How States Should Respond to the Federal Tax Cuts for “Pass-Through” Business Income

States can expect to see a change in revenues due to the major federal tax legislation enacted in December 2017. One major change that carries a significant cost in some states is the new deduction for “pass-through” income, that is, income from certain businesses that owners claim on their individual tax returns. Six states — Colorado, Idaho, Minnesota, North Dakota, Oregon, and South Carolina — are “coupled” to the new deduction and will need to decouple to avoid losing revenue. All states should consider new taxes on pass-through businesses to recoup some of the federal tax windfall these businesses will receive from the deduction.

What Is “Pass-Through” Business Income?

Some companies are structured as “C corporations,” whose profits are held by the corporation and then may be distributed to shareholders through dividends. C corporations are subject to the federal corporate income tax, and any distributed dividends may also be subject to personal income tax when received by stockholders. Other companies are structured so that, for tax purposes, profits are directly “passed through” to owners and immediately taxed at the owners' tax rates, regardless of whether the profits are actually distributed. However, these pass-through businesses are *not* subject to the corporate income tax. Pass-through businesses take a variety of forms, including S corporations, limited liability companies, and partnerships.

How Did the Federal Tax Legislation Change How This Income Is Taxed?

Income from pass-through businesses was previously taxed similarly to wages and other forms of income. Now people with this income can deduct up to 20 percent of it. (There are a number of complicated restrictions on which types of businesses qualify for the deduction and how much profit can be deducted.) This new deduction will cost the federal government about $50 billion a year, and most of that revenue will go to wealthy people, since more than half of pass-through business income flows to the highest-income 1 percent of tax filers. This tax break is one reason why the overall federal tax legislation is so heavily skewed to the wealthy.[1]

How Will the New Federal Deduction Affect State Revenues?

Unless they take action, six states — Colorado, Idaho, Minnesota, North Dakota, Oregon, and South Carolina — will lose personal income tax revenue from this provision because their definition of state taxable income is tied to the federal definition, and the federal provision was written as a special deduction that reduces taxable income. These six states can avoid the revenue loss by “decoupling” their tax code from the federal one for this provision. (Two additional states, Kentucky and Montana, might also be affected and might need to decouple.) Other states will not be affected unless they choose to enact a pass-through deduction that mirrors the federal change.

How Have Past State Deductions Fared?

Some states have already tried their own pass-through deductions, which have failed to generate the hoped-for business formation or economic growth. Adding a new state deduction on top of the federal one, as at least one state is considering, will likely have the same outcome. The best evidence of this comes from Kansas, which fully exempted pass-through income for almost four-and-a-half years but didn't experience substantial business growth: the state had fewer additional taxpayers reporting income from S corporations and partnerships than all but one of its neighbors and the United States overall.[2] Ohio has also provided a generous tax break for pass-throughs since 2013 yet its economic growth has been lackluster.

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[1] See Chye-Ching Huang, Guillermo Herrera, and Brendan Duke, “JCT Estimates: Final GOP Tax Bill Skewed to Top, Hurts Many Low- and Middle-Income Americans,” Center on Budget and Policy Priorities, December 19, 2017, https://www.cbpp.org/research/federal-tax/jct-estimates-final-gop-tax-bill-skewed-to-top-hurts-many-low-and-middle-income.

[2] Michael Mazerov, “Kansas Provides Compelling Evidence of the Failure of ‘Supply-Side' Tax Cuts,” Center on Budget and Policy Priorities, January 22, 2018, https://www.cbpp.org/research/state-budget-and-tax/kansas-provides-compelling-evidence-of-failure-of-supply-side-tax-cuts.

Also, there is no justification for taxing pass-through owners more favorably than people who receive the same amount of income from wages and salaries — income is income. And while the distributional effects of the pass-through deduction will differ among states, the savings are likely to flow predominantly to very high-income households. In Idaho, for example, the top 5 percent of resident households would get 73 percent of the state tax savings from conforming to the federal deduction, the Institute on Taxation and Economic Policy estimated. And in Oregon, the top 5 percent would receive 61 percent of the tax break, the state Legislative Revenue Office estimated.

How Should States Respond?

States linked directly to the federal provision should decouple.

All seven of the directly affected states should decouple from the federal tax code for this provision. Doing so would not be unusual, since states have decoupled from many provisions of the federal code in the past. Oregon is the only one of the seven states that has already enacted legislation decoupling from the pass-through provision, although the governor has not signed it and it is possible she will decide not to.

Other states should not take steps to link to the change.

Other states would not lose revenue unless they choose to add a new state-level deduction for pass-through income that mimics or builds on the federal change. But proposals in Iowa would do just that, allowing pass-through owners to deduct either all or a quarter of the income deducted at the federal level (in the state Senate and House bills, respectively), and other states may be tempted to consider similar tax cuts. States should reject such proposals as wasteful giveaways to mostly wealthy people (who just received a large federal tax cut) that will do little or nothing to boost their economies.

States should consider new taxes on pass-through businesses.

Given how skewed to the wealthy the federal tax legislation is and many states' dire need for revenue, states should consider going beyond the basic steps above and impose new taxes on pass-through businesses to recoup some of the windfall these businesses receive, and use the revenue to invest in broader prosperity.

Currently, lawmakers in Connecticut, New Jersey, and other states are considering a new tax on pass-through businesses as part of their efforts to provide a "workaround" for the new cap on the federal deduction for state and local taxes (SALT). This new pass-through tax would apply to businesses as entities, and not to individual owners who receive pass-through income. Since businesses — unlike individuals — can still fully deduct their state and local taxes, the tax would not be subject to the SALT cap. The state would simultaneously create a new income tax credit designed to offset for these individual owners the cost of the new tax. This workaround has the added benefit of increasing the chance that the taxes due from out-of-state owners will be paid in full, which states often find difficult to ensure. It's not clear whether the IRS will allow this arrangement, but it holds more promise than other prominent workaround proposals.

That said, given many states' need for revenue, they should recoup some of the large and unwarranted federal pass-through tax cut by crediting less than 100 percent of the tax imposed on the passthrough business itself back to its owners, at least at high levels of income. Unfortunately, proposals under consideration in Connecticut and New Jersey would provide a credit equal to 100 percent of the owners' share of the tax on pass-through businesses.

Going forward, all states — including those most affected by the SALT cap — should consider ways to recoup some of the federal tax law's windfall for pass-through business owners. Policy options for doing so include imposing:

- A surcharge on pass-through income. The surcharge could be set to allow people with this income to still receive an overall tax cut from the combined federal-state changes.
- An entity-level tax on pass-through businesses (in addition to income taxes on the individual owners). California, Illinois, and Massachusetts already have such a tax.
- The regular corporate income tax on large pass-through businesses. Many of these businesses are a lot larger than many taxable C corporations, while providing limited liability for all their owners just like C corporations do. It's hard to justify pass-through treatment in these circumstances.