

Vermont Legislative Joint Fiscal Office

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Qualified Production Activities Income Deduction (QPAI)

The American Jobs Creation Act of 2004 passed by Congress contains a provision (Sec. 199), the qualified production activities income deduction (QPAI), which has significant negative fiscal impact for the states. This benefit was intended to replace the federal extraterritorial income (ETI) exclusion that was declared an illegal trade subsidy and was eliminated. The QPAI deduction may be taken against federal corporate income or as an adjustment to individual, estate or trust income, which is passed through, and reduces Vermont taxable income.

The deduction began in 2005 at 3% and is phased-in over five years, increasing to 6% in 2007 and 9% in 2010. The Joint Committee on Taxation's (JCT) initial estimate for Vermont was a \$3.0 million revenue loss at full implementation. The Center on Budget and Policy Priorities (CBPP) estimated the Vermont impact at \$4 – 5 million as more details of the tax implications have emerged. Last session, the Vermont Tax Department adjusted the initial JCT estimates for Vermont. This revenue loss, net of the ETI elimination, has been incorporated into the January 2006 consensus revenue estimates. These figures will likely be adjusted upwards when they are revised.

Vermont QPAI Revenue Impact

Fiscal Year	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012
QPAI only	(1,000,000)	(1,480,000)	(1,950,000)	(2,300,000)	(2,800,000)	(3,400,000)	(3,700,000)
Net revenue impact	(860,000)	(865,000)	(630,000)	(580,000)	(990,000)	(1,500,000)	(1,700,000)

“Qualified production activities” is a broad category that includes, but is not limited to, traditional manufacturing, construction, engineering, energy production, software development, filmmaking, and processing of agricultural products. QPAI income is broadly defined and is anticipated to create tax compliance and enforcement difficulties as firms have an incentive to characterize as much income as possible as “QPAI” income. Taxpayers, particularly small businesses, may find it difficult to understand and comply with these complex new rules, which will require additional accounting and recordkeeping.

Most states that use federal taxable income as a starting point for state taxes are impacted by many of the provisions in the American Jobs Creation Act, both positively and negatively. The QPAI provision stands out because of its large, and growing, state fiscal impact. In addition, a state that conforms to the QPAI deduction has no guarantee that the deduction will be for in-state production activity and therefore state revenues may be reduced, with no in-state benefit. In response, nineteen states and the District of Columbia have acted to decouple from the QPAI provision. Of the New England States, Maine, Massachusetts and New Hampshire are preventing the pass-through of the QPAI deduction (see attached list).

States not passing through the federal QPAI deduction (Sec. 199):

Arkansas
California
District of Columbia
Georgia
Hawaii
Indiana
Maine
Maryland
Massachusetts
Minnesota
Mississippi
New Hampshire
New Jersey (partial conformity)
North Carolina
North Dakota (for corps only)
Oregon
South Carolina
Tennessee
Texas
West Virginia

States with no corporate income tax:

Michigan (imposes a single business tax--sometimes called value added tax)
Nevada
Texas (imposes a franchise tax on net worth)
Washington
Wyoming