TAX POLICY CENTER
URBAN INSTITUTE & BROOKINGS INSTITUTION

What Federal Business Tax Changes Mean for the States

Norton Francis
April 20, 2017

If Congress changes how the federal government taxes businesses, the outcome will not only affect firms and federal revenues, it will also have a profound effect on state taxes.

This year, Congress will consider what may be the biggest tax bill in decades. This is one of a series of briefs the Tax Policy Center has prepared to help people follow the debate. Each focuses on a key tax policy issue that Congress and the Trump administration may address.

The 44 states with a corporate income tax "piggyback" on federal tax law to determine a corporation's state taxable income. For example, a corporation that pays taxes in Vermont starts its Vermont return with federal taxable income from Internal Revenue Service form 1120 (line 28 in the 2016 form) and then subtracts federal "special deductions." Similarly, states with an individual income tax also tie back to federal definitions of "income."

In general, these changes are much more important to states than changes to federal tax rates. But states may benefit if firms increase investment either because their federal taxes were cut or new tax laws encouraged them to bring overseas profits back to the United States. Similarly, states may be affected by the evolving policy of penalizing companies that want to relocate outside the United States. However, quantifying the effects of these changes on individual states is difficult.

HOW ARE BUSINESSES TAXED?

Businesses are taxed in two ways at the federal level: under the corporate income tax or under the individual income tax. C Corporations, which include publicly traded companies, pay the corporate income tax. Other businesses including S corporations, partnerships, and sole proprietorships, often known as pass-through businesses, do not; instead, the business owners pay business taxes on their individual Form 1040. Changes to the federal individual income tax will directly affect partnerships and sole proprietors, while changes to corporate income tax will affect corporations. Furthermore, changing these tax laws could influence the way business decide to organize themselves, and thus which tax they pay.

Most states tax the shareholders of pass-through businesses through the state income tax but there are some differences. For example, Kentucky taxes shareholders on some of their income, but those shareholders' companies may still pay tax on capital gains and other investment income. If federal proposals push more taxpayers to organize as partnerships, states could see a shift from corporate income to personal income tax revenue.

HOW DIFFERENT CHANGES WOULD AFFECT STATES

Broad-based reforms, such as switching to a value-added tax or making the corporate tax a cash-flow tax would affect states more than any other proposed change. Currently, most states piggyback on the federal corporate income tax and only a few tax cash flows. If Congress moves in that direction, states would either have to make their system conform to the new federal tax or, less likely, try to retain a state-level corporate income tax without the benefit of Internal Revenue Service administration. Since the corporate income tax is a relatively small share of state tax revenue, some states may eliminate their corporate taxes entirely and increase other taxes or cut spending.

OTHER TAX CHANGES

The House Republicans' tax plan released last June and Donald Trump's final campaign plan both proposed deep cuts in business and individual tax rates. Reducing income tax rates generally would have no direct effect on state taxes because states apply their own rates. (One exception: Some states allow firms to deduct their federal taxes from either the state corporate income or the individual income.) Similarly, states would not be affected by most changes in tax rates on capital gains or other investment income.

However, they might enjoy some additional tax revenue from proposals to treat carried interest as ordinary income rather than capital gains. Some states give preferential treatment to capital gains, as defined by the federal law. New Mexico, for example, exempts from taxation 50 percent of capital gains income from any source.

The House Republicans' tax plan would allow the immediate expensing of business investment but disallow the deduction for interest costs. Although most states rely on the federal calculation of income, many have diverged when it comes to the treatment of business expensing. After Congress adopted more generous depreciation rules for business in 2001, 31 states decoupled from the provision because complying would have cost them revenue.

New federal rules for taxing US-based multinational companies would directly affect state taxable income. By changing the income the federal government includes in its tax base, either by moving to a territorial system or border adjustment, the states' base would change too. Repealing or reducing federal tax preferences would also likely affect states. One example is the domestic production activity deduction, designed to promote manufacturing in the U.S. Several states refuse to allow the deduction against their corporate income taxes, but 20 allow it. Repeal would boost tax revenues in these states.

Besides federal tax reform, Congress may consider three other pieces of legislation that would directly affect state taxes. Two, the Business Activity Tax Simplification Act (BATSA), the Marketplace Fairness Act (MFA), affect the ability of states to tax online and catalogue sales. The third, the Mobile Worker State Income Tax Simplification Act (MWA), limits the ability of states to tax transient workers who spend less than a month in their jurisdictions.

- BATSA would require companies to have physical presence in a state before the state could tax the company at all. Currently, states can tax sales of intangible goods such as services or movie downloads even if a seller does not have a physical presence in their jurisdiction. However, they cannot require firms to collect tax on tangible goods unless the sellers meet that physical presence test. Increasingly, states have expanded the scope of activities that meet that test.
- MFA addresses a similar issue, but would it would apply to the sales tax. Under a pre-internet Supreme Court decision, states cannot require a company that does not have physical presence in their state to collect the sales tax on purchases made by that state's residents. MFA would allow states to require remote sellers to collect sales tax.
- MWA would bar states from taxing the income of transient or mobile workers (other than athletes and performers) who spend 30 days or less in its jurisdiction. As the Congressional Budget Office reports, states with large employment centers like New York and Illinois would lose revenue.