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STATES CAN AVERT NEW REVENUE LOSS AND PROTECT THEIR ECONOMIES BY DECOUPLING FROM FEDERAL EXPENSING PROVISION

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A recent change in federal tax law regarding business investment in machinery and equipment could be very costly for many states and hurt their economies. Eighteen states are on track to lose $4.6 billion in state corporate and individual income tax revenues during the current and next two state fiscal years: some will lose revenue unless their legislatures act to prevent it, while others will lose revenue if they follow their previous practice of altering their tax codes to conform to such federal changes. Conversely, three states have acted explicitly this year to prevent the provision from affecting their revenues. Another 24 states and the District of Columbia could lose $10.8 billion in state revenue, but only if they *break* from their previous practice and conform to the federal change.

These losses would come on top of states' record revenue losses, which are creating budget shortfalls of unprecedented size and causing harm to state economies by forcing cuts in education, health care and other areas. Fortunately, states can protect themselves from these revenue losses – and avert harm to their economies -- by "decoupling" the relevant part of their tax codes from the federal change.

The federal change, part of the tax-cut compromise legislation enacted in December, allows businesses to immediately deduct from their federal gross income the *entire* cost of capital investments in machinery and equipment — a practice known as "expensing" — rather than gradually deducting or "depreciating" these costs over several years. The deduction applies to purchases made from September 8, 2010 to December 31, 2011. (For purchases in calendar year 2012, businesses can deduct 50 percent of the cost of capital investments and then apply the regular depreciation schedule to the remaining value of the equipment.) The new law extends and doubles the size of an existing provision of law that allowed 50 percent depreciation — so-called "bonus depreciation" — in 2008-2010 and was supposed to expire at the end of 2010.

Because most states use the federal definition of income as the starting point for their own tax calculations, this proposal could cost state governments significant amounts of revenue. Affected states would experience immediate revenue loss in the current and upcoming fiscal years. These revenue losses would add to state budget shortfalls, which are projected to be $125 billion for state fiscal year 2012 (which starts July 1, 2011 in most states), and thus would necessitate even larger

state budget cuts or tax increases than states would otherwise have to impose to meet their balanced-budget requirements.

Whatever the benefits of this policy to the national economy, there are *no benefits* to states from following suit. States are already cutting spending to help close recession-induced budget shortfalls, reducing payments to businesses, nonprofits, and employees, with ripple effects through the economy; the additional revenue loss from conforming to the expensing provisions would create additional economic harm and loss of jobs. The benefits of expensing for corporations do not offset that effect because they flow to a substantial degree to multi-state corporations, which may spend them out of state or simple accrue them as profits. Moreover, state expensing does not create an incentive for a corporation to purchase or locate equipment in that state, as explained below.

States can pass a statute to decouple their business depreciation rules from the section of the federal tax code that allows expensing, just as most of them decoupled from temporary federal "bonus depreciation" provisions over the past decade that expanded business write-offs. Thirty-three states decoupled from a bonus depreciation proposal enacted in 2008, and during the 2001-04 period, when a similar bonus depreciation provision was in effect, over 30 states fully or partially decoupled from it, with minimal adverse consequences.

Table 1 shows the amount of revenue potentially at stake in the states that are most at risk.

Table 1

Eighteen States On Track To Lose $4.6 Billion

Estimated State Revenue Losses from Conforming to Full Expensing

State	Revenue loss (millions)	State	Revenue loss (millions)
Alabama	$239	Nebraska	$88
Colorado	226	New Mexico	39
Delaware	77	North Dakota	43
Florida	629	Oklahoma	143
Illinois	1,009	Oregon	270
Kansas	198	Pennsylvania	833
Louisiana	191	South Dakota	9
Missouri	190	Utah	159
Montana	55	West Virginia	166
		Total	**$4.6 billion**

Amounts shown are for those states that conform automatically or routinely to federal depreciation law and therefore will likely lose revenue without legislative action. We did not include those states that have permanently decoupled from bonus depreciation provisions in a way that will generally protect them from revenue losses stemming from the most recent federal change. The identification of states as to whether they are conformed automatically to federal bonus depreciation was based on a review of available sources, including resources from CCH and Tax Analyst and state statutes, tax forms, and Department of Revenue publications.

States Coping with Large Revenue Losses

The economic downturn has caused state tax revenues to decline 11 percent below pre-recession levels. Meanwhile, the cost of providing services has risen, due both to normal population growth and to increased human need resulting from the recession (such as more people losing their jobs and employer-based health coverage and qualifying for Medicaid). The result has been large budget gaps in nearly every state.

States faced (and have mostly closed) budget gaps of $130 billion for the current state fiscal year. States are facing a similarly large projected gap — $112 billion — for state fiscal year 2012; however, the challenges will be even greater in that year because federal fiscal relief will have almost entirely expired. While states had $59 billion in funding from the 2009 Recovery Act in fiscal year 2011, they will have only $6 billion in fiscal year 2012. Preliminary data suggest that state budget shortfalls for 2013 will also be large: 26 states have already reported shortfalls of $75 billion.

Because states must balance their budgets regardless of the state of the economy, they are closing these shortfalls with budget cuts and tax increases, both of which remove demand from the economy. As many economic analysts have noted, the economic drag from such state actions is costing hundreds of thousands of jobs. Indeed, states and localities have cut 497,000 jobs since August 2008,[1] with ripple effects causing additional job losses in the private sector and making it more difficult for the economy to recover.

Why Expensing Reduces State Revenue Further

The eighteen states most likely to lose revenue due to the new federal expensing provision fall into one of two categories.

- Some states' tax codes automatically change to reflect any change in federal tax law. This is sometimes called "rolling conformity." Such states must take explicit legislative action to prevent federal actions from affecting state tax rules.

- Other states' tax codes reflect the federal tax code as it existed on a particular date (this is sometimes called "fixed-date conformity"), but those states commonly move that date forward to incorporate federal tax changes, including depreciation rules. If a state moves the date forward periodically and has not permanently decoupled from federal bonus depreciation legislation, it is reasonable to expect that — absent specific efforts to "decouple" — the state will incorporate the full expensing provisions now and hence lose revenue.

States in those categories are shown in Table 1, along with the potential revenue loss.

Another 27 states and the District of Columbia are at a lesser risk of revenue loss. These are states that both (a) would need to act affirmatively to conform to the federal expensing change, and (b) have shown from past experience a willingness to forgo such action — specifically, they did *not* conform to the federal law relating to depreciation enacted in 2008, or have already decoupled from the expensing provision.[2] But, of course, past actions are an imperfect indicator of future actions. With changes in political leadership in many states, plus the potential that economically significant corporations will press lawmakers to conform to the expensing change, some of those states might consider conforming and hence lose revenue. Oregon decoupled in 2008, but conformed to federal bonus depreciation for 2011. Although in past years Pennsylvania has decoupled from federal bonus depreciation provisions, the Pennsylvania Department of Revenue conformed to the expensing provision this month, without state legislation.[3] Table 2 on page 7 provides the potential revenue loss if those states chose to conform.

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[1] CBPP calculations from Bureau of Labor Statistics data.

[2] In most cases, this is either because they have fixed-date conformity for their tax code as a whole (or for depreciation provisions in particular) or because they have a specific provision that requires businesses to add back any benefit they receive from the section of the federal tax law that provides for expensing.

[3] See "Revenue Department Adopts Business-Friendly Approach to Corporate Tax Bonus Depreciation," Pennsylvania Department of Revenue, February 24, 2011,

A few of these 27 states have already taken action to protect their revenue. Idaho, North Carolina, and Virginia have decoupled from the bonus depreciation provision in 2011. Five states are unaffected by this provision. Four of these states (Nevada, Texas, Washington, and Wyoming) have neither corporate nor personal income taxes; California for decades has used its own depreciation rules, which differ from the federal government's.

How Can States Decouple from Expensing?

For a number of decades, virtually every state other than California simply conformed to federal depreciation rules. In the last decade, however, this has shifted somewhat. In 2002-04, the federal government first allowed corporations an immediate deduction for 50 percent of their equipment purchases, a provision known as "bonus depreciation." Over 30 states decoupled from this temporary provision. (Then, as now, states were facing significant budget shortfalls due to an economic slowdown and could not afford an additional revenue loss.) When Congress reinstated bonus depreciation in 2008, roughly the same number of states decoupled. Since the new expensing provision uses the same basic concept and the same section of the federal tax code (section 168(k)) as bonus depreciation, states can use the same basic approach to decoupling.

Decoupling statutes merely require businesses to calculate their state taxable income as if the federal depreciation change had not been enacted. Some are more detailed about the steps involved, requiring businesses to add back to their federal taxable income the amount of the new federal deduction and then allowing them to subtract the amount of depreciation they would normally have claimed. There is no obvious advantage to any one of these approaches.

However, states *should* decouple in such a way that the decoupling applies to any future change in federal depreciation rules beyond 2012 — or, even better, in such a way that it applies to any future changes in *any* part of federal tax law. This would prevent any future federal tax law change from automatically reducing state revenues. As noted above, 27 states and the District of Columbia have already decoupled from federal depreciation provisions in a way that — if they do not change it — protects them from revenue loss from the new expensing provision.

State Revenue Losses Would Aggravate Fiscal Crisis

The Joint Committee on Taxation estimates that the expensing provision will cost the U.S. Treasury approximately $110 billion over the next two years but that the federal government will recoup $89 billion of that amount later in the decade, because corporations' immediate write-off of equipment costs would substitute for depreciation deductions that would otherwise have reduced tax payments in those later years.

We estimate that if every state other than California were to conform, they would lose $15.3 billion in state corporate and personal income tax revenue.[4] These losses would affect the 2012 and

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http://www.portal.state.pa.us/portal/server.pt/document/1046612/revenue_department_adopts_business-friendly_approach_to_corporate_tax_bonus_depreciation_pdf?qid=28860246&rank=1.

[4] Our state estimates assume that at the federal and state levels, 75 percent of the revenue loss would occur in corporate income taxes and the remainder in personal income taxes. The estimates also assume that each state would lose the same percentage of personal and corporate income revenues as would occur at the federal level. State tax revenue data come from the Census Bureau and the Nelson A. Rockefeller Institute of Government. Federal tax data come from the Congressional Budget Office.

2013 fiscal years and possibly 2011 as well. In state fiscal year 2011, the revenue losses — if any — would be modest and would mostly take the form of lower estimated corporate tax payments; the exact timing of the loss could depend in part on the timing of the state's enactment of conformity/decoupling legislation. In any case, the losses in fiscal years 2012 and 2013 would result from final payments made when personal and corporate tax returns are filed and would be much larger.

Some proponents of conforming to the federal expensing provision may argue that expensing is merely a timing shift: a state that loses money from conforming in 2012 and 2013 might begin recouping a small portion of the revenue loss beginning in 2014, and states (like the federal government) would over a long period recoup most of their revenue losses. But that would not help them over the next few years when they will remain in fiscal crisis, because they — *unlike* the federal government — must balance their budgets in all years, including those in which the economy is weakest. As described further below, the revenue losses over the next few years would likely compel further cuts in state programs and/or additional state tax increases, which would reduce the demand for goods and services and partly offset any stimulus resulting from expensing.

States should be suspicious of the "recoupment" argument for other reasons as well:

- It is not clear whether in fact the federal government will allow the expensing provision to expire as scheduled. If expensing expires on schedule on December 31, 2012, then no revenue loss would be expected to occur after 2013. However, there is no guarantee that it will expire on schedule. In the early 2000s, Congress extended bonus depreciation one year after enacting it, and the bonus depreciation enacted in 2008 was scheduled to expire at the end of 2010 but was both expanded and extended with the December tax legislation. If the expensing provision does not expire on schedule, recoupment will be substantially delayed.

- Although the recoupment of revenue could begin as early as 2014, the bulk of it would occur after 2015. (Some revenues might not be recouped for 19 years — or perhaps ever, if corporations go out of business before making up the lost revenue.) This is of little help to states that are legally required to balance their annual operating budgets, as nearly all states are. Most states expect revenues to remain below pre-recession levels for several more years.

- Allowing corporations to pay lower taxes now, based on the premise that they will pay an equivalent amount in increased taxes in five, ten, or 15 years, is equivalent to giving them an interest-free loan. Like any interest-free loan that gets repaid, there is a hidden cost to the borrower, in this case the state. And due to a loophole in federal budget rules, this hidden cost is not reflected in the official congressional cost estimate of the expensing provision, as the *Wall Street Journal* has noted.[5]

Little Economic Benefit to State from Conforming to Federal Change

Rather than going along with the federal expensing change, a better approach to stimulating a state economy would be to decouple from the federal change and use the revenue to help balance the budget — thereby reducing the need to cut spending or raise new revenues. The savings from decoupling also could be invested in education, infrastructure, or other areas that have been shown to increase long-term economic growth.

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[5] Jesse Drucker, "Cost of Business Tax Cuts Underestimated," *The Wall Street Journal*, February 11, 2008, http://online.wsj.com/article/SB120269331004557779.html

States considering decoupling should note that it will not impair a corporation's ability to benefit from the *federal* expensing provision. Regardless of state action, corporations will receive a very generous investment incentive through their federal tax returns. Since federal tax rates are higher than state rates, the federal deduction for expensing is far more valuable than any state deduction would be.

Moreover, part of the revenue loss in states that fail to decouple will subsidize investments that multi-state corporations make in *other* states. No matter where a corporation buys a piece of equipment, it can deduct the cost of that purchase from its taxable income in every state where it pays taxes. (The tax that a corporation pays each state is based on a formula that reflects the share of its entire U.S. operation that takes place within the state.) Thus, a state's decision to conform to the federal expensing provision wouldn't give corporations an incentive to buy equipment from within the state, since a corporation would receive the same tax deduction if it bought equipment from outside the state.

Large, multi-state corporations represent a large portion of most states' corporate tax bases, and those corporations' capital investments are spread around the country. A corporate taxpayer in Iowa, for example, is likely to make most of its depreciable investment purchases in states other than Iowa. So much of the state's cost of conforming to expensing would subsidize out-of-state investments.

Small businesses, by contract, are largely unaffected by this expensing rule. A separate and permanent provision of federal tax law already allows 100 percent expensing for small businesses, and all states generally conform either fully or partially to this provision.[6]

In short, conforming to expensing is not likely to materially improve any state's economic performance or cushion its economic downturn.

[6] That permanent federal provision is known as Section 179; the temporary expensing provision discussed in this paper is Section 168(k). Section 179 normally limits full expensing to capital purchases of up to $25,000, though Congress has temporarily increased that limit to $500,000. A few states have decoupled from the temporary increase in the Section 179 expensing limit but still conform to the permanent Section 179 rules, so businesses making capital purchases of less than $25,000 are unaffected if these states decouple from Section 168(k).

Table 2

Twenty-Seven States Would Lose An Estimated $10.8 Billion If They Act To Conform To Federal Expensing Provision

State	Revenue Loss If State Chose to Conform (in millions)
Alaska*	$234
Arizona	220
Arkansas	200
Connecticut*	341
Georgia	410
Hawaii	60
Idaho**	66
Indiana	325
Iowa	142
Kentucky	230
Maine	98
Maryland	486
Massachusetts	955
Michigan*	379
Minnesota	450
Mississippi	150
New Hampshire	189
New Jersey	1,045
New York	2,197
North Carolina**	698
Ohio	199
Rhode Island	73
South Carolina	102
Tennessee	334
Vermont	48
Virginia**	507
Wisconsin	465
District of Columbia	150
Total	**$10.8 billion**

This reflects the potential revenue loss for states that are decoupled from federal law on bonus depreciation, in the event that they were to conform.

*Alaska, Connecticut, and Michigan are partially, not fully, decoupled under current law. This estimate shows the impact if they fully conformed to the federal law.

**Idaho, North Carolina and Virginia have already taken legislative action to decouple from the current expensing provision.