dependent, and annually adjusts for inflation. Exemptions phase out between taxable adjusted gross income levels of \$180,000 and \$200,000
- Created three taxable income brackets with a top rate of 5.99 percent
- Eliminated the alternative flat tax and the alternative minimum tax
- Treated capital gains as ordinary income as provided in current law
- Permitted eight credits against the tax

### Background

Rhode Island is often perceived to be a high tax state, potentially impacting its ability to attract and retain businesses. With this backdrop in 2010, the Governor and Legislature considered numerous tax reform strategies to enhance the State's competitiveness.

**Top Marginal Tax Rates for New England States**

	Applies to Taxable Income	
	Top Rate	Above:
<b>Rhode Island (Pre-reform)</b>	<b>9.9% or 6.0% FT</b>	<b>\$372,950</b>
Vermont	8.95%	\$372,950
Maine	8.50%	\$19,750
Connecticut	6.50%	\$500,000
<b>Rhode Island (S-2921)</b>	<b>5.99%</b>	<b>\$125,000</b>
Massachusetts	5.30%	-
New Hampshire	None	

The reforms adopted in 2010 created a new income tax structure that maintains federal AGI as the starting point for the Rhode Island income tax calculation beginning in tax year 2011. The law created three taxable income brackets with a top marginal rate of 5.99 percent, eliminating both the alternative flat tax and the alternative minimum tax. The brackets are adjusted annually by inflation.

Prior to reform, Rhode Island had two different tax systems where tax filers can elect to pay the lowest tax liability using either the existing five taxable income bracket system that has tax rates ranging from 3.75 percent to 9.9 percent, or the alternative flat rate system (6.0 percent in tax year 2010, which does not permit deductions or exemptions, and does not permit the use of tax credits).

Post-reform, a standard deduction is used to determine Rhode Island taxable income, thus no longer permitting taxpayers to itemize their deductions. The standard deduction was reduced by 20.0 percent for each \$5,000 in taxable AGI above \$175,000, and is completely eliminated for incomes above \$200,000.

<b>Standard Deduction</b>	<b>TY2010</b>	<b>TY2011</b>
Married Filing Joint	\$9,500	\$15,000
Single	5,700	7,500
Married Filing Separate	4,750	7,500
Head of Household	8,350	11,250
Widow	9,500	15,000

A personal and dependent exemption amount of \$3,500 per exemption will be allowed. Current law allows for a \$3,650 personal and dependent exemption. Like the deduction, exemptions are reduced by 20.0 percent for each \$5,000 in taxable AGI above \$175,000, and are completely eliminated for incomes above \$200,000.

#### ***Fiscal Impact of 2010 Personal Income Tax Reforms***

In 2010, the State's Office of Revenue Analysis (ORA) estimated that the proposal would result in a net decrease in income tax collections of \$284,068 compared to current law, based on 2008 taxpayer data. This equated to an overall decrease of 0.03 percent. Applied to the FY2011 Personal Income Tax estimate from the May 2010 Revenue Estimating Conference, the proposal would result in \$282,836 less in income tax collections on a full-year basis, or \$141,418 less in FY2011. There were projected tax incidence distributional impacts, shifting some of the overall Personal Income Tax burden among different income earners.

At the time, ORA estimated that there were 593,418 income tax filers, of which 497,338 (84.0 percent) are resident tax filers and 96,080 (16.0 percent) are non-resident tax filers. Of resident filers, approximately 79.2 percent would experience a change in their tax bill – of these filers, an estimated 297,489 (75.5 percent) would experience a tax decrease, and 96,461 (24.5 percent) would experience an increase in tax liability. The highest effective tax rate on resident filers would be 5.56 percent, while the highest non-resident rate would be 5.99 percent. Resident tax filers net an estimated tax savings of \$4.0 million, while taxes for non-resident filers are estimated to increase by \$3.7 million. Resident filers with AGI above \$175,000, on average, would experience a personal income tax increase.





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## APPENDIX

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## Department of Revenue Division of Taxation

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### Special Legislative Commission to Study Installation and Implementation of Itemized State Income Tax Refunds as Federal Deductions

January 30, 2014

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## Department of Revenue Division of Taxation

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### Background

- ❑ **Federal Law:** State and local income tax refunds are taxable in a given year, if the individual took the state and local income tax as an itemized deduction in the prior year.
  - ❑ **Rhode Island Law:** The starting point for Rhode Island personal income tax is federal adjusted gross income; therefore any state and local refund taxable at the federal level is also taxable for Rhode Island.
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## Department of Revenue Division of Taxation

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### Background

- ❑ Rhode Island – Personal Income Tax Reform:
    - Prior to tax year 2011 Rhode Island residents could either itemize their deductions or use standard deductions.
    - For tax year 2011 and thereafter, Rhode Island residents can only use standard deductions.
  - ❑ Individuals who receive state and local tax refunds that are taxable at the federal level must still include the amount in Rhode Island taxable income even though they do not have an option to itemize at the state level
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## Department of Revenue Division of Taxation

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### Example

- ❑ On the following slide is an example of how the process works over two tax years.
  - ❑ The example outlines the tax situation of a single taxpayer with no dependents earning wages of \$65,000 per year and interest income of \$2,000.
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## Department of Revenue Division of Taxation

### Example

TAX YEAR 2011			TAX YEAR 2012		
<b>Federal Return</b>			<b>Federal Return</b>		
Wages	65,000		Wages	65,000	
Interest Income	2,000		Interest Income	2,000	
Adjusted Gross Income		67,000	State Tax Refund	1,390	
Itemized Deduction	(12,000)		Adjusted Gross Income		68,390
Personal Exemption	(3,700)		Itemized Deduction	(12,000)	
Total Exemption/Deductions		(15,700)	Personal Exemption	(3,800)	
Taxable Income		51,300	Total Exemption/Deductions		(15,800)
Total Tax Due		8,956	Taxable Income		52,590
Federal Withholding		(12,500)	Total Tax Due		9,174
Refund		(3,544)	Federal Withholding		(12,500)
<sup>1</sup> Includes taxes paid to the State of Rhode Island			Refund		(3,326)
<b>Rhode Island Return</b>			<b>Rhode Island Return</b>		
Federal AGI	67,000		Federal AGI	68,390	
Standard Deduction	(7,500)		Standard Deduction	(7,800)	
Personal Exemption	(3,500)		Personal Exemption	(3,650)	
Taxable Income		56,000	Taxable Income		56,940
Total Tax Due		2,111	Total Tax Due		2,135
State Withholding		(3,500)	State Withholding		(3,500)
Refund		(1,390)	Refund		(1,365)



## Department of Revenue Division of Taxation

### Items to Consider

- ☐ Adding a new modification will make the personal income tax return more complex
- ☐ Division of Taxation will not be able to immediately verify modification amount
- ☐ Standard deduction amounts were increased under the personal income tax reform to offset elimination of itemized deductions. Personal income tax reform took effect in tax year 2011



## Department of Revenue Division of Taxation

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### Standard Deduction Amounts

Rhode Island Standard Deductions				
	Tax Year 2010	Tax Year 2011	Tax Year 2012	Tax Year 2013
Single	5,700	7,500	7,800	8,000
Married Filing Joint	9,550	15,000	15,600	16,000
Married Filing Separate	4,750	7,500	7,800	8,000
Head of Household	8,400	11,250	11,700	12,000
Federal Standard Deductions				
	Tax Year 2010	Tax Year 2011	Tax Year 2012	Tax Year 2013
Single	5,700	5,800	5,950	6,100
Married Filing Joint	11,400	11,600	11,900	12,200
Married Filing Separate	5,700	5,800	5,950	6,100
Head of Household	8,400	8,500	8,700	8,950

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## Department of Revenue Division of Taxation

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# Questions?

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## RI Special Legislative Commission to Study Installation and Implications of itemizing State income Tax Refunds as Federal Deductions

January 30, 2014

My name is Grafton Willey but everyone knows me as Cap. I am a managing Director of CBIZ Tofias, a national accounting and CPA firm that employs over 80 people in RI. I also an the chair of the SBA Small Business Summit Tax & Budget Committee and serve on the RISCPA Tax Committee.

It is critical that when you look at a change to the personal income tax system for the taxation of state tax refunds that the primary focus is that you need to do what is right and fair. You need to focus on good tax policy, not the potential revenue loss. Too often these chambers in this building focus only on the revenue impact of making a change. To not make a change because it will have a revenue impact would be wrong. If the tax policy is wrong then I would maintain that you have been collecting revenue under false pretenses.

I consider myself one of the architects of the 2010 personal income tax reform and worked closely with then Chairman Constantino on passage of the final legislation. It is a critical piece of the efforts to make our tax system more competitive. Your work on improving the RI business climate is not done but the personal income tax reforms are a major component.

Changing the individual income tax system from a system based off of IRS taxable income with a high marginal tax rate of 9.9% which was among the highest in the country to a system based off of federal Adjustable Gross Income with a standard deduction and standard exemptions enabled us to get to a marginal tax rate of 5.99% brought us back to the middle of the pack when compared to other states. I can tell you that the change has made a difference when businesses are looking at the RI tax burden when compared to other states.

This undertaking was extremely complex and required extensive analysis of what the changes would mean across the spectrum of income brackets. The desire was to produce a new system that was essentially revenue neutral across the various income brackets recognizing that within those brackets there would be some winners and losers. The result for the most part has achieved those goals. The replacement of itemized deductions with a standard deduction has meant that some taxpayers that had high mortgage interest and high property taxes actually were paying more RI taxes than they were paying under the old system.

After working with the new system for now three years we are noticing some things that probably should have been addressed in the original legislation that frankly were not

considered when the bill was put together in 2010. I take some responsibility for not figuring out some of these up front. I should have.

One of the major problem areas is the taxability of State Tax Refunds for RI tax purposes. For Federal tax purposes you get an itemized deduction for State Income Taxes paid on a cash basis. If you get a State tax refund then you in reality have over deducted your state tax itemized deduction. Because you report taxes on a cash basis, you have to report the state tax refund as taxable income in the next year, the year you receive the refund. That system works fine because you received a tax benefit of the deduction in the prior year, and when you report it as income in the next year you are evening out the tax deduction and benefit.

Under the Internal Revenue Code Section 111, it deals with the recovery of tax benefits. Section 111 states that “Gross income does not include income attributable to the recovery during the tax year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter”. This is a general rule of taxation. If you take a deduction and you recover the benefit you need to report the income. Conversely for Federal income tax purposes there is an exclusion from gross income for recovered income that the taxpayer did not get a tax benefit. So when it comes to state tax refunds if you itemized your deductions in the previous tax year you did not get a tax benefit for the tax payments so you would not be required to recognize the state tax refund as income in the next tax year. Also if you were subject to the AMT and did not receive a net tax deduction for your state tax payments, you do not have to recognize taxable income for the refund.

When RI changed its system to a standard deduction system from an itemized deduction system taxpayers no longer will get a tax benefit from state income taxes paid. They should not have to pay a RI tax on the State tax refunds received. Unfortunately when the new RI tax system was passed the definition of RI taxable income started with Federal Adjusted Gross Income. In cases where the taxpayer itemized deductions and were not in the AMT they could have an item of income that was taxable for federal income tax purposes due to the state tax refund. As a matter of good tax policy and fairness RI should not tax state tax refund income for which there was no RI tax deduction. RI should add a provision similar to the Federal Section 111 exclusion into our laws to allow the Tax Administrator to make adjustment or modification to the RI taxable income for items of income that there are no RI tax benefits. Most other states that work off of Federal adjusted gross income allow for a modification for state tax refunds. RI does not.

The RI individual tax reform was passed in 2010 effective for tax year 2011. There should not be a problem for 2011 tax refunds because the 2010 tax filing allowed a deduction for state income taxes. The first filing year where this problem arises is 2012 because any state tax



payment made in 2011 and refunded in 2012 is affected unless it was excluded for federal income tax purposes. I embarrassingly have to tell you that my own tax return was impacted by this.

I have talked to a number of attorneys who are considering instituting a class action lawsuit on this issue. I believe that they have legitimate grounds. The fact is that the current statute will tax the same item of income received by different taxpayers differently depending on how the taxpayer reported the item on their Federal income tax return.

Taxpayer one received a \$1,000 RI state tax refund. He did not itemize his deductions in the previous year. The state tax refund will not be reported as taxable income on his current year federal tax return so his refund would not be taxed by RI.

Taxpayer two received a \$1,000 RI state tax refund. In the previous year he was subject to the AMT, so he did not receive a federal tax benefit for the deduction of his state taxes. The state tax refund will not be reported as taxable income on his current year federal return so his refund would not be taxed by RI.

Taxpayer three received a \$1,000 RI state tax refund. He did itemize deductions on his federal income tax returns and paid the regular tax not an AMT tax. His state tax refund will be considered taxable income for federal income tax purposes because he received a tax benefit in the previous year. His refund will be taxed by RI and he will pay an additional \$60 in RI tax.

What we are talking about in recommending this change is a matter of fairness to the taxpayers and correcting an error in drafting the original legislation. Our tax system should be based on sound tax policy. Providing a tax benefit rule is sound tax policy. Not having one is not sound tax policy.



Special Legislative Commission to Study Installation and Implications of Itemizing State Income Tax Refunds as Federal Deductions			
	Residents	Non-Residents	Total
<b>2010 Tax Liability</b>	\$ 739,794,062	\$ 138,745,494	\$ 878,539,556
Total Number of Taxpayers who Itemized with Refunds > 0	204,718	41,091	245,809
TY 2009 Total Amount of Refunds for Filers who Itemized	\$ 121,209,215	\$ 35,209,183	\$ 156,418,398
TY 2010 Number of Itemizers	215,466	45,736	261,202
<b>Estimated Revenue Loss</b>	\$ (8,970,416)	\$ (1,438,635)	\$ (10,409,051)
<b>Revenue Loss as a Percentage of Total Current Law Tax Revenue</b>	<b>-1.21%</b>	<b>-1.04%</b>	<b>-1.18%</b>
<b>Fiscal Note prepared in 2013 using Tax File 2010:</b>			
RI Budget Office Estimates	<b>FY 2013</b>	<b>FY 2014</b>	<b>FY 2015</b>
Reported in the S-0831 Fiscal Note	\$ 1,033,600,000	\$ 1,129,000,000	\$ 1,188,900,000
TY 2010 PIT Collections	\$ (12,299,840)	\$ (13,435,100)	\$ (14,147,910)
2010 Tax File Liability as a percent of TY 2010 Collections	\$ 1,053,411,625		
Adjusted TY 2010 PIT Revenues	83.40%		
	\$ 862,016,769	\$ 941,579,849	\$ 991,536,123
<b>TY 2010 Estimated Revenue Loss of -1.18 % on Adjusted Base</b>	<b>\$ (10,213,287)</b>	<b>\$ (11,155,961)</b>	<b>\$ (11,747,849)</b>

## Special Legislative Commission to Study Installation and Implications of Itemizing State Income Tax Refunds as Federal Deductions

	Residents	Non-Residents	Total
<b>2011 Tax Liability</b>	\$ 809,023,112	\$ 166,278,508	\$ 975,301,620
Total number of Taxpayers who Itemized with Refunds in TY 2010 > 0	150,769	26,343	177,112
TY 2010 Total Amount of Refunds for Filers who Itemized	\$ 104,933,377	\$ 17,932,269	\$ 122,865,646
TY 2010 Number of Itemizers	215,466	45,736	261,202
<b>2011 Tax Liability of filers who itemized in TY 2010</b>	\$ 472,138,304	\$ 75,798,809	\$ 547,937,113
<b>Estimated Revenue Loss</b>	\$ (6,508,334)	\$ (533,685)	\$ (7,042,019)
From allowing the deductions of refunds if an individual itemized federally calculated on ONLY those taxpayers who Itemized in TY 2010			
<b>Revenue Loss as a Percentage of Total Current Law Tax Revenue</b>	<b>-1.38%</b>	<b>-0.70%</b>	<b>-1.29%</b>
	<b>FY 2014</b>	<b>FY 2015</b>	<b>FY 2016</b>
RI Budget Office Estimates	\$ 1,120,700,000	\$ 1,153,900,000	\$ 1,211,241,789
TY 2011 PIT Collections	\$ 1,053,411,625		
2011 Tax File Liability as a percent of TY 2011 Collections	92.59%		
Adjusted TY 2011 PIT Revenues	\$ 1,037,600,592	\$ 1,068,338,827	\$ 1,121,428,747
<b>TY 2011 Estimated Revenue Loss of -1.29% on Adjusted Base</b>	<b>\$ (13,335,113)</b>	<b>\$ (13,730,157)</b>	<b>\$ (14,412,462)</b>
TY 2011 Estimated Revenue Loss Utilizing the Revenue Loss Percentage calculated on 2010 file (-1.18%)	\$ (12,293,627)	\$ (12,657,817)	\$ (13,286,834)

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