INTRODUCTION

Sometimes, doing nothing can be costly. If New Jersey does not take action to separate itself from a recent federal tax change related to depreciation by businesses, the state will lose millions of dollars in the next few years.

Depreciation is a broad concept that, simply put, represents the degree of lost value of such tangible items as machines and equipment. When used for tax purposes, depreciation enables businesses to decrease their reported income - and in so doing, lower their taxes - by an amount reflecting the fact that depreciable items are now another year older and closer to being unusable. Formulas for calculating depreciation are determined by law and, obviously, businesses pay close attention to the legislative process and seek the most favorable possible treatment.

From a business standpoint, the federal economic stimulus package passed by Congress and signed into law by President Bush in March makes depreciation deductions more generous. The economic stimulus package, named the Job Creation and Worker Assistance Act of 2002, introduces what is called "bonus depreciation," which allows businesses to claim an immediate, additional tax deduction of up to 30 percent of the cost of certain new equipment purchases - instead of following the standard accounting practice of depreciating the full cost gradually over several years.

Like any tax break granted by the federal government, bonus depreciation will cost the federal treasury money. But the implications go deeper. Because of the way state tax laws are written, federal bonus depreciation also will cost state treasuries money. And New Jersey is among those that stand to lose the most. There are, however, steps that a state can take to protect itself from this revenue loss. This report explains the situation New Jersey faces and what can be done.

BONUS DEPRECIATION'S IMPACT

The new federal depreciation provision is slated to expire in less two and a half years and is retroactive to September 10, 2001. The depreciation is called a bonus for good reason. It is available to businesses in addition to the "normal" first-year depreciation on the remaining 70 percent of an asset's cost. And, because of the provision's retroactivity, businesses were able to immediately claim the deduction on their 2001 tax returns and their estimated 2002 spring tax payments. So, the 46 states whose depreciation rules historically have been based on those in the federal Internal Revenue Code could lose tax revenue unless they de-couple.
By 2004, this change in federal tax law will have reduced total federal tax revenues from profitable businesses by $97 billion. The corresponding decline in state revenues is projected to be $14 billion to $14.7 billion through 2004 if no states de-coupled. This is a situation similar to that with regard to linkage between the states and the federal government on estate taxes (see NJPP's report, *Burying the Inheritance Tax Puts New Jersey in the Hole*, February 2002).

The amount of revenue lost includes money from the personal income tax because some firms - including S corporations, partnerships and sole proprietorships - do not pay corporate income taxes. For these small businesses, depreciation expenses are reflected in the business owners' personal adjusted gross income, which is the basis for most states' calculation of personal income taxes. The exception will be for the smallest businesses. They are unaffected by the new bonus depreciation rules because the rules do not apply to investments totaling less than $24,000 per year.

As matters stand, the new bonus depreciation provision would significantly lower corporate and personal income tax revenues in New Jersey and almost every state in the current fiscal year and the next two. According to an analysis by the Center on Budget and Policy Priorities, a Washington-based research organization, New Jersey is projected to lose $586 million in tax revenue over that period, just as the state is trying to find ways to dig itself out of a serious budget shortfall.

The Federation of Tax Administrators, a membership organization of the tax collection agencies of the 50 states, described similar scenarios playing out in other states across the country: "Enactment of the bonus depreciation in mid-year when nearly every state is facing a substantial budget shortfall sets up what could be a dire situation for state treasuries."

According to the Center on Budget and Policy Priorities, only five states can expect to lose more tax revenue from bonus depreciation than New Jersey. The following is a list of these states:

**State Revenue Loss from Bonus Depreciation**

<table>
<thead>
<tr>
<th>State</th>
<th>Revenue Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>New York</td>
<td>$1.457 billion</td>
</tr>
<tr>
<td>Illinois</td>
<td>806 million</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>753 million</td>
</tr>
<tr>
<td>Texas</td>
<td>730 million</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>597 million</td>
</tr>
<tr>
<td>New Jersey</td>
<td>586 million</td>
</tr>
</tbody>
</table>

Source: The Center on Budget and Policy Priorities

These projected revenue losses are based on state corporate and personal income tax
collections for 2000 and 2001. In 2000, according to the US Census Bureau, New Jersey collected 5.5 percent of all corporate income taxes in the US, and 4.6 percent of all personal income taxes. In 2001, according to the Rockefeller Institute of Government, New Jersey collected 4.8 percent of all corporate income taxes in the nation, and 4.3 percent of all personal income taxes.

Not only does bonus depreciation give a major tax break to businesses now, and in the process deplete state revenue, but in doing so it exacerbates a larger trend that challenges state economies: an overall decline in corporate taxation by states. Research has shown that state corporate income tax obligations, as a percentage of total business profits, have declined precipitously in the last ten years. Across the country, state business tax rates have declined from an average effective rate of 6.5 percent in the 1980s to close to 3.8 percent in the late 1990s.

New Jersey has been no exception. As the Philadelphia Inquirer reported in March, "New Jersey businesses are paying a smaller share of state taxes than a decade ago - shifting the burden increasingly to individual taxpayers, and leaving the state at a time of fiscal crisis with less money for services." The newspaper's analysis noted that, as a share of state tax revenues, in Fiscal Year 2001 corporate taxes were 24 percent less than 10 years ago. New Jersey's corporate tax revenues have been reduced by state actions that have included increasing the number of business tax credits, changing the taxation formula applied to large businesses to reduce their tax liability and reducing the tax rate applied to small businesses.

**HOW TO AVOID THE LOSS**

Different states will have to take different courses of action to de-couple from the new federal depreciation rules, depending on how their laws are written. According to the FTA, in about half the states conformity with the federal tax code is automatic, so federal bonus depreciation will be incorporated into state tax codes unless legislatures take action to de-couple state depreciation rules from the federal rules. New Jersey is one of those states. In other states, bonus depreciation would take effect only if the legislature were to take specific action to affirmatively maintain the linkage between state rules and the federal depreciation system.

In whatever form linkage might take, such nonpartisan organizations as the National Governors Association and National Conference of State Legislators recognized the threat that bonus depreciation posed to state budgets and state economies and communicated their concerns to Congress before the legislation was passed. The president of NCSL, New York State Sen. Stephen M. Saland, wrote to the leaders of both houses of Congress: "The depreciation allowance would have a staggering impact on most states' budgets. Since states will have no option but to offset the impact with other tax increases or spending cuts, the depreciation allowance is counterproductive to the stated goal of providing economic stimulus."

Ironically, a decision by New Jersey not to de-couple could have the opposite effect of stimulating the state economy. That will certainly occur if New Jersey cuts its budget to
make up for the lost revenue. When a state budget is cut, a state weakens one of the most effective engines for economic stimulus. Economists Peter Orszag and Joseph Stiglitz note that if states reduce their spending on goods and services to pay for a tax cut, a state's economy could be hurt and economic recovery slowed. A dollar in a state budget that is dedicated to a government program likely goes to a town, school, worker or other taxpayer who will probably use that dollar for purchases. In contrast, a dollar in a state budget that is allocated to a tax cut will probably not be fully spent by the corporation. Rather, some portion of it will be saved.

STATES' ACTION SO FAR

In the several weeks since the federal legislation containing bonus depreciation passed, ten states already have completely de-coupled from the new federal rules. In at least ten other states, the governors, administrative officials and/or legislatures have taken some action to move towards de-coupling from bonus depreciation. Only three states, West Virginia, Alabama and Utah have decided to conform fully to bonus depreciation.

At the same time that several states have moved rapidly to de-couple from bonus depreciation, the federal government has acted to facilitate the process of businesses claiming the new depreciation deduction for the current tax year. According to the Center on Budget and Policy Priorities, "the IRS has already published instructions and forms so that taxpayers can claim the bonus allowance for tax year 2001." In effect, then, a race is taking place, in which businesses try to take advantage of the stepped-up depreciation formula on their 2001 federal tax returns, while states scramble to prevent them from being able to do so.

So far, Arkansas, Georgia, Idaho, Indiana, Iowa, Massachusetts, Mississippi, Nebraska, Texas and Virginia have de-coupled completely from the federal depreciation rules. Further, the governors, administrative officials and/or legislatures in Arizona, Connecticut, Illinois, Maryland, Minnesota, New Jersey, Ohio, Pennsylvania, Vermont and Wisconsin have moved towards de-coupling from bonus depreciation in some fashion. For example, the Maryland legislature included de-coupling from both the bonus depreciation and estate tax changes in the same bill. This overall de-coupling bill also included a provision which specified that Maryland would be held harmless from any federal enactments for one year to give the state legislature time to respond to federal decisions. Pennsylvania's Revenue Secretary has called on that state's legislature to pass de-coupling legislation, saying: "In these tough economic times, we cannot afford to lose more tax revenue. By decoupling, we could protect the state budget by breaking Pennsylvania's otherwise automatic link to the new federal tax code provision."

In New Jersey, Governor McGreevey stated in his Fiscal Year 2003 budget that New Jersey stands to lose a significant amount of revenue "if it does not address the recent federal change that accelerated depreciation for businesses."

A COURSE FOR NEW JERSEY

To protect the state from further revenue loss, the Legislature can de-couple New Jersey's
depreciation rules from the federal depreciation rules for the three-year period the bonus depreciation provision is in effect.

It is important to point out that state de-coupling would in no way interfere with businesses' ability to take advantage of bonus depreciation in their federal taxes. Indeed, even if New Jersey de-couples, businesses in the state stand to gain roughly $3 billion to $4 billion through this federal tax break over the next three years.

There are two ways to de-couple from bonus depreciation. The first is to de-couple from the federal code using a "date-certain" reference. Using this method, the Legislature would change the applicable reference to the federal IRS code to specify linkage to the federal code as it existed on September 1, 2001 (or another date prior to the September 11, 2001 effective date of the new provision.). De-coupling from the new federal depreciation rules would require businesses to add back to their state taxable income the additional depreciation allowed by the federal government under bonus depreciation. Pennsylvania's Commonwealth News Bureau explains that "for corporate taxpayers, the additional depreciation that would be added back to state taxable net income would be the difference between the deduction allowed under Public Law 107-147 [the economic stimulus package] and the deduction permitted under prior law."

Further, CBPP explains that de-coupling through a date-certain reference results in "businesses having an addback in the first year, and a subtraction in second and later years that precisely accounts for the difference between old depreciation and new depreciation." After the Legislature de-couples through a date-certain reference, the New Jersey Division of Taxation would revise state tax forms and instructions so businesses add to their federal income the amount by which depreciation under the new, temporary "bonus" provision is greater than depreciation under permanent law.

The second de-coupling option is for the state to specify in statute the addback and subtraction for the depreciation deduction. An advantage of this approach is that it indicates clear legislative intent.

De-coupling from the federal depreciation rules would add some additional work for businesses when paying their taxes. The Federation of Tax Administrators says, "de-coupling creates a series of taxpayer compliance, burden and audit issues in future years. Taxpayers will have to deal with the complexities of having two different depreciation deductions for as long as they are depreciating the asset or property."

Until last month, almost every state had a business depreciation system that matched the federal rules, but there is precedent for states choosing not to conform to federal changes. For example, a change in federal law in 1981 creating what is known as "accelerated depreciation," - which gave large tax breaks to corporations - prompted about half the states to de-couple from the federal tax change. New Jersey was among them. According to the Center on Budget and Policy Priorities, New Jersey, New York and Kentucky continued to require depreciation schedules that differed from the federal schedule for at least some industries into the early 1990s. In fact, New Jersey required that all industries use a separate state depreciation schedule until July 1993.
And while some states have chosen to protect themselves from federal depreciation changes in specific time periods, California has gone a step further. Since the 1970s the state has operated under its own depreciation rules, separate from the federal rules. Businesses already need to adjust their income for California tax purposes because of that state's three decades of nonconformity with federal business tax rules. Since businesses operating in multiple states including California already need to maintain books for two separate depreciation schedules, using additional state schedules should not prove excessively burdensome. Moreover, according to CBPP, "there is no evidence that the additional bookkeeping requirements have impeded economic development in California."

CONCLUSION

Federal bonus depreciation threatens state budgets and state economies across the country by giving a major tax break to businesses - a tax break that has never appeared to be a high priority for business. New Jersey is one of the states that could be most damaged by this federal change.

But New Jersey has before it the option of following the lead of other states where governors and state legislatures have acted to protect their programs and citizens. Any bookkeeping challenges de-coupling would pose for businesses and states are more than made up for by the state revenue that is saved for important programs that many taxpayers depend on.

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END NOTES

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