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STATES CAN AVOID SUBSTANTIAL REVENUE LOSS BY DECOUPLING FROM NEW FEDERAL TAX PROVISION

by Nicholas Johnson

A new provision of federal tax law, signed into law March 9, threatens to reduce corporate and personal income tax revenue in nearly every state to a significant degree in the current and upcoming fiscal years. The provision is known as "bonus depreciation." It allows a business to claim an immediate tax deduction of up to 30 percent of the cost of new equipment purchases, rather than following the standard accounting approach of depreciating the full cost gradually over several years as under previous federal law. The bonus is effective *retroactive to September 2001*, meaning that businesses can begin immediately to claim the deduction in their tax returns for 2001 and their estimated tax payments due in spring, 2002. It expires in September 2004, by which time it will have reduced federal taxes on profitable businesses by $97 billion.

In addition to the reduction in federal revenue, states stand to lose more than $14 billion[1] in corporate and individual tax revenue over three years, because income taxes in nearly every state traditionally have been calculated based on federal tax law. Because the provision is retroactive, states that conform to it will experience immediate revenue loss.

This revenue loss would cause serious problems for states that are already struggling to balance their budgets. The National Governors Association, in a March 11 news release, described the provision as "an assault on the states' revenue base" that could result in cuts in education, health care and transportation services. The National Conference of State Legislatures has criticized the provision in similar terms. The additional spending cuts that likely would result from failure to decouple would cause harm to state economies at this moment of economic recovery.

There is a way states can protect themselves from this immediate and large revenue loss while the federal provision is in effect. States can, at their own option, "decouple" their business depreciation rules from the federal rules for the period of time that bonus depreciation is in effect. In other words, states can choose not to conform to this federal change. California already used its own depreciation schedules even before the change. Another ten states that previously followed federal rules — Arkansas, Georgia, Idaho, Indiana, Iowa, Massachusetts, Mississippi, Nebraska, Texas and Virginia — plus the District of Columbia have now decoupled from the bonus depreciation provision (seven of those through legislative action, three through pre-existing statutory authority). At least ten additional

[1]This amount includes the expected revenue loss from investments made through September, 2004, the month in which the provision is scheduled to expire.

states appear poised to decouple, as legislation to decouple has advanced in Connecticut, Maryland, and Wisconsin, and governors or top legislators have called for decoupling in Arizona, Illinois, Ohio, Minnesota, New Jersey, Pennsylvania, and Vermont. In the early 1980s, responding to a similar federal change, some 21 states decoupled from federal depreciation rules.

Table 1 shows the approximate revenue loss to each state in fiscal years 2002, 2003 and 2004 if they conform to the new federal depreciation rules. It reflects official revenue estimates from individual state tax departments, where available; for the remaining states, it reflects Center on Budget and Policy Priorities estimates based on calculations by Congress' Joint Committee on Taxation and the Congressional Research Service.

How Can States Avoid This Loss?

In some states, the revenue loss from bonus depreciation will occur automatically in the absence of legislative action. In other states, this revenue loss will occur if states pass legislation to update their tax codes to incorporate federal changes, as has been annual standard practice in recent years.

Although most states in recent years have conformed to federal depreciation rules, there is no obligation to do so. There is ample precedent and opportunity for states to use their own depreciation rules that differ from federal rules.

- California for a number of years has used its own depreciation rules, different from federal rules, for computing corporate and personal income tax. There is no evidence that the additional bookkeeping requirements have impeded economic development in California.[2]

- When the federal government sharply increased depreciation allowances in 1981 by adopting the "accelerated cost recovery system," about half of the states promptly decoupled in whole or in part. The states included Alaska, Arkansas, California, Connecticut, Florida, Georgia, Kentucky, Maine, Minnesota, New Jersey, New York, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Virginia, and West Virginia.[3] Several of those states, including New York, New

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[2]Since the California rules apply to equipment outside of California as well as within California, and since nearly every large corporation has a California presence and files a California tax return, the California rules apply to a large share of all depreciable assets in the United States. In 1998, for instance, total depreciation on California corporate returns equaled about 68 percent of total depreciation on all federal corporate returns nationwide.

[3]At least four other states, Indiana, Iowa, Nebraska, and Wisconsin, raised corporate income tax rates to offset the revenue loss due to the federal changes. Sources: Advisory Commission on Intergovernmental Relations,

Jersey and Kentucky, continued to require different depreciation schedules from the federal schedule for at least some industries into the early 1990s.

- Ten states plus the District of Columbia that previously followed federal depreciation rules have determined that they will disallow the new bonus provision (or taken equivalent action to decouple), and others are likely to follow. In seven states—Georgia, Idaho, Indiana, Iowa, Massachusetts, Nebraska, and Virginia — and in D.C. the decoupling resulted from explicit legislative action.[4] Two other states, Arkansas and Texas, do not have legislative sessions this year and therefore are decoupled automatically under pre-existing tax law. The tenth state that has decoupled is Mississippi, as a result of a ruling by the state tax commissioner that the bonus depreciation deduction fails to meet the state standard for a "reasonable allowance" for depreciation.

- Legislation to decouple is expected to advance in at least ten other states that are still developing their budgets for next fiscal year. Decoupling legislation has won support from joint legislative finance committees in Connecticut and Wisconsin; in Maryland, a bill to decouple awaits the governor's signature. Governors in Arizona, Minnesota, New Jersey, Pennsylvania and Vermont have requested legislation to decouple, as have legislative leaders in Illinois and Ohio.

The Mechanics of Decoupling

For calculating corporate income tax, the starting point in most states is taxable income as defined by the federal Internal Revenue Code. Taxable income is income after allowable expenses such as depreciation. For firms that do not pay corporate income tax (such as S corporations, partnerships, and sole proprietorships), depreciation is reflected in the owners' federal adjusted gross income, which is the starting point for most states' calculations of state individual income tax liability. Because bonus depreciation reduces both the taxable income of corporations and the adjusted gross income of individuals, it can reduce states' tax bases to a commensurate degree.

States nevertheless can prevent the change from affecting them for the three years it is in effect. One method of doing so is to change the applicable reference to the federal Internal Revenue Code to

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Significant Features of Fiscal Federalism, 1982-83 Edition, pp. 68-70; Federation of Tax Administrators, *Tax Administrators News*, February 1984; National Conference of State Legislatures, *The 1982 Federal Tax Increase and State Revenue: The Major Issues*, January 1983.

[4] In Georgia, Idaho, Indiana, and Iowa, the decoupling was accomplished by updating tax codes to conform to other recent federal tax law changes but chose *not* to conform to the bonus depreciation change, thereby remaining decoupled from that provision.

specify the Code as it existed on September 1, 2001 (or on some other date prior to the September 11 effective date of the new provision).[5] Tax departments then can revise tax forms and/or instructions so that businesses add to their federal income the amount by which depreciation under the new, temporary "bonus" provision is greater than depreciation under permanent law. Many states already require corporations to make various additions and subtractions to federal taxable income to calculate taxable income for state purposes; a revised state tax form might include one additional line for a corporation to add back the bonus depreciation amount.[6]

Any complications that would be caused by decoupling would be temporary, since the federal change expires in less than three years. In addition, note that small businesses with $24,000 or less in annual equipment purchases generally are unaffected by bonus depreciation rules because such businesses account for capital expenditures in a different way.

Impact on State Budgets

Conforming to the federal changes will hit states with an additional revenue loss that they cannot afford. As a result of the recession, the terrorist attacks, last summer's federal tax changes, and rising health care costs, among other factors, most states are experiencing very tight fiscal times. Many had already planned or enacted spending cuts and tax increases. Any additional spending cuts or tax increases required to replace revenue lost as a result of bonus depreciation conformity would be unpopular and difficult.

Recognizing the potential fiscal danger to states from the bonus depreciation provision, organizations of state officials such as the National Governors Association and the National Conference of State Legislators asked Congress to include fiscal relief in the form of additional Medicaid funds in the stimulus bill. "States must keep their budgets balanced and without relief, the result will be steep cuts and tax increases that might threaten economic recovery," NGA Chairman John Engler told members of Congress. Congress, however, chose not to provide such relief.

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[5]Some states have avoided conforming to the bonus depreciation provision by referring to the Internal Revenue Code as it *existed* on January 1, 2002, which presumably would exclude the bonus depreciation provision. A reference date of September 1, 2001, however, would be clearer.

[6]Under this approach, additional adjustments in later years may be appropriate in order to allow businesses to deduct the full value of the purchase over time. These additional adjustments can create new accounting and administrative burdens on businesses and state tax administrators. The new federal tax law has prompted a number of state revenue departments and legislatures to begin developing other approaches to decoupling in order to minimize those accounting and administrative burdens while avoiding substantial revenue loss; one example is the decoupling legislation enacted in Nebraska, LB 1085.

Three Years of Bonus Depreciation Is Not Effective Economic Stimulus and Can Create Economic Distortions

There is significant doubt as to the effectiveness of the three-year federal bonus depreciation provision in creating economic growth. Last fall and early this winter, a number of economists advised that such a proposal could provide useful near-term stimulus *if* it were made effective for one year. Doing so would encourage firms to accelerate purchases into 2002 to take advantage of this tax break.

But the enacted legislation makes the provision effective for three years rather than one. According to the nonpartisan Congressional Budget Office, the three-year term weakens the provision's ability to stimulate the economy. "Temporarily cutting taxes on investment can provide one-time opportunities for saving that may induce firms to advance their investment plans to the present," CBO noted in a January report, but firms "might not take [such action in the near-term] if they knew that the tax advantage would remain in place and be available to them later."

Bonus depreciation allows a large share of the cost of investment to be counted as an expense in the first year rather than subtracted gradually over the life of the asset. This "partial expensing" could create unintended economic problems when the economy returns to full employment, as is likely to occur before the provision expires. For example, among the types of investments that it does cover, partial expensing reduces the costs of longer-lived investments more than shorter-lived investments — and thereby biases firms toward making longer-lived investments even if that would not make economic sense in the absence of the tax provision. More broadly, by spurring demand for covered investments, partial expensing puts upward pressure on interest rates and thereby dampens demand for investments not covered by the partial expensing (such as residential housing). Partial expensing can thus skew incentives toward particular types of investment and away from other types. In other words, partial expensing can distort economic decisions and create economic inefficiencies.

Conforming to the federal change would exacerbate a trend toward lower corporate taxation at the state level. State corporate income tax payments, as a share of total corporate profits, have declined dramatically over the last decade, from an average effective rate of 6.5 percent in the 1980s to about 3.8 percent in 1998. In part this has occurred because multi-state corporations increasingly are able to exploit shortcomings in state tax law to minimize their tax payments.[7] By decoupling, states can prevent additional erosion of the corporate tax base.

[7]Steve Maguire, *Average Effective Corporate Tax Rates*, Congressional Research Service, February 29, 2000; Peter Fisher, "Tax Incentives and the Disappearing State Corporate Income Tax," *State Tax Notes*, January 17, 2002.

Impact on State Economies

The tax hikes or spending cuts needed to balance state budgets would have another effect as well: They would take money out of state economies at a time when states should be contributing to economic activity, not preventing it. For every dollar that bonus depreciation would put into the hands of corporations in the form of a tax break, the state would have to take a dollar away from state or local workers or contractors, or from other taxpayers. Because states must balance their budgets, the combination of conforming to bonus depreciation while cutting spending would at best be a zero-sum game and have no effect on state economies. However, as economists Peter Orszag and 2001 Nobel Prize winner Joseph Stiglitz have noted, cutting spending on goods and services to pay for a tax cut could *hurt* a state's economy and slow an economic recovery.[8] For example, a $1 reduction in direct state spending on goods and services reduces consumption within the state by at least $1. The new tax break is unlikely to provide sufficient stimulus to offset the effects of the spending cuts it would cause, because the businesses would not necessarily spend all of the tax break; some is likely to be retained as savings by the corporation. Moreover, as explained below, businesses are highly likely to spend their tax break in a state other than the one that is providing the tax break.

It is worth noting that state decoupling will not impair a corporation's ability to benefit from the *federal* bonus depreciation provision. In other words, 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 bonus depreciation is far more valuable than any state deduction would be.

One reason that Congress chose not to provide fiscal relief to states in the stimulus bill may have been a belief that states could protect themselves by decoupling from the provision.[9] In other words, the expectation that the bonus depreciation would assist the U.S. economy, whether correct or incorrect, was *not* dependent on states conforming to it.

A further reason to question state conformity to the bonus depreciation rule is that states are likely to suffer a substantial revenue loss to subsidize investments made in *other* states. Multi-state corporations pay taxes to each state where they operate based on their total income minus total expenses, including depreciation; the amount that they pay to each state is based on the extent of their

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[8] Peter Orszag and Joseph Stiglitz, *Budget Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive than the Other During a Recession?* Center on Budget and Policy Priorities, November 6, 2002 (http://www.centeronbudget.org/10-30-01sfp.htm).

[9] For instance, this point was made by the staff director for the U.S. House Ways and Means Committee in a December meeting with state legislators who chair tax and finance committees.

physical presence and sales in the state, not on where their expenses occur.[10] And states are barred by the U.S. Constitution from requiring corporations to depreciate out-of-state equipment purchases less favorably than in-state equipment purchases. No matter where the equipment is purchased, it would reduce taxable income. Thus, if a corporation replaces a piece of equipment at a factory out of state, it would receive the exact same bonus depreciation deduction as it would for replacing a piece of equipment within the state. Since multi-state corporations represent a large portion of most states' corporate tax bases, much of the cost of conforming to the temporary depreciation rule would subsidize out-of-state investments.[11]

Summary

The change to federal depreciation rules that is now in effect, and will remain in effect for another 30 months, threatens to do significant damage to state budgets without benefitting state economies. To avoid this damage, states must depart from the practice of the last several years of routinely conforming to changes in federal tax law. Instead, as many did in the early 1980s, states will have to adjust their tax forms and instructions to recapture the lost revenue.

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[10]Specifically, the share of a corporation's nationwide profits taxed in a particular state generally depends on the shares of the corporation's nationwide property, payroll, and/or sales located in that state.

[11] The same can be said with respect to the state *personal* income tax revenue losses flowing from the bonus depreciation provisions, since many "S" corporations, partnerships, and Limited Liability Companies also have multistate operations. Depreciation deductions taken by such business entities flow through to the state personal income tax returns of their owners.

Table 1
Cost to States of Conforming to Bonus Depreciation Rules,
By State Fiscal Year (Dollars in Millions)

	FY 2002	FY 2003	FY 2004	Total
Alabama	$49	$45	$41	$135
Alaska	31	73	52	156
Arizona	48	113	81	242
Arkansas	*24*	*56*	*40*	*119*
California	n/a	n/a	n/a	n/a
Colorado	38	91	65	194
Connecticut	44	104	74	222
Delaware*	5	15	15	35
Florida*	126	146	124	396
Georgia	*78*	*185*	*132*	*394*
Hawaii	9	22	15	46
Idaho	*14*	*32*	*23*	*69*
Illinois	159	378	270	806
Indiana	*79*	*187*	*134*	*400*
*Iowa**	*14*	*46*	*48*	*108*
Kansas	25	59	42	126
Kentucky	32	76	55	163
Louisiana	25	59	42	127
Maine	13	31	22	67
Maryland	52	123	88	262
Massachusetts	*118*	*279*	*200*	*597*
Michigan	13	51	47	111
Minnesota*	104	130	117	351
Mississippi	*24*	*58*	*41*	*123*
Missouri	38	91	65	195
Montana	10	23	16	48
*Nebraska**	*0*	*35*	*32*	*67*
Nevada	n/a	n/a	n/a	n/a
New Hampshire	19	44	32	95
New Jersey	116	274	196	586
New Mexico	17	41	29	88
New York	--	912	545	1,457
North Carolina	86	203	145	434
North Dakota	7	16	12	34
Ohio	39	152	139	330
Oklahoma	21	50	36	107
Oregon	45	106	76	227
Pennsylvania	148	352	252	753
Rhode Island	8	20	14	42
South Carolina	25	60	43	129
South Dakota	3	8	6	17
Tennessee	48	113	81	242

Table 1 *(continued)*
Cost to States of Conforming to Bonus Depreciation Rules,
By State Fiscal Year (Dollars in Millions)

	FY 2002	FY 2003	FY 2004	Total
Texas	*198*	*279*	*253*	*730*
Utah	19	45	32	97
Vermont*	3	14	8	25
Virginia	*60*	*143*	*102*	*305*
Washington	n/a	n/a	n/a	n/a
West Virginia*	16	35	21	72
Wisconsin	62	146	104	312
Wyoming	n/a	n/a	n/a	n/a
New York City	170	403	288	860
District of Columbia	*35*	*32*	*29*	*96*

Notes: n/a = Not applicable. Nevada, Washington and Wyoming do not have income taxes based on federal definitions of income; California does not conform to federal depreciation provisions.

All other states, plus New York City and the District of Columbia, historically have utilized federal depreciation schedules in computing corporate and/or personal income taxes.

States in italics (*Arkansas, Georgia, Idaho, Indiana, Iowa, Massachusetts, Mississippi, Nebraska, Texas, Virginia and the District of Columbia*) are now decoupled from federal bonus depreciation provision and therefore not expected to be affected by revenue loss; see text for discussion.

Estimates marked with an asterisk (*) are official published state estimates where available. All others are approximations based on the federal Joint Committee on Taxation (JCT) estimate of impact on federal tax receipts ($97 billion over three federal fiscal years). Using the JCT estimate, the Congressional Research Service (CRS) has estimated the effect of the provision on states to total between $14 billion and $15 billion over those three years. The approximations shown here were developed by updating the CRS estimate to reflect the most recent JCT estimates and then distributing the result among affected states, based on the size of each state's actual corporate and personal income tax receipts. Most state fiscal years are different from the federal fiscal year, and corporate filing rules also differ state to state; amounts were adjusted accordingly. In nearly all affected states, additional revenue losses are expected to occur in FY 2005, not shown here.