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STATE REVENUE LOSSES FROM THE FEDERAL "DOMESTIC PRODUCTION DEDUCTION" WILL DOUBLE IN 2007

States Could Save Billions by Disallowing This Deduction

By Nicholas Johnson

In 2004, the federal government created an entirely new corporate tax break that is costing not only the federal government but also 29 states a large, and growing, amount of money. Known as the "domestic production deduction," the tax break allows many corporations to claim a tax deduction equal to a percentage of certain profits from their U.S. operations. Since most states base their own tax codes on the federal tax code, the tax break was implicitly carried over into many states at the expense of state treasuries.

The new deduction allows companies to claim a tax deduction based on profits from "qualified production activities," a sweeping category that goes well beyond manufacturing to include such diverse activities as food production, filmmaking, and utilities — a substantial share of states' corporate income tax base.

Initially, the revenue loss to states was relatively modest because the deduction was limited to three percent of qualifying income. As of January 1, 2007, however, the percentage rate is rising to six percent, with another increase to nine percent scheduled for 2010. As a result, revenue losses to states likely will double over the coming year and will at least triple by 2010. Federal estimates suggest that allowing this deduction is likely to cost states more than five percent of their corporate tax revenue, plus a portion of their individual income tax receipts.

States are not required to allow this deduction. Indeed, some 18 states already have chosen to disallow it. But

KEY FINDINGS

- **The "domestic production deduction" — sometimes also known as the "qualified production activities income" or QPAI deduction — is a large corporate tax break enacted by the federal government in 2004. It is doubling in size in 2007, and tripling by 2010.**
- **Some 18 states have disallowed the deduction, even though states typically base their tax codes on the federal. But 29 other states allow it, costing them a billion dollars per year or more. (The rest are unaffected.)**
- **The tax break is unjustified as state economic policy. The main beneficiaries are large, profitable, multi-state corporations. They can benefit even if they have *no* in-state employees.**
- **Disallowing the deduction is administratively straightforward. The revenue that would be saved can be used for other, more productive purposes.**

TABLE 1 STATE TREAMENT OF THE IRC SEC. 199 DOMESTIC PRODUCTION DEDUCTION			
State Name	**Allow the deduction?**	**State Name**	**Allow the deduction?**
Alabama	Yes	Missouri	Yes
Alaska	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	Yes
District of Columbia	Yes	North Carolina	No
Florida	Yes	North Dakota	No
Georgia	No	Ohio	Yes
Hawaii	No	Oklahoma	Yes
Idaho	Yes	Oregon	No
Illinois	Yes	Pennsylvania	Yes
Indiana	No	Rhode Island	Yes
Iowa	Yes	South Carolina	No
Kansas	Yes	South Dakota	N/A
Kentucky	Yes	Tennessee	No
Louisiana	Yes	Texas	No
Maine	No	Utah	Yes
Maryland	No	Vermont	Yes
Massachusetts	No	Virginia	Yes
Michigan	Yes	Washington	N/A
Minnesota	No	West Virginia	No
Mississippi	No	Wisconsin	Yes
		Wyoming	N/A

Notes:
Alabama – Allow deduction on corporate tax only.
Michigan – No corporate income tax – deduction is allowed on personal income tax. 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 – Deduction is allowed for gross receipts from qualifying production property which was manufactured or produced by the taxpayers, but not for gross receipts from other qualifying production property including property that was grown or extracted by the taxpayer.
Pennsylvania – Deduction allowed 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.

another 29 states plus the District of Columbia continue to permit it. (Four states are unaffected.) If they continue to do so, the tax break will cost those states some $800 million to $1.3 billion in fiscal year 2008, rising to $1.2 billion to $1.9 billion in years after 2010. (These estimates are based on current levels of corporate profits and are likely to rise over time.)

There is no good reason why states should accept such revenue loss. The beneficiaries of the deduction are likely to be mostly large, profitable corporations — including many multi-state corporations — and their shareholders. The 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.

Decoupling from the domestic production 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.

Indeed, decoupling might even spare a state entanglement in the extensive administrative and legal action that is likely to occur in coming years. The Internal Revenue Service has stated that the provision is complex and difficult for taxpayers to understand. It also has noted that it is subject to abuse. States that conform to the federal provision are likely to become involved with these difficult and time-consuming enforcement issues.

Lastly, it is important to note that decoupling from the provision can be accomplished without regard to whether or not states conform to other aspects of federal tax law. States have good reasons to want to conform to other federal tax changes that were enacted at the same time as the Domestic Production Deduction; states may do so while decoupling from this problematic provision.

State Actions to Decouple from the Section 199 Domestic Production Deduction

As of December 2006, some 18 states have decoupled from Section 199, the portion of the Internal Revenue Code that created the Domestic Production Deduction. Arkansas, California, 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 deduction, according to a survey by the Federation of Tax Administrators and information from state tax departments. A 19th state, New Jersey, has partially decoupled.

Most of those states still conform 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 conform 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 have conformed to the 2004 elimination of some costly and inappropriate tax shelters. But conforming to those other provisions does not require conformity to Section 199, nor do the merits of the other provisions enacted at the same time make conformity to Section 199 good state policy.

TABLE 2 PROJECTED REVENUE LOSS IN STATES THAT STILL ALLOW THE DOMESTIC PRODUCTION DEDUCTION			
State	**Revenue Loss (in millions of dollars)**	**State**	**Revenue Loss (in millions of dollars)**
Alabama	24 to 38	Missouri	23 to 36
Alaska	29 to 47	Montana	7 to 12
Arizona	39 to 63	Nebraska	13 to 21
Colorado	26 to 42	New Mexico	13 to 21
Connecticut	36 to 58	New York	220 to 355
Delaware	13 to 21	Ohio	70 to 113
Florida	85 to 139	Oklahoma	19 to 30
Idaho	10 to 16	Pennsylvania	18
Illinois	105 to 170	Rhode Island	12 to 19
Iowa	14 to 22	Utah	18 to 28
Kansas	19 to 31	Vermont	4 to 7
Kentucky	42 to 69	Virginia	52 to 83
Louisiana	15 to 24	Wisconsin	48 to 78
Michigan	85 to 138	Washington DC	2
		TOTAL	$1.2 to $1.9 billion

Projected revenue loss is based on full implementation at the nine percent level (tax years 2010 and later) applied to actual revenue collections in state fiscal year 2006.
See Appendix for sources and methodology.

Decoupling from the Domestic Production Deduction Is Fiscally Responsible

The federal deduction for domestic production — sometimes also known as the "Qualified Production Activities Income" or QPAI deduction — is broad in its scope and therefore costly in its fiscal impact. Deductible 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 law, businesses in 2007, 2008 or 2009 can claim a deduction equal to six percent of QPAI income, with the percentage rising to nine percent in 2010 and years thereafter.

The domestic production 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. Similarly, most states begin their corporate income tax calculations with federal "taxable income" from the federal corporate tax form. 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.

To understand how this deduction affects state income taxes, consider a hypothetical corporation with $1 million in "domestic production" income, located in a state with a five percent corporate income tax rate. In 2010, nine percent of that income will be deductible — meaning the corporation gets to claim $90,000 of profits as tax-free income. At a tax rate of five percent, the corporation gets a tax break worth $4,500.

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, 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. No data are yet available from the IRS that would indicate the extent to which corporations are claiming this deduction. The Joint Committee on Taxation, which estimates federal revenue impacts for Congress, estimates that the Section 199 provision cost the federal government $3.6 billion in federal fiscal year 2006, when three percent of qualified income was deductible. As the deductible percentage rises to six percent in the tax year 2007 and to nine percent in 2010, the revenue loss also will rise. 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 federal revenue loss of $22.3 billion by fiscal year 2011.

These JCT and OMB estimates equal 3.6 percent to 5.8 percent of projected federal revenue from corporate income taxes plus another 0.2 percent to 0.4 percent of projected revenue from personal income taxes. It is reasonable to think that states could face losses of comparable size. Thus it is possible to make a reasonable projection based on the Joint Tax and OMB estimates. If the deduction had been in full effect in FY 2006 and all states had conformed, the cost to states would have equaled $2.2 billion to $3.5 billion. State-by-state amounts are shown in Table 1 for the states that continue to conform; the Appendix provides additional data and explains how these figures were calculated.

The divergence between the JCT and OMB estimates reflect continued uncertainty about exactly how the deduction is working in practice, given the likelihood that corporate tax accountants are devising new ways of exploiting it. The 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, wrote at the time of passage:

> 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

[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.

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 interpretations and enforcement actions. It is unclear how effective the IRS can be at limiting excessive Section 199 claims, given that its budget is declining in real terms as its workload rises. As a recent IRS directive notes drily, "Due to the complexity of the law, there is the potential to spend substantial audit resources in an examination"[4] – resources which the IRS may or may not have available.

Decoupling from Section 199 Is Administratively Feasible

From an administrative perspective, decoupling from the domestic production deduction is likely to be relatively straightforward: simply require an add-back of the deduction amount to federal taxable income.

Such decoupling from federal tax changes has become routine in the last several years.

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

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

- Some 18 states 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 over their useful lives.

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 deduction and prevent abuse.

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[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.
[4] *Industry Director Directive on Domestic Production Deduction (DPD),* December 6, 2006, downloaded from http://www.irs.gov/businesses/article/0,,id=164979,00.html.

Administrative Problems Predicted with the Domestic Production Deduction

In a letter to Congress discussing the domestic production deduction provision of the federal tax bill that included the domestic production 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.

Disallowing the Domestic Production Deduction Is Good Economic Policy

The domestic production 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 deduction is unlikely to achieve it.

- The domestic production 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 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 domestic production deduction would have no direct relationship to jobs or income within that state. A state that conforms to Section 199 would have no guarantee that the income claimed under the deduction 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 multi-state firm could use a state's domestic production deduction to reduce its state corporate income taxes without having a single production employee in that state.*

- Revenue lost from Section 199 conformity is unavailable for other, more economically beneficial investments. This occurs because states must balance their budgets. Conforming to Section 199 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.

Section 199 Decoupling Need Not Affect Conformity to the Rest of the Federal Tax Code

The federal law that created the deduction – P.L. 108-357, the American Jobs Creation Act of 2004 – has dozens of provisions that were unrelated to the domestic production deduction. Most states decoupling from Section 199 nevertheless conformed to other provisions. For instance, a major provision of the bill phased out a tax shelter for "extra-territorial income" (ETI) from foreign exports because the World Trade Organization had said the ETI exclusion is illegal under international law. States that allowed this exclusion are conforming 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.

Some advocates of conformity sought to depict the domestic production deduction as a "swap" for elimination of the ETI exclusion, as well as for elimination of other tax shelters, both for individual corporate taxpayers and for the state as a whole. But such a depiction is inaccurate. For one thing, the overall cost of the domestic production deduction when fully implemented is estimated to be some 70 percent larger than the revenue gained from the ETI change, according to the original estimates from the Joint Committee on Taxation. And corporations that benefit from the new deduction often are not the same ones that are losing due to elimination of the ETI exclusion. The ETI exclusion generally has been for exporters only; the domestic production 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 new corporate tax break instead of, say, broader-based tax reductions, new public-sector investments, or new rainy-day fund investments.

Appendix
Calculating the Impact of the Domestic Production Deduction

The state estimates in this paper represent an approximation of the potential impact of the domestic production 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 the deduction on corporate and personal income tax revenues.[5] These figures were divided by the Congressional Budget Office's projections of actual corporate and personal income tax revenues for those years. The figure used for the JCT estimate is for 2009, at which time the percentage rate of the deduction will equal six percent. The following year, the deduction will rise to nine 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 the new deduction would reduce corporate tax revenues by about 3.6 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.[6] The OMB projections indicate that when fully implemented, the domestic production deduction will reduce corporate tax revenues by about 5.8 percent and personal income tax revenues by 0.4 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 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 and yields results that are larger in dollar terms. This is in part due to newly available JCT and OMB data. It is also due to the recent increase in corporate profits and hence corporate income tax revenue in most states, which means that the base for computing the impact of the new deduction is larger.

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 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 or OMB estimates as a starting point, but rather generate their own estimates based on state-level data on production activities.

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[5] Joint Committee on Taxation, Estimates Of Federal Tax Expenditures For Fiscal Years 2006-20010, April 25, 2006, p. 35. Available at http://www.house.gov/jct/s-2-06.pdf.

[6] Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2007*, p. 292. Available at http://www.whitehouse.gov/omb/budget/fy2007/.

TABLE 3 POTENTIAL ANNUAL REVENUE LOSS IF DOMESTIC PRODUCTION DEDUCTION IS STILL ALLOWED WHEN FULLY PHASED IN (DOLLARS IN MILLIONS)			
State	**Potential Revenue Loss**	**State**	**Potential Revenue Loss**
Alabama	**24 to 38**	**Nebraska**	**13 to 21**
Alaska	**29 to 47**	**Nevada**	**n/a**
Arizona	**39 to 63**	New Hampshire	20 to 33
Arkansas	17 to 28	**New Jersey***	**126 to 205**
California	487 to 790	**New Mexico**	**13 to 21**
Colorado	**26 to 42**	**New York**	**220 to 355**
Connecticut	**36 to 58**	North Carolina	68 to 110
Delaware	**13 to 21**	North Dakota	5 to 8
Florida	**85 to 139**	**Ohio**	**70 to 113**
Georgia	*49*	**Oklahoma**	**19 to 30**
Hawaii	9 to 14	*Oregon*	*27*
Idaho	**10 to 16**	***Pennsylvania***	***18***
Illinois	**105 to 170**	**Rhode Island**	**12 to 19**
Indiana	47 to 76	South Carolina	18 to 30
Iowa	**14 to 22**	**South Dakota**	**n/a**
Kansas	**19 to 31**	Tennessee	33 to 54
Kentucky	**42 to 69**	Texas	52 to 86
Louisiana	**15 to 24**	**Utah**	**18 to 28**
Maine	10 to 16	**Vermont**	**4 to 7**
Maryland	*40*	**Virginia**	**52 to 83**
Massachusetts	*42*	**Washington**	**n/a**
Michigan	**85 to 138**	West Virginia	22 to 36
Minnesota	54 to 87	**Wisconsin**	**48 to 78**
Mississippi	15 to 25	**Wyoming**	**n/a**
Missouri	**23 to 36**	***Washington DC***	***2***
Montana	**7 to 12**	TOTAL	$2.2 to $3.5 billion
		Total – conforming states only	**$1.2 to $1.9 billion**

Amounts shown are the range of potential impacts had QPAI been in full effect in state fiscal year 2006.
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 allow the deduction. *New Jersey partially allows the deduction.

For example, the figure in Table 3 for Massachusetts is based on the state Department of Revenue's estimate. The Massachusetts Department of Revenue estimated that the revenue loss for tax year 2005 (when the credit equals 3 percent of eligible income) would have been $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 have equaled $42 million. The figures in Table 3 for the District of Columbia, Georgia, Maryland, Oregon and Pennsylvania were also derived from state estimates using a similar methodology.