FEDERAL TAX LEGISLATIVE CHANGES AND STATE CONFORMITY

LeAnn Luna and *Ann Boyd Watts,* The University of Tennessee

INTRODUCTION

BEGINNING IN 2002, CONGRESS PASSED A SERIES OF tax acts in response to the terrorist attacks of September 11, 2001 and to stimulate the economy out of the subsequent recession. The initial legislation was followed by two additional significant tax acts that promoted a variety of incentives for firms at the federal tax level. Although all eligible U.S. firms benefited from these tax incentives at the federal level, states have wide latitude regarding their own tax policy and can choose to decouple or not conform to these or other federal provisions. Despite this flexibility in designing tax policy, most states now follow the federal lead on matters of the income tax and broadly accept the federal tax base as a starting point for their own calculations of state corporate taxable income (Fox and Swain, 2007). Although broad conformity to federal taxable income is a common practice, most states do not conform to one or more specific provisions of the Internal Revenue Code (IRC) (Gravelle and Gravelle, 2007).

This paper investigates states' decisions to decouple from the federal tax base. We examine in detail nine specific tax deductions or credits that have been adopted by some states and decoupled from by others. These nine tax provisions include those that have existed for several years in the Internal Revenue Code (IRC) as well as recently enacted items. The provisions represent temporary tax deductions, permanent tax deductions, and tax credits. In this examination, we specifically look at the characteristics of a state's corporate income tax system as well as economic and political factors to determine whether these factors explain decisions to decouple from federal tax legislation.

BACKGROUND ON FEDERAL/STATE TAX CONFORMITY

Despite the wide latitude states possess regarding their tax system, 46 states impose a corporate income tax, with Texas and Michigan imposing nontraditional versions (discussed later), and virtually all of those states rely heavily on the federal income tax base as a starting point for their own tax calculations. States have a number of incentives for broadly conforming to the federal income tax base. Conformity allows states to rely on federal codes and regulations as well as related judicial decisions. States that have broad conformity can also piggyback on federal tax audits and professional education programs, participate in data exchange programs, and cooperate in compliance initiatives such as recent efforts targeting tax shelters. For these and other reasons, 93.4 percent of states used federal income as a starting point in 2005 versus only 56.1 percent in 1967 (Hildreth et al., 2005).

From a taxpayer's standpoint, conformity also has significant benefits. Most important are the administrative and compliance benefits of a (more or less) parallel federal and state income tax regime. For example, businesses located in states that adopt federal depreciation rules need only keep one set of depreciation records. Taxpayers and tax preparers would also begin tax returns with federal taxable income and only then need to account for the specific state differences that might relate to the manufacturing deduction in this example. Conformity also benefits day-to-day business decision-making, since the tax effects of a particular transaction are generally the same for both federal and state tax purposes with the exception of the applicable marginal corporate tax rate.

Despite the many incentives to conform, all states have legislated departures from federal law. There are several reasons for the many exceptions to the norm of conformity. First of all, the state budgetary impact of a federal change is not often taken into account by Congress. For example, in the period following September 11, 2001, the federal government intended to provide substantial business incentives in an effort to combat the recession. At the federal level, the revenue losses were financed through deficits—an option most states simply do not have. State governments that conformed to the most generous federal incentives confronted revenue losses estimated in the billions. This was at a time when budget demands were high and no easy financing options were available to the states. The states were faced with the decision to cut expenditures during a recession, a difficult

proposition, or to raise other taxes to finance the business incentives.

States are also actively competing for increasingly mobile businesses. This competition has led to a number of concessions offered to important business groups. On a purely state level, the three-factor (sales, payroll, property) apportionment approach has been reformulated to favor asset-intensive activities such as manufacturing by increasing the sales factor and decreasing the importance of payroll and property (Klassen and Shackelford, 1998). This benefit is realized when a manufacturing firm produces goods in a state using an approach that heavily weights sales and then ships these goods to a state that uses the three-factor approach. On a broader level, the competition for businesses also encourages elected officials to conform to federal business tax incentives because decoupling will make their state less competitive with others that followed the federal lead.

Of course, the costs of decoupling are in some cases obvious, such as increased compliance costs for taxpayers and increased administration costs for state revenue departments (Faber, 2006). In the case of depreciation, for example, businesses in states that decouple must maintain two (or more) sets of books for their depreciable assets, and states are unable to rely on federal audits of depreciable assets. Other costs are less obvious. Businesses have become adept at exploiting the differences in state tax rules to reduce overall tax liabilities. For example, differences in the taxation of royalties enabled passive investment companies to emerge and systematically shift income from operating businesses to nontaxable entities located in tax sheltered localities (Bruce et al., 2007). And, the existence of combined reporting and separate reporting states facilitates income shifting from high to low-tax states. Furthermore, there is some concern that states are engaged in a "race to the bottom" with regard to corporate income taxes (see Duncan and Luna (2007) for a full discussion of federal/state relationships).

Background on Federal Tax Provisions

We examine nine federal tax provisions, representing temporary tax deductions, permanent tax deductions, and tax credits. A temporary deduction reduces both taxable income and pretax book income; however, the period in which the temporary deduction occurs is not the same period for book and tax purposes. A permanent deduction only reduces taxable income but does not change book expenses or pretax book income. In other words, with a permanent deduction the item will never be included in taxable income. However, with a temporary item, it is just a timing issue of when the item will be included in taxable income (Mills and Plesko, 2003). Generally speaking, a tax credit is more valuable than an equivalent tax deduction because a tax credit represents a direct dollar-for-dollar reduction of taxes owed. A tax deduction, regardless of whether it is temporary or permanent, only reduces the amount of tax owed by the amount of the deduction times the marginal tax rate. In the following discussion, we briefly explain the nine federal tax provisions, organized by type of incentive, to give the reader some sense of the magnitude of the federal provisions and the impact on businesses from decoupling from the provisions.

Temporary Tax Deductions

1. ***ACRS and MACRS***. The Tax Reform Act of 1986 (P.L. 99-514) created a number of changes in the way depreciation was calculated for all assets acquired after December 31, 1986. This tax act made significant changes to the earlier Accelerated Cost Recovery System (ACRS) and created the modified ACRS (MACRS). In general, the recovery periods were extended. A 200 percent (double) declining-balance MACRS formula replaced the 150 percent declining-balance ACRS tables. Also, the recovery rate for real property fell from 175 percent declining-balance to a straight-line computation in MACRS, and in 1993, the recovery period for nonresidential real property was extended from 31.5 years to 39 years.
2. ***"Bonus" Depreciation.*** The federal Job Creation and Worker Assistance Act of 2002 (JCWAA) (P.L. 107-147) allowed taxpayers an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property acquired after September 10, 2001 and placed in service before May 6, 2003. The federal Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) (P.L. 108-27) increased the additional first-year depreciation allowance to 50 percent for qualified property acquired after May 5, 2003 and placed in service before January 1, 2005.

3. ***Asset Expensing Election***. JGTRRA increased the IRC §179 expense limitation from $25,000 to $100,000 and the investment limitation from $200,000 to $400,000. The federal American Jobs Creation Act of 2004 (AJCA) (P.L. 108-357) extended the increased IRC §179 asset expense and investment limitations, which were due to expire December 31, 2005, to December 31, 2007.

Permanent Tax Deductions

4. ***Dividends Received Deduction***. Under IRC §243, corporations generally may deduct 70 percent of dividends received from domestic corporations. The deduction is 80 percent if dividends are received from 20 percent-or-more owned corporations, except that dividends from small business investment companies and affiliated group members are 100 percent deductible. Under IRC §245, a 70 percent deduction is allowed for the U.S.-source portion of dividends received from 10 percent-or-more-owned foreign corporations. The deduction is 80 percent in the case the U.S.-source portion of dividends is received from 20 percent-or-more-owned foreign corporations. A 100 percent deduction is allowed for dividends received from wholly owned foreign subsidiaries as long as the dividends are out of earnings and profits for the tax year and the subsidiary's income is effectively connected with a U.S. business.
5. ***Domestic Manufacturing Deduction.*** AJCA created a new deduction for manufacturers (i.e., IRC §199) that will effectively reduce the federal corporate income tax rate for domestic manufacturing by 3 percent, from a top rate of 35 percent down to 32 percent. When fully phased in by 2010, the deduction will be equal to 9 percent of the lesser of qualified production activities income for the year or taxable income for the year.
6. ***Temporary Dividends Received Deduction***. The IRC §965 temporary dividends received deduction enacted under the federal AJCA allows corporate taxpayers to deduct 85 percent of the cash dividends received during the tax year by the corporate shareholder from controlled foreign corporations that are invested in the United States. The taxpayer may elect to apply the IRC §965 deduction for repatriated dividends to either the taxpayer's last tax year that begins before October 22, 2004 or the taxpayer's first tax year that begins during the one-year period beginning on October 22, 2004.

Tax Credits

7. ***Enterprise Zone Credit***. To encourage revitalization of economically distressed inner cities and rural areas, Congress authorized a federal program in the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) where selected geographic areas across the United States became eligible for special tax incentives and federal funding. From a set of areas nominated by state and local governments, the Department of Housing and Urban Development and the Department of Agriculture designated 104 areas for these special incentives.
8. ***Investment Tax Credit***. Until 1986, businesses could claim a federal investment tax credit of 10 percent for investments in qualifying machinery and equipment under IRC §46. While no federal investment tax credit is currently allowed in the IRC, many states that had previously conformed or created their own version of the tax credit still allow taxpayers to take advantage of the credit.
9. ***Research & Development Tax Credit***. Businesses can claim a federal credit for research and development expenses calculated under alternative formulas set forth in IRC §41 or can capitalize and amortize such expenditures under IRC §174. The credit is calculated by taking 20 percent of qualified research expenditures that exceed the base amount of expenditures incurred from 1984 through 1988. Qualified research expenditures are comprised of wage, supply, and contractor expenses incurred. The Tax Relief and Health Care Act of 2006 (H.R. 6111) retroactively extended the tax credit from January 1, 2006 through December 31, 2007.

DESCRIPTIVE RESULTS

Figure 1 shows the overall time trend of decoupling from 2000 through 2006. As new tax legislation is enacted, states are continuing to choose

to decouple and protect the corporate tax base as evidenced by the total time trend across all provisions. However, the time trend scaled by the number of provisions represents the average number of states choosing to decouple and indicates that, despite the occurrence of decoupling during the sample period, the rate of decoupling showed little growth over time. This general trend indicates that perhaps states respond in a similar manner to their neighboring states or that the response in based on specific characteristics of states (i.e., a certain small number of states decoupled from each tax provision examined). To better understand the geographic relationship between states, Figure 2 shows the level of decoupling by state for 2006. This figure indicates that a neighbor relationship may exist among the mid-Western states, a band of Southern states, and the upper Northeastern states.

Figure 3 provides a graphical representation of the level of decoupling by provision by year (2000-

Figure 1: **Time Trend of Decoupling**

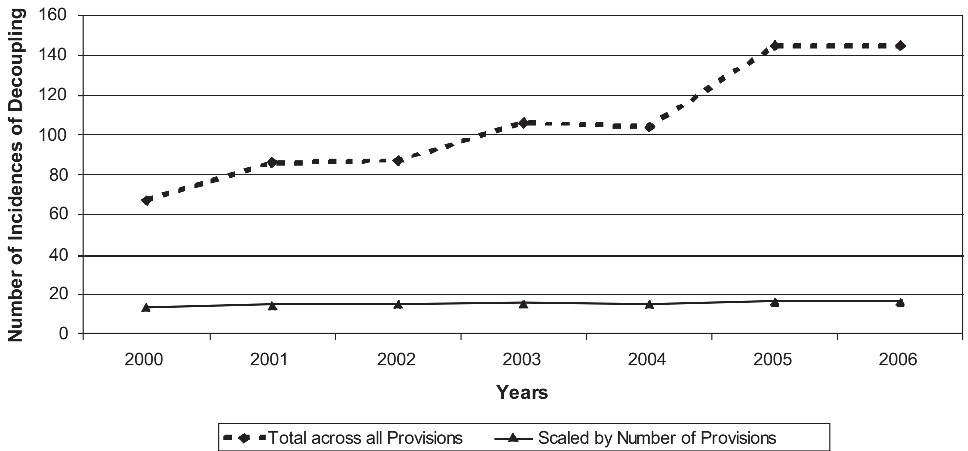


Figure 2: **Level of Decoupling by State for 2006**

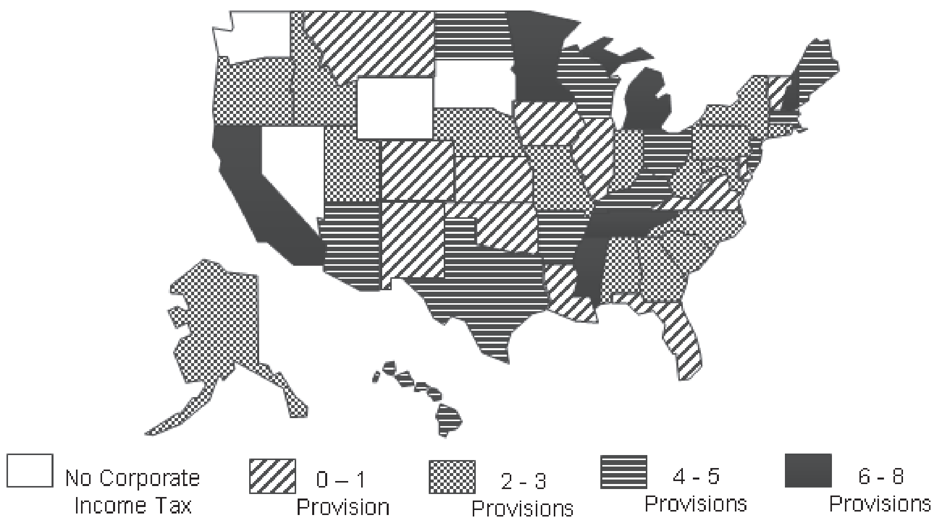
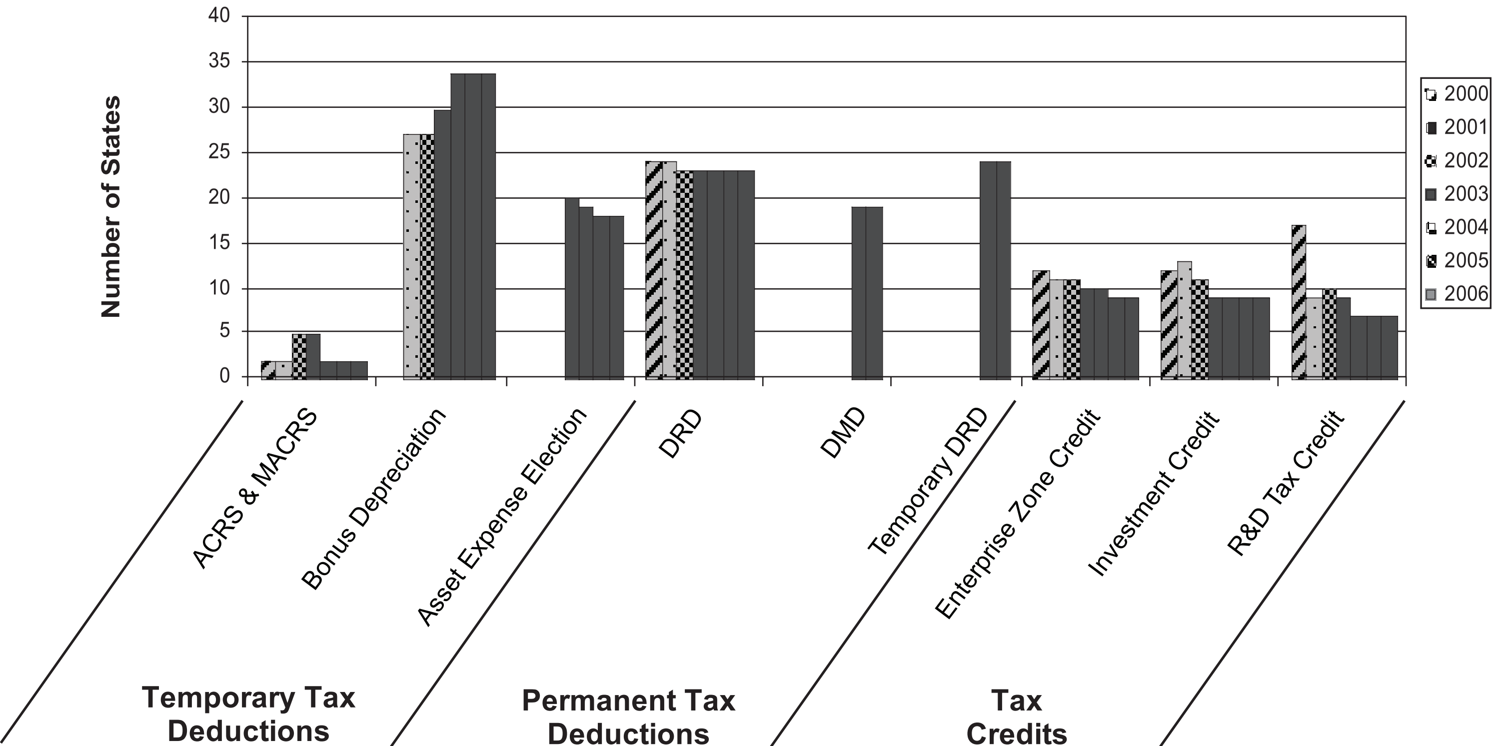


Figure 3: **The Level of Decoupling by Provision by Year**



2007). Figure 3 shows more states are choosing to decouple from temporary deductions such as "bonus" depreciation than permanent deductions. This finding is contrary to a state strategy of maximizing long-term revenue given no additional corporations filing in a given state. However, states may view decoupling from permanent tax deductions as more politically difficult given the harsher long-term effect on businesses. With a temporary provision such as "bonus" depreciation, states will eventually receive the same revenue from the firms; it is just a matter of timing. For example, if a firm takes less depreciation currently, it will report a correspondingly smaller gain (or larger loss) when the asset is sold or disposed. However, tax revenue losses from a permanent tax deduction are not recouped in later years. The results may indicate a political preference, perhaps for competitive reasons, for conforming to permanent federal corporate tax incentives. States are choosing to decouple from the group of tax credits least frequently. This is perhaps due to the fact that the federal credits included in the sample will initially have no effect on state taxable income as the starting point for calculating state taxable income is federal taxable income before consideration of tax credits. As a result of the method for calculating state taxable income, many states will conform to the conceptual notion of specific tax credits but require vastly different methods for calculating. In this study, we simply focus on conformity with the conceptual notion of the tax credit without quantifying differences in the value of the tax credits taken at the federal and state levels.

REGRESSION ANALYSIS

We use an ordinary least squares regression model to investigate the factors that may influence a state to decouple from the nine federal tax provisions from 2000-2006. We collect data for 44 states and exclude Nevada, Washington, and Wyoming because they do not have a corporate income tax. We also exclude South Dakota because its corporate tax is limited to financial institutions as well as Texas because it only imposes a franchise tax on earned surplus. Michigan is also excluded because it has a single business tax that is sometimes described as a business activities tax or value added tax. The average ratio of decoupled provisions to the total number of federal tax provisions equals 0.302 with a range from 0 to 0.889.

We model the decision to decouple as a function of three groups of variables: states' corporate income tax characteristics, fiscal variables, and political variables. Corporate income tax characteristics include the requirement of combined reporting, the requirement to automatically incorporate the IRC into state statute, the requirement for addbacks for related party transactions, the highest marginal tax rate, and the weight of the sales factor. Fiscal variables include the growth in corporate tax revenues, personal income, and population. We also control for state industrial structure by including the number of employees in the government, service, and manufacturing sectors. Our last group of variables controls for the political environment in the state. We include the political party of the governor and the popular vote in the presidential election. Finally, we also include fixed effects that account for both differences in economic structure and other unmeasured state factors that influence the decision to decouple as well as unmeasured factors that occurred across the time period.

The results from the regression model show that the highest marginal tax rate is negative and significant at $p < 0.10$, indicating that as the tax rate increases states will choose to decouple from fewer tax provisions. While none of the other variables are statistically significant, the unemployment rate is positive indicating that as unemployment rises states are more likely to decouple from federal tax provisions as a means of raising revenue. The combined reporting variable is negative indicating states with combined reporting can raise revenue through this mechanism without having to decouple from federal tax provisions.

CONCLUSION

The purpose of this study is to initially examine both recent and historic federal tax legislative changes and investigate the factors that led to states' decisions to decouple from federal tax legislation. More specifically, we begin to examine the differences between decoupling from temporary tax deductions, permanent tax deductions, and tax credits as we look at the changes across time. We contribute to this area of sparse research by providing insight into these factors that affect legislative changes. By analyzing the different types of tax provisions, we shed light on the temporary

and permanent tax provisions that states should specifically focus on to protect their ever eroding tax base and suggest some reasons why states may be more likely to decouple from temporary tax provisions.

References

Bruce, Donald, John Deskins, and William F. Fox. On the Extent, Growth, and Consequences of State Business Tax Planning. In Alan J. Auerbach, James R. Hines Jr., and Joel Slemrod, eds. *Corporate Income Taxation in the 21st Century*. New York, NY: Cambridge University Press, 2007, pp. 226-256..

Duncan, Harley and LeAnn Luna. Lending a Helping Hand: Two Governments Can Work Together. *National Tax Journal* 60 (September 2007): 663-679.

Faber, Peter. Should the States Determine Their Own Tax Destinies? Federalism in the 21st Century. *State Tax Notes* 40 (April 2006): 111-135.

Fox, William F. and John A. Swain. The Federal Role in State Taxation: A Normative Approach. *National Tax Journal* 60 (September 2007): 611-630.

Gravelle, Jane G. and Jennifer Gravelle. How Federal Policymakers Account for the Concerns of State and Local Governments in the Formulation of Federal Tax Policy. *National Tax Journal* 60 (September 2007): 631-648.

Hildreth, Bartley W., Matthew N. Murray, and David L. Sjoquist. Interstate Tax Uniformity and the Multistate Tax Commission. *National Tax Journal* 58 (September 2005): 575-589.

Klassen, Kenneth J. and Douglas A. Shackelford. State and Provincial Corporate Tax Planning: Income Shifting and Sales Apportionment Factor Management. *Journal of Accounting & Economics* 25 (June 1998): 385-406.

Mills, Lillian F. and George A. Plesko. Bridging the Reporting Gap: A Proposal for More Informative Reconciling of Book and Tax Income. *National Tax Journal* 56 (December 2003): 865-893.