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 COULD LOSE $8 BILLION TO $11 BILLION OVER TEN YEARS AS A RESULT OF SENATE FINANCE COMMITTEE PROPOSAL

By Iris J. Lav and Nicholas Johnson

The Senate Finance Committee “mark” as revised by Chairman Charles Grassley exempts from taxation up to $500 in dividends per tax return, plus an additional one-tenth of dividends over $500 received in 2004 through 2007 and two-tenths of dividends over $500 received in 2008 through 2012. The provision would expire at the end of tax year 2012.

Over the period in which it is in effect, the exemption would deprive states of roughly $8 billion to $11 billion in state revenues over the next 10 years.

States have closed or are in the process of closing deficits for state fiscal year 2003 that totaled nearly $80 billion, along with deficits for fiscal year 2004 that exceed $70 billion. These deficits have been closed by a combination of depleting reserves, raising taxes, and cutting needed programs such as education and health insurance for low-income families. Most observers expect state fiscal problems to continue in fiscal year 2005, and further rounds of tax increases and program cuts will be made as states struggle to meet their balanced budget requirements.

Some 37 states and the District of Columbia use federal definitions of income in their own tax systems. These states, with a few exceptions such as California, would automatically exclude dividends from state taxable income if they were excluded from federal taxable income. A few states — Alabama, Arkansas, Mississippi, New Jersey, Pennsylvania, and Tennessee — ask taxpayers to report directly the amount of dividends they receive rather than deriving dividend income from the federal tax return. These states would not automatically lose revenue, but would undoubtedly face pressure to conform to the federal treatment.

Under the Senate Finance Committee proposal, states would be in jeopardy of losing $8 billion to $11 billion in revenue, with the actual amount of loss depending on which states conformed to the federal treatment. California, which has a tradition of allowing its tax structure to deviate from federal law, might decouple, but most other states likely would not. Although 30 states did decouple from the federal “bonus depreciation” provision enacted in 2002, only 17 states have decoupled from the phase-out of the estate tax credit that eliminates state estate taxes. The same pressures that are being brought to bear to push for a dividend exclusion at the federal level also exist in state capitols. For these reasons, when the dividend proposal was first released in January, Standard & Poor’s commented on the dim prospects for decoupling, “State legislative changes to tax structure, even given the obvious necessity and benefit, will likely prove difficult, at best.”

Table 1
Estimates of State Revenue Loss Resulting From Partial Federal Dividend Exclusion Tax Years 2004 - 2012

(in millions of dollars)

	Revenue Loss		Revenue Loss
Alabama	*$113*	Missouri	$253
Arizona	134	Montana	67
Arkansas	*126*	Nebraska	81
California	3,019	New Hampshire	71
Colorado	201	*New Jersey*	*253*
Connecticut	248	New Mexico	59
Delaware	58	New York	1,464
Georgia	341	North Carolina	389
Hawaii	80	North Dakota	13
Idaho	63	Ohio	465
Illinois	371	Oklahoma	104
Indiana	126	Oregon	256
Iowa	172	*Pennsylvania*	*346*
Kansas	134	Rhode Island	62
Kentucky	133	South Carolina	169
Louisiana	130	*Tennessee*	*190*
Maine	88	Utah	79
Maryland	249	Vermont	47
Massachusetts	440	Virginia	375
Michigan	333	West Virginia	49
Minnesota	310	Wisconsin	281
Mississippi	*51*	District of Columbia	85
		Total	12,076

Total: States that currently use federal taxes as basis for taxing dividends	**$11.0 billion**
Total: States that currently use federal taxes as basis minus California	**$8.0 billion**
Total: All states that tax dividends	**$12.1 billion**

Notes:

States in italics tax dividends, but do not derive the amount of dividends to be taxed from the federal tax form. Some other states, such as California, tax dividends based on the federal tax forms but would not automatically conform to changes in the federal law.

These estimates are based on Joint Committee on Taxation's estimate that the Finance Committee provision would cost the federal treasury $80.5 billion and on the rule of thumb that, if all states with income taxes conform to a federal tax change, the impact on states equals about 15 percent of the federal impact. The state-by-state numbers are based on information on taxable dividend income by state from the Internal Revenue Service, *Statistics of Income Bulletin,* Spring 2002. The dividend income reported in the SOI was adjusted to remove interest payments from mutual funds that the IRS requires to be reported as dividends, and to include personal trust dividend income that is reported elsewhere. See William G. Gale, "About Half of Dividend Payments Do Not Face Double Taxation," *Tax Notes*, November 11, 2002.

Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not levy any form of income tax and thus would not lose revenue.