MBPC Montana Budget & Policy Center

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Montana Can Bypass a Costly and Ineffective Federal Tax Break for Corporations

Montana's tax code is based on the federal tax code, so deductions passed at the federal level are automatically implemented at the state level, unless specifically disallowed by the state. The federal "domestic production deduction" tax break is estimated to cost Montana $6 million in revenue in fiscal year 2011.

Twenty-one states and the District of Columbia have disallowed this deduction. Another 25 states, including Montana, will have lost an estimated $505 million because of the deduction.[2] Montana can and should disallow this costly and ineffective deduction. If Montana disallows the deduction, companies will still be able to claim the deduction on their federal tax returns.

What is the Domestic Production Deduction?

The deduction allows companies to claim a tax deduction based on profits from "qualified production activities." These production activities are not limited to manufacturing, but include a wide range of activities such as:

- Filmmaking
- Mining and oil extraction
- Electricity/ natural gas production
- Software development
- Publishing
- Construction
- Food processing

> **What is a tax deduction?**
>
> If a company has profits, a deduction lowers reported profits for tax purposes, thus lowering the taxes due.[1]

Even businesses outside of these industries have benefited. Businesses whose primary activities are retail sales, financial services and entertainment have been able to utilize the domestic production deduction.[2] The domestic production deduction allows a company to deduct a portion of the profits that are due to qualified production activities. In other words, the deduction allows firms to not pay taxes on some of the profits derived from domestic production. (A firm must have positive profits to benefit from this deduction.)[1]

The impact of the deduction is increasing as the law is fully phased in. Initially, the deduction was limited to three percent of qualifying income. In 2007, it increased to six percent. In 2010, the final increase will raise the deduction to nine percent of qualifying income.

Why is the Domestic Production Deduction Bad for Montana?

This tax break may or may not be good policy at the federal level, but it is clearly bad economic policy for Montana because:

- **It does not create an incentive for corporations to relocate operations to Montana.** Companies are allowed to claim the deduction for all qualified domestic activities that occur anywhere in the United States. Thus, a multi-state firm can claim the deduction in Montana for activities in another state, even if they don't have a single employee working in a qualifying industry in our state.
- **It fails to help businesses create jobs in industries that are struggling.** The domestic production deduction's value is limited by a firm's profits. A company struggling to keep employees and remain profitable will not

benefit much, if at all, from this deduction even though they need the help more than profitable companies.

- **It favors large corporations, which are a small minority of Montana businesses.** Nationally, an analysis of 2006 corporate tax returns showed that 94% of the deduction was claimed by the 0.4% of firms with assets over $100 million.[2]
- **It decreases state revenue for other priorities that would benefit Montana families and the economy far more.** Targeted tax cuts may stimulate the economy if they are directed at low-income households who will spend all of the extra income resulting from the cut. State spending on public services and infrastructure also stimulates the economy. Money circulating through the economy – buying goods, paying salaries, generating jobs – is needed to move out of a recession. This is true whether the money is from a small mom-and-pop operation or state and local governments. Governments pay salaries, buy goods and services, and generate jobs, which can be particularly important during a recession, when individuals and businesses are spending and investing less in the economy. Ineffective corporate tax breaks limit our ability to invest in public services, education, and infrastructure that will help create a more prosperous economy for all Montanans.
- **It only increases the complexity of Montana's income tax system and makes compliance more costly for both the state and the taxpayers.** Due to the complexity of the rules for determining qualifying activities, rolling back this deduction could save the Department of Revenue substantial audit resources and save taxpayers compliance and recordkeeping costs.[3] IRS Commissioner Mark W. Everson predicted that because of the domestic production deduction's complexity, "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."[3] By disallowing this deduction, Montana can avoid the increased collection costs and potential litigation anticipated at the federal level.

Rolling back the deduction would require only a single sentence change in the state tax code, and taxpaying corporations would only need to add back the deduction amount to their taxable income on Montana forms. Furthermore, disallowing the deduction in Montana will not affect a company's ability to claim the deduction on their federal tax returns.

In the face of proposed cuts to public services like health care and education, Montana cannot afford to give away this ineffective corporate subsidy that was never voted on by the state legislature.

Endnotes

1. If a firm is not profitable, an increased deduction will increase the firm's losses. Losses can be carried forward or back to offset past or future profits for tax purposes.

2. Johnson, N. and A. Singham, *States Can Opt Out of the Costly and Ineffective "Domestic Production Deduction" Corporate Tax Break.* 2010, Center on Budget and Policy Priorities: Washington DC.
3. Everson, M.W., *Letter Regarding Conference Report to H.R. 4520.* 2004, Congressional Record October 11, 2004.