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STATES CAN DECOUPLE FROM THE "QUALIFIED PRODUCTION ACTIVITIES INCOME" DEDUCTION

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For the fourth year in a row, the federal government in 2004 enacted a major tax law that affects state tax collections. Provisions of P.L. 108-357, the "American Jobs Creation Act of 2004," could cost states substantial revenue. Although the bill has dozens of separate, complex provisions, including a host of narrow tax breaks for specific industries, one provision stands out for its breadth and its great potential to cost states revenue: the tax deduction for "qualified production activities income," or QPAI.

When it is fully phased in, the QPAI deduction will represent the largest single tax break for corporate America in years. The Joint Committee on Taxation estimates that this deduction will cost the federal government $10.7 billion annually when fully phased in, equivalent to a three to four percent reduction in federal tax revenue from the profits of incorporated and unincorporated businesses.[1] (The actual impact will depend largely on how the Treasury Department and the federal courts interpret the law.) There is every reason to think that many states will face a comparable percentage decline in state tax revenue should they conform to this provision. Had the full deduction been in effect in 2004 and had all states fully conformed to it, the total revenue loss for states could have equaled $1.3 billion or more.

Even though it is standard practice for most states to allow most federal tax deductions for state income tax purposes, states do not have to allow corporations to claim the QPAI deduction. They can require that the QPAI deduction be ignored — i.e., that the amount of the deduction be added back to total income — for purposes of calculating state corporate and personal income taxes. This type of "decoupling" from QPAI would be administratively straightforward, fiscally responsible, and economically neutral, and could be accomplished whether or not states conform to other portions of P.L. 108-357. As of June 2005, nineteen states have already decoupled or are likely to decouple from this provision. Arkansas, the District of Columbia, Georgia, Hawaii, Indiana, Maine, Maryland, Massachusetts, Mississippi, North Carolina, North Dakota, Tennessee, Texas and West Virginia have decoupled and California, Minnesota, New Hampshire, New Jersey, Rhode Island and South Carolina are considered likely to decouple according to a survey by the Federation of Tax Administrators. Decoupling by all of these states would save approximately $770 million of the $1.3 billion at risk annually.

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[1] See Appendix for discussion of data.

TABLE 1
POTENTIAL REVENUE LOSS IF QPAI DEDUCTION WERE ALLOWED
(DOLLARS IN MILLIONS)

State	**Potential Revenue Loss**	**State**	**Potential Revenue Loss**
Alabama	12	Nebraska	7
Alaska	12	Nevada	n/a
Arizona	19	New Hampshire	14
Arkansas	8	New Jersey	96
California	292	New Mexico	5
Colorado	12	New York	107
Connecticut	16	**North Carolina**	37
Delaware	5	**North Dakota**	2
Florida	46	Ohio	29
Georgia	49	Oklahoma	7
Hawaii	3	*Oregon*	18
Idaho	3	Pennsylvania	56
Illinois	62	Rhode Island	3
Indiana	26	South Carolina	8
Iowa	5	South Dakota	n/a
Kansas	8	**Tennessee**	24
Kentucky	13	**Texas**	63
Louisiana	10	Utah	7
Maine	5	Vermont	3
Maryland	40	Virginia	22
Massachusetts	42	Washington	n/a
Michigan	7	**West Virginia**	7
Minnesota	28	Wisconsin	28
Mississippi	11	Wyoming	n/a
Missouri	12	**Washington DC**	6
Montana	62	TOTAL	1,301

Amounts shown are the potential impact had QPAI been in full effect in state fiscal year 2004.
n/a = not applicable (Nevada, South Dakota, Washington and Wyoming lack income taxes).
See Appendix for sources and methodology.
For states in italics, the estimate shown was produced by the state.
States in bold have decoupled.

The legislation that includes the QPAI deduction is extensive and complex. Most states will want to conform to some portions of it, since it includes two provisions that favorably impact state taxes. These are the phase-out of a provision that protects “extraterritorial income” from foreign exports that the World Trade Organization has said is illegal under international law, and the elimination of some costly and inappropriate tax shelters.

Likely Administrative Problems Associated with the QPAI Deduction

In a letter to Congress discussing the QPAI provision of the new federal tax bill on October 7, 2004, IRS Commissioner Mark W. Everson wrote:

"Many businesses, particularly small businesses, will find it difficult to understand and comply with these complex new rules, which will affect not only the computation of a taxpayer's regular tax liability but also its alternative minimum tax liability. It will be difficult, if not impossible, for the IRS to craft simplified provisions tailored to small businesses or other taxpayers….

"Taxpayers will be required to devote substantial additional resources to meeting their tax responsibilities, including not only employees and outside tax advisers, but also recordkeeping and systems modification resources. The resulting costs will reduce significantly the benefits of the proposal. Some small businesses may find that the additional costs outweigh the benefits, particularly during the initial phase-in period….

"It will be necessary to devote significant audit resources to administering the new deduction. This will be due not only to the novelty of the rule but also to the benefits that are provided to ``production activities'' over other aspects of a taxpayer's business. Taxpayers naturally will classify everything possible as production activities. Audits, particularly those involving integrated businesses, will have to focus on classification and the allocation of income and costs. Significant additional IRS resources will be needed to administer the provision to avoid diverting resources from other compliance issues (such as tax shelters)….

"Finally, for all of the reasons discussed above, we anticipate a significant increase in controversies between taxpayers and the IRS. This will increase the number of IRS appeals cases and litigated tax cases."

Source: *Congressional Record*, October 11, 2004.

Nevertheless, if states conform to the legislation as a whole, it is likely to result in a net loss of revenue. Nor is there any reason for a state to conform to the whole. The QPAI deduction is not a "swap" for the loss of the extraterritorial income exclusion because the latter benefits only exporters while the QPAI deduction is for any domestic producer. And closing tax shelters used by a limited number of taxpayers to avoid taxes is good policy in its own right.

Decoupling from QPAI Is Fiscally Responsible

Under the new federal law, businesses will be allowed to claim a deduction for "Qualified Production Activities Income." This income is defined in the law as profits — that is, receipts minus costs — from manufacturing, food processing (but not retail food sales), software development, filmmaking, electricity/natural gas production, and construction. Under the new law, businesses in 2005 can claim a deduction equal to 3 percent of QPAI income; the percentage gradually rises in succeeding years, reaching 9 percent in 2010.

The QPAI deduction affects states because states generally prefer to conform their tax codes to the federal Internal Revenue Code, for reasons of administrative simplicity and taxpayer convenience. For personal income taxes, most states use "taxable income" or "adjusted gross

income" as calculated for federal tax purposes as the starting point for their own income tax calculations. Therefore, when federal legislation narrows the definition of taxable or adjusted gross income, taxpayers report less income, and states typically see a decline in revenue. Similarly, most states begin their corporate income tax calculations with federal "taxable income" from the federal corporate tax form.

To understand how a QPAI deduction affects state income taxes, consider a hypothetical corporation with $1 million in QPAI income, located in a state with a 5 percent corporate income tax rate. In 2010, 9 percent of the QPAI income will be deductible — meaning the corporation gets to claim $90,000 of profits as tax-free income. At a tax rate of 5 percent, the state loses $4,500 in revenue.

Although this deduction is often described as a tax break for manufacturing activities, it is far broader, including food processing, software development, filmmaking, electricity/natural gas production, and construction. In 2001, IRS data indicates that manufacturing industries accounted for 34 percent of all corporate income subject to tax. Adding in software, construction, and other firms within industries most likely to claim the new deduction brings the proportion to 46 percent of corporate income subject to tax.[2]

The Joint Committee on Taxation, which estimates federal revenue impacts for Congress, estimates that the QPAI provision will cost the federal government $2.1 billion in the current federal fiscal year, rising to $10.7 billion in fiscal year 2011, the first year of full impact. That amount is roughly equal to 4 percent of the federal government's revenue from corporate income taxes, or 3 percent of revenue from all business income taxes (corporate income taxes plus personal income taxes from pass-through entities). The Massachusetts Revenue Department estimates that QPAI will cost the state $42 million, an amount approximately equal to 3.6 percent of its current corporate income tax revenues.[3] It is reasonable to think that other states as well could face losses of comparable size. A rough estimate, based on the Joint Tax estimate, is that if QPAI had been in full effect in FY 2004 and all states had conformed, the cost to states would have equaled $1.3 billion. State-by-state amounts are shown in Table 1; the Appendix explains how these figures were calculated.

This projected revenue loss comes at an inopportune time for states. Tax revenue in most states fell sharply from 2001 to 2003. Although revenues have begun to grow again, it would require several years of rapid revenue growth for revenues to return to previous levels. State corporate taxes in particular are a declining revenue source for states, with the result that state tax burdens are being shifted away from businesses and onto families.

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[2] Calculated from IRS Statistics of Income data for tax year 2001, the latest available. These percentages are at best an approximation of the scope of the QPAI deduction, because the new deduction would be available not just to corporations with primary activities in those industrial sectors but to all corporations or unincorporated businesses that can attribute some of their profits to qualifying activities.

[3] The Massachusetts Department of Revenue estimates that the revenue loss for tax year 2005 (when the credit equals 3 percent of eligible income) would be $14 million. Once fully in effect the credit will equal 9 percent, so the impact in tax year 2005 if the credit were fully in effect would equal $42 million which is 3.6 percent of Massachusetts corporate income tax revenue.

Moreover, there is some reason to think that the QPAI deduction could lead to even greater revenue losses than are now supposed, as corporate tax accountants devise new ways of exploiting it. The QPAI deduction has been widely derided by tax policy experts as an incentive for corporations to engage in complicated new accounting schemes solely for the purposes of reducing tax liability. Economist Kimberly Clausing, an expert on taxation of international firms, writes:

> The bill [will] create compliance and enforcement difficulties as firms [will] have incentives to characterize as much income as possible as production income. For instance, firms [will] have an incentive to make those divisions subject to favorable tax treatment more profitable than those that do not receive such treatment. By shifting paper profits among divisions, firms can reduce their overall tax liability.[4]

For the Internal Revenue Service, which is already short on resources, limiting the creativity of the bookkeeping will pose major challenges. "It's a whole new skill that the IRS is going to have to bring to the table, and a whole new dimension to the audits," Tom Ochsenschlager, the vice president for taxation with the American Institute of Certified Public Accountants, told the trade journal *Tax Notes*.[5] Lengthy court battles are quite likely as corporations challenge IRS interpretations and enforcement actions. It is unclear how effective the IRS can be at limiting excessive QPAI claims, given that its budget is declining in real terms as its workload rises.

Decoupling from QPAI Is Administratively Feasible

Different states will need to pass different legislation in order to avert the revenue loss that would result from conformity to QPAI. Some state tax codes automatically conform to changes in federal tax law, unless they enact a law to opt-out. Such states must enact legislation that specifically decouples from QPAI in order to avert the revenue loss. Other states must pass a new law in order to conform to a new federal law. But, for reasons described below, they are not likely to simply ignore the new law; instead, care must be taken that any conformity legislation excludes QPAI.

From an administrative perspective, decoupling from the QPAI deduction is likely to be relatively straightforward. Although it is still not entirely clear how the QPAI deduction will appear on federal tax forms, states probably can simply require an add-back of the QPAI deduction amount.

Moreover, decoupling from federal tax changes has become quite routine in the last several years.

- Some 31 states plus the District of Columbia have decoupled from a new federal deduction for "bonus depreciation," saving those states roughly $13 billion over fiscal years 2002-05.

- Some 17 states plus the District of Columbia have decoupled from federal changes to the estate tax, protecting roughly $8 billion over fiscal years 2003-07.

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4 Kimberly A. Clausing, *The American Jobs Creation Act of 2004: Creating Jobs for Accountants and Lawyers,* Urban-Brookings Tax Policy Center, December 2004.

5 Quoted in Warren Rojas, "New Manufacturing Deduction Presents Many Open Questions," Tax Notes, October 18, 2004.

- Some 18 states have decoupled from an expansion of what is known as "Section 179 expensing," a provision that allows small and mid-sized businesses to write off all their capital investment purchases right away instead of depreciating them.

As of June 2005, some 19 states plus the District of Columbia have already decoupled or are considered likely to decouple from the QPAI provision according to a recent survey by the Federation of the Administrations. (See Table 2 for more details.) Massachusetts acted shortly after the federal legislation was passed at the urging of Gov. Mitt Romney (R). Other states are likely to follow suit.

Decoupling does create some minor administrative difficulties for states, but it is possible that the administrative challenges of failing to decouple would be even greater. State revenue departments, along with the IRS, could well find themselves involved in extensive legal action as the courts try to resolve the exact limits to the QPAI deduction.

Decoupling from QPAI Is Economically Neutral

The QPAI deduction has been depicted in some accounts as a tax break for domestic manufacturing, with the stated goal of protecting manufacturing jobs. While the preservation of manufacturing jobs and other jobs is a worthy goal, state conformity to the QPAI deduction is unlikely to achieve it, for several reasons.

- The QPAI deduction is not just for manufacturing. A wide range of economic activity, from filmmaking to roasting coffee beans, would benefit from the new law. To the extent that corporations change their behavior in response to the QPAI deduction, they are more likely to make simple accounting changes to make existing production activities appear more profitable than to increase those activities.

- A state-level QPAI deduction would have no direct relationship to jobs or income within that state. A state that conforms to QPAI would have no guarantee that the income claimed under QPAI was generated within that state or created jobs there. Multi-state corporations pay taxes to each state where they operate based on a share of their total income minus total expenses. The amount they pay to each state is determined by the extent of their physical presence and sales in the state without regard to which part of the operation — sales, administration or production — is in the state. In other words, a multistate firm could use a state's QPAI deduction to reduce its corporate taxes without having a single production employee in that state.

- The revenue lost from QPAI conformity would be unavailable for other, more economically beneficial investments. This is because states must balance their budgets. Conforming to QPAI could make it harder for a state to find the money to fund health care, education, infrastructure or other expenditures that have been shown to have strong positive economic benefits. Conformity could also make it harder for a state to put money into its rainy day fund or even enact alternative types of tax cuts that might have greater economic benefits for a state.

TABLE 2
STATE CONFORMITY TO IRC SEC. 199 QPAI DEDUCTION
June 1, 2005

State Name	Conform to Sec. 199	State Name	Conform to Sec. 199
Alabama	Yes	Missouri	Yes
Alaska	Likely Yes	Montana	Yes
Arizona	Yes	Nebraksa	Likely Yes
Arkansas	No	Nevada	N/A
California	Likely Not	New Hampshire	Likely Not
Colorado	Yes	New Jersey	Likely Not
Connecticut	Yes	New Mexico	Yes
Delaware	Likely Yes	New York	Likely Yes
District of Columbia	No	North Carolina	No
Florida	Yes	North Dakota	No
Georgia	No	Ohio	Yes
Hawaii	No	Oklahoma	Yes
Idaho	Yes	Oregon	Likely Yes
Illinois	Likely Yes	Pennsylvania	Likely Yes
Indiana	No	Rhode Island	Likely Not
Iowa	Yes	South Carolina	Likely Not
Kansas	Yes	South Dakota	N/A
Kentucky	Yes	Tennessee	No
Louisiana	Likely Yes	Texas	No
Maine	No	Utah	Yes
Maryland	No	Vermont	Likely Yes
Massachusetts	No	Virginia	Yes
Michigan	Likely Yes	Washington	N/A
Minnesota	Likely Not	West Virginia	No
Mississippi	No	Wisconsin	Likely Yes
		Wyoming	N/A

Notes:
Alabama – Conform on Corporate Tax Only. Regular session has adjourned.
Michigan – Reference is the IRC as of 1/1/99, but the IRC in effect for the tax year may be used at the option of the taxpayer.
Pennsylvania – Conform on corporate net income tax only.

Source: Federation of Tax Administrators based on survey responses from state tax agencies.

QPAI Decoupling Need Not Affect Conformity to the Rest of the "FSC-ETI" Bill

As noted above, the federal law that created the QPAI deduction has dozens of other provisions. Even if state decouples from QPAI, it likely will want to conform to other provisions. For instance, a major provision of the bill phases out a tax shelter for "extra-territorial income" (ETI) from foreign exports; the World Trade Organization has said the ETI exclusion is illegal under international law. Most states now allow this exclusion and will want to conform to its repeal. Other provisions of the law eliminate other costly and inappropriate tax shelters. The federal government is eliminating these because excessive tax-sheltering makes the tax code less fair and less economically neutral. Most states likely will want to follow suit because they lack the resources to police such shelters on their own.

Other provisions of the new law likely will cost states money (though none so much as QPAI), and states may want to consider decoupling from them as well. For instance, the new law extends a corporate tax break first enacted in 2003. This tax break aids small and mid-sized businesses that spend between $25,000 and $100,000 a year on new equipment. It allows them to "expense," or write-off immediately as a deduction, the equipment's full cost, rather than depreciating it over several years as standard accounting rules provide. The tax break had been scheduled to expire after 2005, but the new law extends it through 2007. Some 18 states already have decoupled from this provision known as Section 179; others may wish to do so as well.

Overall, according to the Federation of Tax Administrators, the new federal law is probably a modest revenue-loser for states that conform to all its provisions. This is because the revenue lost due to QPAI, the expensing provision, and a few others exceeds the revenue gain from closing tax shelters.

It may be tempting for some state budget analysts to depict the federal bill as more-or-less a revenue wash for states. In particular, the QPAI deduction may be depicted as a "swap" for elimination of the ETI exclusion, both for individual corporate taxpayers and for the state as a whole, as well as for elimination of other tax shelters. But such a depiction would be inappropriate. For one thing, the overall cost of the QPAI deduction when fully implemented is estimated to be some 70 percent larger than the revenue gained from the ETI change, according to the Joint Committee on Taxation. And corporations that benefit from QPAI often will not be the same ones that are losing due to elimination of the ETI exclusion. The ETI exclusion generally has been for exporters only; the QPAI deduction is for any domestic producer. As for the revenue generated by closing corporate tax shelters, it is important to recognize that this is good policy in its own right, and also that these shelters were used by a limited number of taxpayers.

There is no particular reason why the revenue generated by eliminating the ETI exclusion or closing other tax shelters should be used to create a QPAI tax break instead of, say, broader-based tax reductions, new public-sector investments, or new rainy-day fund investments. At the very least, if shelter-closing revenue is to be spent on conformity to QPAI, the decision should be made explicitly and openly.

Appendix
Calculating the Impact of QPAI

The state estimates in this paper represent a rough, first-order approximation of the potential impact of the QPAI deduction on state tax revenues.

The first step in the estimating process was to use the estimate of the Joint Committee on Taxation that the QPAI deduction in federal fiscal year 2011 would cost the federal government $10.7 billion. This amount was compared to the Congressional Budget Office's estimates of corporate and personal income taxes for federal fiscal year 2011. Since QPAI may be claimed on personal income tax returns that have income from pass-through entities (e.g. S corporations, partnerships and sole proprietorships), a portion (7.6 percent) of projected personal income tax revenues was added to projected corporate income tax revenues to generate an estimate of projected business-income tax revenues for FY2011. (This 7.6 percent figure reflects IRS data on total pass-through entities' income as a share of AGI in 2002.) This set of calculations resulted in a finding that the Joint Tax estimate for 2011 equals 2.8 percent of projected business-income tax revenue in that year.

The second step of the estimation was based on Census Bureau tabulations of state tax data collected from July 2003 through June 2004 (reflecting most states' fiscal year 2004). (Data for Texas' corporate franchise tax, which is largely an income tax, came from Texas' state comptroller.) An estimate of business-income tax revenue was generated for each state by adding corporate income tax revenue to 7.6 percent of personal income tax revenue, again reflecting the fact that the QPAI deduction may be claimed on personal income tax returns for pass-through entities.

The third step was to multiply the 2.8 percent figure generated in the first step by the state tax total generated in the second step.

Note that those steps assume that pass-through entities are as likely as taxable corporations to claim the QPAI deduction. However, IRS Statistics of Income data suggest that this is probably not the case, because pass-throughs generally engage in less production activity than taxable corporations. (For example, compared to taxable corporations, a much smaller percentage of pass-through entities' incomes derive from manufacturing, although a larger percentage comes from construction). Therefore, the three steps described above were repeated using a slightly different operating assumption: namely, that *only* corporations that are subject to corporate income tax (that is, non-pass-through entities) would claim the QPAI deduction. This assumption applied at the federal level yielded a calculation that the QPAI revenue loss would equal 4.1 percent of corporate income taxes; the percentage was then applied to state corporate income taxes.

Since the second set of calculations probably overstated the impact on the corporate income tax — just as the first set probably understated the impact — the results of these two calculations were then averaged together. (In most states, the results were very similar under either set of assumptions.)

The spreadsheet used to generate these estimates is available upon request from Elizabeth McNichol.

It may well be possible for state revenue departments or state fiscal offices to improve substantially on these estimates. For instance, a state may have its own data on the types of industries that pay taxes, and may find that a higher or lower share of taxable income is likely to be eligible for the QPAI deduction. This is likely to be particularly true in smaller states with relatively lower or higher tax reliance from manufacturing, electricity/natural gas production, and/or construction. In addition, states may choose not to use the Joint Tax estimate as a starting point, but rather generate their own estimates based on state-level data on production activities.

For example, the figure in Table 1 for Massachusetts is based on the state Department of Revenue's estimate. The Massachusetts Department of Revenue estimates that the revenue loss for tax year 2005 (when the credit equals 3 percent of eligible income) would be $14 million. Once fully in effect the credit will equal 9 percent, so the impact in tax year 2005 if the credit were fully in effect would equal $42 million. Our estimate using the methodology described above was $49 million. The figures in Table 1 for Maryland and Oregon were also derived from state estimates using a similar methodology.