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The “QPAI” Corporate Tax Break: How it Works and How States Can Respond

The past quarter century has seen a dramatic decline in the yield of corporate income taxes at both the federal and state levels. Major federal corporate tax legislation enacted in 2004 created a new tax break, known as the “Qualified Production Activities Income” (QPAI) deduction that has further accelerated the decline of the corporate tax. This policy brief evaluates the QPAI deduction and discusses possible state policy responses.

The Origin of QPAI

Over the past 35 years, the federal government has allowed a series of tax breaks designed to encourage exports by American manufacturers. One such tax break, the “extra-territorial income” (ETI) shelter, was found to violate U.S. trade treaties with other countries by the World Trade Organization (WTO) in 2002. In the wake of this ruling, the European Union began imposing retaliatory sanctions against the United States in March of 2004.

Congressional tax writers immediately sought to comply with the WTO ruling by repealing the ETI tax break. But lawmakers were wary of being seen as hiking taxes on manufacturers—even when the “tax hike” in question resulted from repealing an illegal tax break—and sought to enact new tax cuts that would offset the lost ETI subsidy for manufacturers. However, as the tax bill took shape, this provision was hijacked by legislators seeking to use the tax bill to provide new tax breaks for other favored corporations. As finally enacted, the QPAI break ballooned to apply to a wide variety of corporate activities, and was the most expensive ornament on a bill derisively labeled a “Christmas tree” by many observers.

How QPAI Works

The QPAI deduction allows a broad category of manufacturing-related business activity, or “QPAI income,” to be partially deducted from a company’s profits. The deduction was phased in over six years: in 2005 and 2006, companies were allowed to deduct 3 percent of their QPAI income and as of 2010, when the changes were fully phased in, they are

now able to deduct 9 percent. At full implementation, QPAI effectively reduces the tax rate on qualifying profits from the current 35 percent to under 32 percent.

QPAI was ostensibly designed to benefit only the American exporters that would be hurt by ETI repeal, but the QPAI deduction’s reach was made broader—and more vaguely defined—as the bill made its way through Congress. The “domestic production” tax break was originally intended for U.S.-based manufacturers, but the enacted law interprets “production” quite loosely to include architectural and engineering services, home and building construction, filmmaking and even coffee-roasting. For example, Starbucks received a \$48 million federal tax break from QPAI over the last five years and during the same period, the Walt Disney Company saved \$370 million.

Corporate activities are vaguely said to be “domestic” under the new law if they take place “in whole or in substantial part” in the United States, with no further explanation of what constitutes a “substantial part.”

The broad nature of the deduction is reflected in its price tag: the Joint Committee on Taxation (JCT) initially estimated that the QPAI tax break would reduce federal revenues by \$77 billion over ten years—far more than the ETI subsidy it was meant to replace. Of course, the expected cost has already grown: JCT anticipated a revenue loss of roughly \$34 billion for the five years beginning in 2006, but 62.1 billion for the five years beginning in 2010. In 2011 alone, the cost is expected

to be \$11.6 billion, which is roughly 3.1 percent of total projected revenue from the federal corporate income tax.

How QPAI Affects the States

Almost every state with a corporate income tax links its tax rules to federal law by using federal taxable income as a starting point in determining a company's state tax liability. This linkage makes it easier for state tax administrators to monitor compliance with tax laws—but also means that states can “inherit” federal tax breaks that reduce federal taxable income, as QPAI does. The QPAI tax cut gives state lawmakers a simple choice: they can conform their state tax rules to allow the QPAI tax break (and accept the resulting revenue loss), or they can “decouple” their state tax rules from this particular federal rule by disallowing the QPAI deduction. Decoupling from QPAI generally requires only a simple statutory change, and does not require decoupling more generally from the linkage to federal taxable income.

As of 2011, 22 of the 47 states (including the District of Columbia) with corporate income taxes had decoupled from the QPAI break, leaving 25 states that will continue to lose corporate tax revenue because of their linkages to the federal tax code. According to estimates calculated by the **Center on Budget and Policy Priorities**, states that continued to comply with the QPAI break stood to lose more than a cumulative \$505 million in fiscal year 2011 alone.

Advantages and Disadvantages of QPAI

The new QPAI break has one clear advantage from the perspective of its beneficiaries: it provides the largest single federal corporate tax cut enacted in years. But for state and federal lawmakers—and taxpayers in general—the costs are much clearer than the benefits:

- The QPAI deduction has little value as an economic development strategy for individual states, because a corporation can use the QPAI deduction to reduce its taxable income for “domestic production” activities anywhere in the United States. That is, a multi-state company that engages in manufacturing activities in Michigan will be able to use those activities to claim the QPAI deduction—and thus cut its taxes—in any state that offers the deduction, even if the company does not have manufacturing facilities in those states.
- By giving a tax preference for manufacturing, filmmaking and

coffee-roasting, the QPAI tax break distorts the allocation of private investment between these tax-favored industries and other less-favored industries. In other words, if the QPAI tax break actually affects businesses' investment decisions, it does so by channeling private resources towards investments that are made only for tax reasons—and thereby channels the same resources away from more productive investments.

- Because the QPAI deduction makes a distinction between “domestic production” that is eligible for the tax break and other activities that are ineligible, businesses have an incentive to artificially shift their profits toward lower-taxed, eligible activities, making its QPAI-related activities appear more profitable than they really are. As former IRS Commissioner Mark Everson has noted, corporations “naturally will classify everything possible as production activities” to take advantage of the tax break.
- The QPAI bill's vague wording is likely to generate long-term administrative and enforcement difficulties. The Treasury Department's 100-plus pages of QPAI regulations were promulgated more than a year after QPAI was enacted. States conforming with the QPAI deduction will likely be swept up in litigation over which corporate activities will be eligible for QPAI even after the regulations are finalized.
- State revenue lost to the QPAI deduction will reduce lawmakers' ability to devote revenues to better-targeted, more effective economic development strategies such as adequate spending on public schools and transportation infrastructure.

Conclusion

The QPAI deduction grew well beyond its intended purpose on the way to enactment, resulting in significant tax breaks for non-manufacturing corporations and revenue losses in the states. States are not powerless in the face of such changes, however. They do not have to stand idly by and accept such unwelcome inheritances from the federal government. They can—and have—selectively severed the connections between the federal tax code and their own tax laws that convey such tax cuts from one level of government. Decoupling from QPAI would allow states to preserve most of the administrative ease of linking to federal rules while also preserving their revenue stream. 🐼