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PRESERVING STATE REVENUE FROM THE EFFECTS OF RECENT FEDERAL LEGISLATION
States Can "Decouple" from Federal Tax Changes

by Iris J. Lav, Elizabeth McNichol, and Nicholas Johnson

At a time when states across the country are facing severe budget problems, two recent cuts in federal taxes could exacerbate fiscal stress. The new federal laws could force states to forego tens of billions of dollars in revenues over the next few years. The loss of this revenue would jeopardize spending on a range of state programs, including spending on low-income and human services programs.

States can avert this loss of revenue — and maintain adequate resources to support programs — by "decoupling." Decoupling means protecting the relevant parts of their tax code from the changes in the federal tax code, in most cases by remaining linked to federal law as it existed prior to the change. A number of states already have acted to decouple.

What Are the Federal Tax Changes and How Do They Affect States?

Estate Tax

- Last summer's tax legislation includes a phaseout of the federal estate tax, culminating in full repeal in 2010. On a much faster track, the legislation repeals *over the next four years* the federal estate tax credit to which all state estate taxes are tied.

- The elimination of the federal estate tax credit will effectively repeal most state estate taxes, unless states change the way they link to the federal law. This is because most state estate taxes use the federal credit that is being phased out over the next four years as the basis for the calculation of state estate tax liability.

Bonus Depreciation

- The economic stimulus legislation Congress approved this spring allows firms to claim an immediate federal tax deduction of up to 30 percent of the cost of new equipment purchases, rather than depreciating the full cost gradually over several years as under prior law.

- The vast majority of states historically have used federal depreciation rules for computing state business taxes (with the exception of period following the 1981 federal tax cut, when 21 states decoupled). As a result of the recent stimulus legislation, most states will be forced to give businesses an additional tax break, on top of the federal break, unless they decouple from the federal provision

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How Much Will States Lose?

- If states allow the loss of the federal estate tax credit to repeal their own estate taxes, they will lose $23 billion over the five year period from fiscal year 2003 to fiscal year 2007.

- Conforming to federal bonus depreciation will cost states more than $14 billion between now and September 2004.

Shouldn't States Go along with These Federal Changes In the Hope That Reducing State Taxes Will Boost the State's Economy?

- When loss of revenue causes states to cut services, the economy usually is harmed rather than helped. Reductions in government spending withdraw demand from a state economy and thereby can weaken it.

- Cutting government services can harm the business climate. Businesses rely on a well-educated workforce, good transportation and public safety services, and a range of other government programs and services that create healthy conditions for business operations.

- The bonus depreciation provision cannot be limited to in-state investment. If states conform to the federal bonus depreciation change, they would be giving many businesses a tax break for investment that takes place in some other state.

- For every dollar that the wealthiest two percent of estates save in estate tax or corporations gain in the form of a tax break, other state residents — including low- and middle-income families — would lose a dollar worth of state programs and services or have to pay an additional dollar in taxes.

What Can States Do?

Choosing whether to enact a major tax cut such as bonus depreciation or estate tax repeal should be a deliberate decision by a state, not something that is forced on states by federal

Effects on States of Estate Tax Repeal and Bonus Depreciation		
	Estate Tax	**Bonus Depreciation**
Federal tax change	phaseout of federal credit for state estate taxes paid.	"bonus depreciation" provision of 2002 economic stimulus legislation
Effective date	Credit is phased out over four years, beginning in 2002	bonus is effective retroactive to September 2001 and expires September 2004
Effect on states	effectively repeals most state estate taxes	reduces state corporate and individual income tax revenue
Potential revenue loss to states	$19 billion to $23 billion between fiscal years 2003 and 2007	more than $14 billion between now and September 2004
States that could potentially be affected	every state except Oklahoma	every state except California, Nevada, Washington, and Wyoming
Will all of these states *automatically* be affected?	no; states whose tax codes are not automatically updated to reflect changes in the federal tax code will not be affected until they update their references to the federal tax code	
How states can "decouple" from the federal action	change state law so the elimination of the federal estate tax credit does not affect the state estate tax	maintain depreciation rules that existed prior to the new bonus depreciation for the period the new federal rules are in effect
States that are decoupled	Arkansas, D.C., Kansas, Maine, Maryland, Minnesota, Nebraska, New York, Oregon, Rhode Island, Virginia, Washington, Wisconsin	Arkansas, D.C., Georgia, Idaho, Indiana, Iowa, Maryland, Massachusetts, Mississippi, Nebraska, Texas, Virginia.

actions. To the extent that these federal changes are harmful to state fiscal conditions, states can take action to mitigate the harm. Specifically, states can maintain their own estate taxes based on the federal credit prior to repeal, and states can continue to use the regular federal depreciation schedules or make equivalent adjustments.

For additional information, including data on the potential revenue loss for each state and details on the specific decoupling steps that states can take, see the following Center reports:

States Can Retain Their Estate Taxes Even as the Federal Estate Tax Is Phased Out, by Elizabeth C. McNichol, Iris J. Lav, and Daniel Tenny, January 31, 2002 (http://www.cbpp.org/1-31-02sfp.pdf)

States Can Avoid Substantial Revenue Loss by Decoupling from New Federal Tax Provision, by Nicholas Johnson, April 29, 2002 (http://www.cbpp.org/3-20-02sfp.htm)

Estimate of Revenue Loss that Can Be Avoided by Fully Decoupling from Federal Estate Tax Changes

	Revenue Loss that Can Be Avoided (millions)					Total
State	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 03-07
For States With a Pickup Tax Only						
Alabama	$15.1	$28.4	$43.4	$56.5	$59.9	$203.3
Alaska	0.7	1.5	2.3	3.1	3.5	11.1
Arizona	18.4	40.8	64.6	86.8	96.3	306.9
Arkansas	6.4	14.3	22.6	30.3	33.7	107.3
California	230.5	510.6	808.0	1,085.7	1,205.1	3,839.9
Colorado	20.4	45.2	71.5	96.0	106.6	339.6
Delaware	10.2	22.5	35.6	47.9	53.2	169.4
District of Columbia	16.9	31.9	48.8	63.6	67.4	228.6
Florida	189.3	419.3	663.6	891.7	989.8	3,153.7
Georgia	31.5	69.7	110.3	148.2	164.5	524.2
Hawaii	4.3	9.6	15.1	20.3	22.6	71.9
Idaho	2.7	6.0	9.5	12.8	14.2	45.2
Illinois	89.1	197.3	312.3	419.6	465.8	1,484.1
Kansas	10.2	22.5	35.6	47.9	53.2	169.4
Maine	7.6	16.7	26.5	35.6	39.5	125.8
Massachusetts	50.2	111.1	175.9	236.3	262.3	835.8
Michigan	51.1	96.2	147.1	191.7	203.3	689.3
Minnesota	13.1	29.0	45.9	61.6	68.4	217.9
Mississippi	6.8	15.1	23.9	32.1	35.6	113.5
Missouri	38.7	85.7	135.6	182.3	202.3	644.6
Montana	2.3	5.1	8.0	10.8	12.0	38.2
Nevada	10.5	23.2	36.8	49.4	54.8	174.7
New Mexico	6.2	13.8	21.9	29.4	32.6	104.0
New York	118.5	341.4	563.9	785.3	915.5	2,724.5
North Carolina	30.4	67.3	106.5	143.1	158.8	506.1
North Dakota	1.3	2.9	4.6	6.2	6.8	21.8
Oregon	10.8	23.9	37.8	50.8	56.4	179.7
Rhode Island	5.4	12.0	19.0	25.6	28.4	90.4
South Carolina	12.1	26.8	42.4	57.0	63.2	201.4
South Dakota	2.1	4.7	7.4	10.0	11.1	35.4
Texas	97.2	191.8	296.5	390.2	420.0	1,395.8
Utah	7.5	16.7	26.4	35.5	39.4	125.4
Vermont	3.1	6.9	11.0	14.8	16.4	52.2
Virginia	30.8	68.3	108.1	145.3	161.3	513.9
Washington	26.4	58.5	92.7	124.5	138.2	440.3
West Virginia	4.3	9.6	15.1	20.3	22.6	71.9
Wisconsin	19.0	42.1	66.6	89.5	99.3	316.6
Wyoming	1.9	4.3	6.8	9.2	10.2	32.5
For States with Their Own Estate or Inheritance Taxes*						
Connecticut	$36.0	$87.0	$138.0	$192.0	$200.0	$653.0
Indiana	8.5	20.1	24.0	24.5	24.5	101.6
Iowa	15.2	26.1	37.6	44.2	45.6	168.6
Kentucky	15.0	25.0	35.0	45.0	47.7	167.7
Louisiana	8.7	19.5	31.7	43.7	47.6	151.2
Maryland	21.0	42.2	63.2	82.4	87.4	296.2
Nebraska	5.2	13.1	18.3	23.6	25.0	85.2
New Hampshire	6.3	9.4	20.8	27.9	31.0	95.3
New Jersey	51.0	101.0	148.0	190.0	209.0	699.0
Ohio	7.0	18.1	39.7	40.7	43.2	148.8
Oklahoma	0.0	0.0	0.0	0.0	0.0	0.0
Pennsylvania	25.0	35.0	50.0	60.0	63.6	233.6
Tennessee	2.4	5.2	8.3	11.2	12.4	39.5

*All estimates for states with their own tax are provided by the state unless otherwise noted.

Notes: See footnotes to Tables 4A & 4B in States Can Retain Their Estate Taxes Even As The Federal Estate Tax is Phased Out. The states in italics (Arkansas, District of Columbia, Kansas, Maine, Maryland, Minnesota, Nebraska, New York, Oregon, Rhode Island, Virginia, Washington, and Wisconsin) have already decoupled for at least one year and so would not face a revenue loss. See paper for details.

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
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.
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.