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

*Special Series* | **Dealing with Deficits: How States Can Respond**

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# OBSCURE TAX PROVISION OF FEDERAL RECOVERY PACKAGE COULD WIDEN STATE BUDGET GAPS

## States Can Avoid Revenue Loss by "Decoupling"

By Michael Mazerov

**KEY FINDINGS**

- A federal tax break in the federal recovery package could cost states up to $5.5 billion in revenue over the 2009-2011 period unless they "decouple" their tax codes from the provision.
- The provision allows businesses that buy back their debt at a discount to wait four years before beginning to pay taxes on the income the discount represents.
- Forty-three states could lose revenue from the provision because their tax laws are linked to the federal code. (Florida, Maryland and Minnesota have already decoupled.)
- In other similar situations, states have used decoupling to protect their revenues from changes in federal tax laws.
- States that fail to decouple could lose substantial amounts of revenue to provide tax savings to multistate corporations that have few facilities or employees in the state. There is no economic justification for conforming to the provision. If anything, doing so will hurt the state economy.

States could lose up to $5.5 billion in business income tax revenues over the next three years as a result of a little-known provision in the federal economic recovery package enacted in February. States can, however, easily avoid this revenue loss by making offsetting changes in their tax laws.

For states to allow this unnecessary revenue loss makes little sense given their current fiscal conditions. State revenues have already been hard hit by the recession, with workers losing jobs and income, retail sales declining sharply, and corporate profits plunging. Forty-seven states confront more than $350 billion in gaps between projected spending and available revenues in the 2009-2011 fiscal years. The fiscal relief in the federal recovery legislation will bridge only about 40 percent of that gap, compelling the states to raise revenues, cut spending, and tap reserves to close the rest. Numerous states have already enacted cuts in K-12 and higher education, health care, human services, and aid to local governments; many more such cuts probably lie ahead.

The provision in question is generally referred to as the "cancellation of debt income" (CODI) provision. When a business or a person borrows money, the amount borrowed is not considered taxable income because it must be repaid. However, if the lender forgives part or all of the loan, the borrower must count the amount forgiven as taxable "cancellation of debt income." Similarly, if a business is able to repurchase its debt on the open

market at a discount, it must count the amount of that discount as CODI. (This could happen if corporate debt falls in value — for instance, if interest rates rise after the debt was issued or if the company's finances worsen enough to lead bond-holders to fear that the corporation might default.) The amount of CODI is expected to spike in the next few years because of the large volume of devalued debt that is available in the marketplace and fewer profitable investment opportunities for excess corporate cash.

Normally, the CODI (like any other taxable income) is taxed in the same year that it is earned. The recovery legislation, however, permits businesses that repurchase their debt in 2009 and 2010 to defer reporting the CODI as taxable income until 2014 and then to spread this income over the five tax years from 2014 through 2018.

Most states' income tax codes are based on federal law, so in most states the CODI provision will cut state revenues as well as federal revenues. Because the provision was retroactive to the beginning of 2009, and because businesses have to pay estimated taxes each calendar quarter, some states could feel the impact as early as the current quarter. State revenue losses will be concentrated in the 2010 and 2011 fiscal years, however, which begin for most states on July 1 of each year.

*States can easily protect themselves from this significant revenue loss.* Specifically, they can amend their tax laws to "decouple" their definition of gross income from the new CODI provision. In recent years, more than 30 states have taken similar action to avoid a revenue loss arising from the "bonus depreciation" tax provision of previous federal recovery bills. (The 2009 recovery bill extends this provision, and many states are likely to decouple from it as well.[1]) In other words, decoupling from the CODI provision would be neither unprecedented nor radical.

Table 1 provides state-by-state estimates of the revenue losses that states affected by the CODI provision could experience. (All states except Nevada, Texas, Washington, and Wyoming could be affected to some extent.) These estimates should be viewed as reflecting rough orders of magnitude since they assume that the revenue losses are spread among the states in proportion to their existing business tax collections. In actuality, only certain businesses are likely to be able to take advantage of the CODI provision, and there is no way to predict exactly which businesses those are or to which states they currently pay income taxes.

The remainder of this analysis examines the following questions:

- Which states might the CODI provision affect — and when?
- How can states decouple from the provision, and which ones already have?
- How much revenue could states lose if they do not decouple?
- Would conforming to the CODI provision give states any benefits that outweigh the revenue loss?

[1] See: Nicholas Johnson, "New Federal Law Could Worsen State Budget Problems," Center on Budget and Policy Priorities, revised February 28, 2008, www.cbpp.org/files/2-13-08sfp.pdf.

| TABLE I: APPROXIMATE REVENUE LOSS IN EACH STATE FROM CONFORMITY TO "CANCELLATION OF DEBT INCOME" PROVISION OF FEDERAL STIMULUS LEGISLATION ($ MILLIONS) | | | | |
|---|---|---|---|---|
| **States That Conform Unless They Affirmatively "Decouple" ("Rolling Conformity" States)** | | | | |
| **State** | **FY09** | **FY10** | **FY11** | **FY09-FY11** |
| Alabama | 21 | 39 | 13 | 73 |
| Alaska | 31 | 80 | 43 | 154 |
| Colorado | 15 | 38 | 20 | 73 |
| Connecticut | 18 | 44 | 23 | 85 |
| Delaware | 8 | 22 | 12 | 42 |
| **Dist. of Col.** | **6** | **11** | **3** | 20 |
| Illinois | 79 | 203 | 108 | 390 |
| **Kansas** | **6** | **14** | **5** | 25 |
| Louisiana | 19 | 48 | 25 | 92 |
| Massachusetts | 59 | 152 | 80 | 292 |
| Michigan | 94 | 173 | 57 | 323 |
| Missouri | 13 | 31 | 16 | 60 |
| Montana | 4 | 11 | 6 | 22 |
| Nebraska | 6 | 16 | 9 | 32 |
| New Jersey | 74 | 191 | 102 | 367 |
| New Mexico | 8 | 21 | 11 | 40 |
| **New York** | **0** | **200** | **200** | 400 |
| North Dakota | 4 | 11 | 6 | 21 |
| Ohio | 7 | 15 | 7 | 29 |
| Oklahoma | 11 | 27 | 14 | 52 |
| Pennsylvania | 57 | 145 | 77 | 279 |
| Rhode Island | 4 | 11 | 6 | 20 |
| Tennessee | 22 | 57 | 30 | 109 |
| Utah | 11 | 29 | 15 | 56 |
| Vermont | 2 | 6 | 3 | 12 |
| **States That Have to Take Action to Conform ("Fixed-Date" Conformity States)** | | | | |
| | **FY09** | **FY10** | **FY11** | **FY09-FY11** |
| Arizona | 18 | 48 | 25 | 91 |
| Arkansas | 9 | 24 | 13 | 46 |
| California | 262 | 668 | 354 | 1284 |
| Georgia | 28 | 70 | 37 | 135 |
| Hawaii | 4 | 9 | 5 | 18 |
| Idaho | 5 | 14 | 7 | 26 |
| Indiana | 24 | 61 | 32 | 117 |
| Iowa | 10 | 25 | 13 | 49 |
| Kentucky | 13 | 33 | 17 | 63 |
| Maine | 5 | 13 | 7 | 26 |
| Mississippi* | 10 | 25 | 13 | 48 |
| New Hampshire | 14 | 36 | 20 | 70 |
| North Carolina | 34 | 85 | 45 | 164 |
| **Oregon** | **13** | **13** | **1** | 27 |
| South Carolina | 10 | 24 | 13 | 46 |
| South Dakota | 2 | 4 | 2 | 8 |
| Virginia | 25 | 62 | 32 | 119 |
| **West Virginia** | **0** | **3** | **10** | 13 |
| Wisconsin | 24 | 60 | 32 | 116 |
| | | | | |
| **US Total** | **1088** | **2872** | **1571** | **5531** |

Estimates for states shown in bold have been prepared by the states themselves.
*Mississippi is not tied to federal definition of federal taxable income but could choose to conform.

## Which States Might the CODI Provision Affect — and When?

All types of businesses can potentially repurchase their debt and therefore realize cancellation of debt income. Large corporations are likely to make the vast majority of such repurchases; for them, the CODI will be taxable on their federal and state corporate income tax returns. Many smaller and mid-sized businesses are organized as "Subchapter S corporations," partnerships, and "limited liability companies," which are exempt from corporate income taxes; their owners report the firm's income on their *personal* income tax returns.

Thus, the CODI provision could affect any state that has a corporate income tax or a personal income tax. Every state except Nevada, Texas, Washington, and Wyoming has at least some businesses subject to one or both types of taxes and therefore is potentially affected by the provision.[2] The District of Columbia is potentially affected as well.

The point at which a state could begin to lose revenue depends on how it updates its tax code:

- **"Rolling conformity" states may already be losing revenue.** The tax codes of some 25 states plus the District of Columbia automatically and immediately reflect many changes made to federal tax laws. This is often called "rolling conformity." The states that have rolling conformity for their corporate income taxes are shown in the top portion of Table 1.[3] Unless they decouple from the CODI provision, rolling conformity states could begin experiencing some revenue loss as early as the current quarter if any businesses subject to personal or corporate income taxes in the state repurchased debt on or after January 1 of this year.

  Initially, the revenue loss would take the form of reduced quarterly estimated tax payments by the businesses. Later, it would be reflected in lower income tax payments reported on the businesses' final tax returns for the year.

- **"Fixed-date conformity" states could lose revenue when they update their tax laws.** The personal and/or corporate tax codes of the remaining 21 states are written in such a way that they reflect the federal tax code as it exists on a particular date.[4] This is generally referred to as "fixed-date conformity." In most of these states, each year the legislature passes a bill to roll that date forward so that the tax code incorporates any federal tax changes enacted since the previous conformity date.[5] (The conformity date is usually December 31 or January 1.)

  If any fixed-date conformity state rolls its date forward to a day between February 17, 2009 (the date President Obama signed the recovery bill into law) and December 31, 2010 (inclusive), it

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[2] South Dakota has neither a personal income tax nor a general corporate income tax. However, it does have a special corporate income tax that applies only to financial institutions, which could receive cancellation of debt income.

[3] Some states may have rolling conformity for their corporate income taxes and fixed-date conformity for their personal income taxes — or vice versa. Since the vast majority of the revenue losses from the CODI provision will occur in state corporate income taxes, the categorization of the states in this report focuses on those taxes. However, the revenue impact estimates presented in Table 1 include the impact on personal income taxes of CODI received by S corporations, limited liability companies, and partnerships.

[4] Among all the states, Mississippi alone does not conform to federal definitions of taxable income and will not be affected by the CODI provision unless it explicitly chooses to. Although that is unlikely, it is possible. Accordingly, Mississippi is treated as a fixed-date conformity state in Table 1.

[5] California's current federal conformity date is January 1, 2005. Like Mississippi, however, California is listed in Table 1 because it is possible that policymakers could choose to conform to the CODI provision.

will lose revenues if it does not explicitly decouple from the CODI provision.

## How Can States Decouple from the CODI Provision, and Which Ones Already Have?

Decoupling from the CODI provision requires a simple, straightforward change to state corporate and personal income tax laws. The state must modify the relevant sections of state law to require taxpayers to add to their state taxable income any cancellation of debt income received in the applicable tax year but excluded from federal gross income due to Section 1231 of the American Recovery and Reinvestment Act of 2009.[6] States with rolling conformity can add that language at any time. States with fixed-date conformity would likely add that language in the legislation that would otherwise trigger the CODI provision by rolling the conformity date forward.[7]

A few states face tighter constraints on their ability to decouple. Since the CODI provision is already part of federal law, it is already in effect under state law in rolling conformity states. Reversing it might therefore be considered a tax increase, and there are a few rolling conformity states that require supermajority votes of the legislature to raise taxes. Most states with rolling conformity, however, could decouple with the normal majority votes in both houses of the legislature followed by the governor's approval.

At this writing, one state with rolling conformity—Maryland—has already decoupled from the CODI provision. Two fixed-date conformity states—Florida and Minnesota—rolled their conformity dates forward and decoupled from the CODI provision. Two fixed-date conformity states — Idaho and West Virginia — enacted legislation rolling their conformity dates forward to conform to the tax changes in the federal recovery package *without* decoupling from the CODI provision.

## How Much Revenue Could States Lose If They Do Not Decouple?

The federal government expects to lose $38 billion over fiscal years 2009-2011 as a result of the CODI provision. Table 1 estimates how much individual states stand to lose from CODI if they do not decouple. These estimates assume that all states with personal and/or corporate income taxes fully conform to the CODI provision by the end of 2009, and that the amount of income that will be eligible for the CODI tax break is distributed among the states in proportion to current state business income tax revenues. Under these two assumptions, *the states that have not already decoupled would suffer a collective revenue loss of approximately $5.5 billion over their 2009, 2010, and 2011 fiscal years.*

These estimates should be viewed as the rough order of magnitude of potential revenue losses. In reality, it is extremely difficult to estimate accurately the impact of the CODI provision on a specific state. While many other federal tax changes (such as the "bonus depreciation" tax break noted above) can be expected to benefit a broad cross-section of businesses, the specific companies that are likely to pay less tax as a result of the CODI provision cannot be readily identified with publicly-available information. They must conform to a rather unique profile:

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[6] This section of ARRA added Subsection (i) to Section 108 of the Internal Revenue Code.

[7] States that decouple also need to add language to their codes allowing for a subtraction in 2014-2018 of CODI that arose during 2009 and 2010. That income will be reported on 2014-2018 federal tax returns and transferred over to conforming state tax returns. Without such an allowed subtraction, the income would be taxed twice.

- They must have issued bonds or other debt that has fallen in value since they issued it.

- They must be profitable. (If a corporation with cancellation of debt income is losing money overall, it is not paying any income tax to begin with.)

- They must either have enough cash on hand to buy back the debt or be sufficiently credit-worthy to have lenders willing to issue them new debt with which to retire the old debt.

The businesses satisfying these criteria are likely to be a fairly select group. There is virtually no way for a state to know whether the particular companies that compose its corporate and small business income tax base are likely to fall into that group in 2009 and 2010, the years covered by the CODI provision. Thus, the impact on state revenues of conforming to the provision is difficult to determine.

This uncertainty is a strong argument in favor of decoupling from the CODI provision. For many states, the estimated revenue losses shown in Table 1 are sufficiently large to be of concern. But states could actually experience much larger losses than those shown here if major corporations subject to their corporate income taxes engage in large debt buy-backs. States may not wish to run that risk, especially in light of their current fiscal stresses.

## Would Conforming to the CODI Provision Give States Any Benefits That Outweigh the Revenue Loss?

Though enacted as part of the federal recovery package, the CODI provision's effectiveness in stimulating the economy is highly questionable. If anything, it could be counterproductive.

Evaluating the tax components of the recovery package in February 2009, the Urban-Brookings Tax Policy Center gave the CODI provision a *C-minus*, the second-lowest grade that any of the package's general business tax provisions received. The authors explained:

> Because [debt buy-back] transactions may both reduce leverage and boost earnings, they appear to already be occurring despite the tax businesses must pay on the trades. Thus, in many cases the new tax benefit may subsidize debt repurchase or exchange that would occur anyway, resulting in a windfall and generating little new economic activity.
>
> In addition, the beneficiaries of this tax break are those that have sufficient cash to repurchase debt. Almost by definition, these businesses are in less need of assistance than cash-constrained competitors. Similarly, this tax break would provide no additional cash flow to unprofitable companies that are paying no tax.[8]

The CODI provision is even more questionable as *state* tax and economic policy. Giving corporations an incentive to reduce their indebtedness may or may not help the national economy in the long run, but it would not help any particular state's economy. To the contrary, because of state balanced-budget requirements, states will likely have to enact some combination of tax increases or

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[8] Rosanne Altshuler *et al.,* "Tax Recovery Report Card, Conference Bill as of February 13, 2009," Urban-Brookings Tax Policy Center, pp. 29-30.

expenditure cuts to offset the revenue losses they experience by conforming to the provision; both measures withdraw demand from state economies and reduce economic growth and job creation.[9]

Moreover, the corporations that would benefit from a state's conformity with the CODI provision are not necessarily the ones that are economically important to the state. A substantial share of state corporate tax revenue often comes from out-of-state corporations that have significant sales in the state but relatively little investment and relatively few employees there. Indeed, states are increasingly shifting their corporate taxes to out-of-state companies by granting large tax incentives for in-state investment and by changing the formulas they use to determine the share of a multistate corporation's nationwide profit subject to taxation. As a result, a state conforming to the CODI provision could well end up losing a great deal of corporate tax revenue primarily to benefit multistate corporations with few facilities or employees in the state.

One argument against decoupling is that it would create an additional record-keeping requirement for businesses with CODI. (This is because the CODI they would report for federal tax purposes would differ from the CODI they report for state tax purposes.) However, the added paperwork is minor compared to the many other disparities between federal and state corporate tax structures that are required by federal law[10] or that a majority of states have created through past policy choices.[11] The trivial record-keeping requirements that corporations that choose to take advantage of the CODI provision may experience in exchange for very large federal tax reductions should not dissuade any state from protecting its tax base and economy.

## Conclusion

If states choose to conform to the federal CODI provision, they will needlessly compound the already serious revenue declines caused by the recession. That, in turn, will necessitate even deeper spending cuts and tax increases, which are likely to slow states' economies and reduce employment. In many cases, the primary beneficiaries would be out-of-state corporations that have few if any facilities within the state and only a small number of employees.

Confronted with similar problem when the federal "bonus depreciation" tax cut threatened to reduce state revenues, a large number of states chose to protect their revenues by decoupling. State policymakers would be well advised to consider following the same strategy with the CODI provision.

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[9] A strong case can be made, however, that state tax increases are likely to have a less adverse impact on state economic growth than an equivalent amount of state spending cuts. See: 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, revised November 6, 2001, www.cbpp.org/archiveSite/10-30-01sfp.pdf.

[10] For example, court decisions interpreting the Constitution bar states from requiring corporations to file the combined or "consolidated" returns for parent and subsidiary corporations that they use for federal tax purposes.

[11] For example, a large majority of states have long disallowed so-called net operating loss carrybacks, and more than 30 states decided not to conform to earlier rounds of "bonus depreciation" in previous federal economic recovery bills.

## Appendix:
## Revenue Loss Estimating Methodology

The congressional Joint Committee on Taxation estimated the federal revenue impact from the CODI provision for each federal fiscal year from 2009 through 2019. These estimates were used to calculate the *percentage* reductions in total federal corporate income tax and personal income tax receipts resulting from the CODI provisions for federal fiscal years 2009, 2010, and 2011 using the January 2009 Congressional Budget Office forecasts of total corporate and personal income tax receipts for each of those years. (JCT staff informally estimated that 90 percent of each year's loss occurred in the federal corporate income tax and 10 percent occurred in the personal income tax.)

*Federal* fiscal year 2008 state corporate income tax and personal income tax receipts were calculated for each state using the Census Bureau's quarterly receipts data series. The 2008 receipts were inflated to 2009, 2010, and 2011 assuming that each state's receipts would grow at the same rate as the comparable federal tax (again, using the CBO forecast). State-by-state revenue losses were then calculated by assuming that the same percentage reductions in corporate and personal income tax receipts that occurred at the federal level would occur in each state in each of the three years due to conformity with the CODI provision. (These estimates of course took into account that several states had only one tax affected.)

Finally, the estimated state revenue losses that had been calculated on a federal fiscal year basis were shifted to a state fiscal year basis. The federal fiscal year ends on September 30; most states' fiscal years end on June 30. Thus, for such states, the *state* fiscal year 2010 revenue loss (for example) was estimated by adding one-fourth of the 2009 revenue loss calculated on a federal fiscal year basis (representing the first three months of the state fiscal year, July, August, and September 2009) and three-fourths of the 2010 revenue loss calculated on a federal fiscal year basis (representing the months of October 2009 through June 2010).