Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

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STATES ARE DECOUPLING FROM THE FEDERAL "QUALIFIED PRODUCTION ACTIVITIES INCOME" DEDUCTION

By Elizabeth McNichol and Nicholas Johnson

Some 18 states plus the District of Columbia have chosen to disallow a new federal tax break. The new tax break, known as the "qualified production activities income" or QPAI deduction, is troubling because of the substantial revenue loss it will produce for the federal government and for state governments that conform to it, as well as for the difficulty that tax agencies are likely to have in administering it and for its likely ineffectiveness in protecting or creating domestic jobs.

By rejecting this tax break, those 18 states are protecting roughly $300 million to $400 million in revenue in the current fiscal year, and as much as $850 million to $1.2 billion annually when the tax break is fully phased in five years from now. Those amounts are roughly half of the potential revenue loss if all states followed the federal government's lead in allowing this tax break. In other words, there is still another $850 million to $1.2 billion annually at risk in the 29 states that have not yet decoupled. (Four states are unaffected.) But it is not too late for those states to eliminate the tax break by "decoupling" from this provision of the federal tax code for this purpose.

The QPAI tax break, enacted in 2004 as Section 199 of the Internal Revenue Code, is the largest new federal tax break for American corporations in years. It allows companies to claim a tax deduction based on their profits from "qualified production activities," a sweeping category that goes well beyond manufacturing to include such diverse activities as food production, filmmaking, and utilities. Estimates published by two separate federal agencies suggest that the federal government will lose $3.6 billion to $5.4 billion in the upcoming fiscal year, rising to revenue loss of $12 billion to $16 billion annually when the provision is fully implemented in 2010. These estimates suggest that states might lose up to 5 percent of their corporate tax revenue, plus some of their personal income tax revenue, if they conform to the provision.

There is no good reason why states should accept such revenue loss. The QPAI deduction is unlikely to protect or create state jobs, because corporations can claim the deduction for out-of-state "production activity" just as they can for in-state activity; the lost revenue from the deduction could be better spent on any number of better in-state investments. Decoupling from the QPAI deduction, as 18 states have already shown, is administratively straightforward – it can be done simply by requiring corporations to add back the deducted amount to their taxable income.

TABLE 1: POTENTIAL ANNUAL REVENUE LOSS IF QPAI DEDUCTION WERE ALLOWED (DOLLARS IN MILLIONS)			
State	**Potential Revenue Loss**	**State**	**Potential Revenue Loss**
Alabama	17 to 24	Nebraska	10 to 14
Alaska	17 to 27	Nevada	n/a
Arizona	28 to 41	**New Hampshire**	**16 to 25**
Arkansas	**11 to 16**	New Jersey*	95 to 140
California	**390 to 560**	New Mexico	9 to 13
Colorado	19 to 25	New York	164 to 225
Connecticut	30 to 41	**North Carolina**	**53 to 74**
Delaware	8 to 11	**North Dakota**	**3 to 4**
Florida	50 to 77	Ohio	53 to 74
Georgia	*49*	Oklahoma	12 to 16
Hawaii	**7 to 10**	*Oregon*	*27*
Idaho	6 to 8	Pennsylvania	75 to 110
Illinois	89 to 130	Rhode Island	6 to 8
Indiana	35 to 50	**South Carolina**	**14 to 19**
Iowa	11 to 14	South Dakota	n/a
Kansas	12 to 16	**Tennessee**	**28 to 43**
Kentucky	20 to 28	**Texas**	**51 to 79**
Louisiana	16 to 22	Utah	10 to 14
Maine	**7 to10**	Vermont	4 to 5
Maryland	*40*	Virginia	39 to 52
Massachusetts	*42*	Washington	n/a
Michigan	13 to 15	**West Virginia**	**11 to 17**
Minnesota	**44 to 62**	Wisconsin	39 to 54
Mississippi	**15 to 22**	Wyoming	n/a
Missouri	17 to 23	**Washington DC**	**9 to 13**
Montana	4 to 6	TOTAL	1,665 to 2,298

Amounts shown are the range of potential impacts had QPAI been in full effect in state fiscal year 2005.
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 is based on one produced by the state.
States in bold have decoupled. *New Jersey has partially decoupled.

Indeed, decoupling might even spare a state entanglement in the extensive administrative and legal action that is likely to occur in coming years as tax auditors and practitioners struggle to understand the deduction's limits. Lastly, decoupling from the QPAI deduction can be accomplished without regard to whether or not states conform to other aspects of federal tax law.

State Actions To Decouple From The Section 199 QPAI Deduction

As of September 2005, some 18 states plus the District of Columbia have decoupled, or are likely to decouple, from Section 199. Arkansas, California, the District of Columbia, Georgia, Hawaii, Indiana, Maine, Maryland, Massachusetts, Minnesota, Mississippi, New Hampshire, North Carolina, North Dakota, Oregon, South Carolina, Tennessee, Texas and West Virginia are not conforming to the QPAI deduction, according to a survey by the Federation of Tax Administrators. A 19th state, New Jersey, has partially decoupled.

Most of those states are conforming to most other provisions of federal tax law, including other changes adopted by Congress at the same time that Section 199 was enacted. One change to federal law enacted in 2004 to which most states are conforming phases out the protection of certain "extraterritorial income" from foreign exports, protection that the World Trade Organization has said is illegal under international law. States generally also are conforming to the elimination of some costly and inappropriate tax shelters. But conforming to those other provisions is scant justification for conformity to Section 199.

Decoupling from QPAI Is Fiscally Responsible

The new federal deduction for "Qualified Production Activities Income" is broad in its scope and therefore costly in its fiscal impact. Deductible QPAI income can be any profits — that is, receipts minus costs — from manufacturing, food processing (but not retail food sales), software development, filmmaking, electricity/natural gas production, or 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.[1]

Not surprisingly, such a broadly available tax break carries a heavy fiscal cost. The Joint Committee on Taxation, which estimates federal revenue impacts for Congress, estimates that the QPAI provision will cost the federal government $3.6 billion in federal fiscal year 2006, when 3 percent of QPAI income is deductible. As the deductible percentage rises to 6 percent in the tax year 2007 and to 9 percent in 2010, the revenue loss also will be roughly proportionately. The Joint Committee on Taxation estimates federal revenue loss of $7.9 billion in fiscal year 2009, which in turn suggests roughly a $12 billion loss in 2011. The Office of Management and Budget projects an even greater revenue loss of $10.7 billion by fiscal year 2010, the latest year for which it has published an estimate. This likely will be to $16 billion in fiscal year 2011, the first year of full impact. These JCT and OMB estimates amounts roughly equal 4 to 5 percent of projected federal revenue from corporate income taxes plus another 0.2 to 0.3 percent of projected revenue from personal income taxes. It is reasonable to think that states could face losses of comparable size. A rough projection based on the Joint Tax and OMB estimate is that if QPAI had been in full effect in FY 2005 and all states had conformed, the cost to states would have equaled $1.7 billion to $2.5 billion. State-by-state amounts are shown in Table 1; the Appendix explains how these figures were calculated.

The divergence between the JCT and OMB estimates reflect uncertainty about exactly how QPAI will work in practice, given the likelihood that corporate tax accountants will 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.[2]

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*.[3] Lengthy court battles are quite likely as corporations challenge IRS

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[1] Calculated from IRS Statistics of Income data for tax year 2001. 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.

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

[3] Quoted in Warren Rojas, "New Manufacturing Deduction Presents Many Open Questions," *Tax Notes*, October 18, 2004.

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.
- 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.

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.

Likely Administrative Problems Associated with the QPAI Deduction

In a letter to Congress discussing the QPAI provision of the federal tax bill that included the QPAI provision, 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.

- 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 typically 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.

One way that states could replace a QPAI deduction with a different policy would be to use the revenue savings from QPAI decoupling to finance supports for working families. An example is

Oregon's decision to fund a newly refundable state Earned Income Tax Credit with the savings realized by decoupling from QPAI. This approach ensured that working families actually benefited, probably a better way of strengthening the state economy by making it more likely that the dollars are spent in-state.

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

The federal law that created the QPAI deduction – P.L. 108-357, the American Jobs Creation Act of 2004 – has dozens of provisions that are unrelated to QPAI. Most states decoupling from QPAI nevertheless are conforming 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, P.L. 108-357 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.

Some advocates of conformity have sought to depict the QPAI deduction 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 is inaccurate. 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.

TABLE 2 STATE CONFORMITY TO IRC SEC. 199 QPAI DEDUCTION			
State Name	**Conform to Sec. 199**	**State Name**	**Conform to Sec. 199**
Alabama	Yes	Missouri	Yes
Alaska	Likely Yes	Montana	Yes
Arizona	Yes	Nebraska	Yes
Arkansas	No	Nevada	N/A
California	No	New Hampshire	No
Colorado	Yes	New Jersey	Partial
Connecticut	Yes	New Mexico	Yes
Delaware	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	No
Illinois	Likely Yes	Pennsylvania	Likely Yes
Indiana	No	Rhode Island	Yes
Iowa	Yes	South Carolina	No
Kansas	Yes	South Dakota	N/A
Kentucky	Yes	Tennessee	No
Louisiana	Likely Yes	Texas	No
Maine	No	Utah	Yes
Maryland	No	Vermont	Yes
Massachusetts	No	Virginia	Yes
Michigan	Likely Yes	Washington	N/A
Minnesota	No	West Virginia	No
Mississippi	No	Wisconsin	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.
New Jersey – Conform for gross receipts from qualifying production property which was manufactured or produced by the taxpayers; does not conform for gross receipts from other qualifying production property including property that was grown or extracted by the taxpayer.
Pennsylvania – Conform on corporate net income tax only.

Source: Federation of Tax Administrators based on survey responses from state tax agencies, updated based on news reports and other sources.

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 estimates of the Joint Committee on Taxation on the impact of QPAI on corporate and personal income tax revenues.[4] These figures were divided by the Congressional Budget Office's projections of actual corporate and personal income tax revenues for those years. The last year for which a JCT estimate is available is 2009, at which time the percentage rate of the deduction will equal 6 percent. The following year, the deduction will rise to 9 percent, with the likely result that the revenue loss from the deduction will rise by one-half, so the JCT figure was multiplied by 1.5. These calculations yielded estimates that QPAI would reduce corporate tax revenues by about 3.5 percent and personal tax revenues by about 0.2 percent.

The second step was to reproduce these calculations, but this time using an alternative set of projections issued by the Office of Management and Budget.[5] The OMB projections indicate that when fully implemented, QPAI could reduce corporate tax revenues by about 5.4 percent and personal income tax revenues by 0.3 percent.

The third step was to multiply those percentage rates by the latest available corporate and personal income tax collections figures for each state, as reported by the U.S. Census Bureau. This produced a range of cost estimates. The differences reflect the uncertainty about the actual fiscal implications of the QPAI deduction, due to its novelty and to the possibility of very broad interpretation. (Note that this methodology is somewhat different from that used in previous versions of this analysis, due to newly available JCT and OMB data. However, the results are reasonably consistent.)

The spreadsheet used to generate these estimates is available upon request from Nicholas Johnson at johnson@cbpp.org

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

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[4] Joint Committee on Taxation, Estimates Of Federal Tax Expenditures For Fiscal Years 2005-2009, January 12, 2005, p. 34. Available at http://www.house.gov/jct/s-1-05.pdf.

[5] Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2006*, p. 321. Available at http://www.whitehouse.gov/omb/budget/fy2006/.

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 Georgia, Maryland and Oregon were also derived from state estimates using a similar methodology.