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Report: Treasury Guidance on the American Rescue Plan Act Leaves Room for State Tax Reform

Michael Lucci, Senior Policy Advisor | May 20, 2021

The United States Treasury has issued comprehensive guidance for the use of $350 billion in aid appropriated to state and local governments in the American Rescue Plan Act (ARPA). For policymakers interested in tax reform, Treasury's interim rule cleared the pathway for some productive uses of coronavirus federal aid dollars, closed off other productive uses, and left still other options unclear.

Report Highlights

- According to Treasury guidance, ARPA funds cannot be used to directly or indirectly offset a reduction in net tax revenue, nor can they be deposited into pension funds.
- A top priority for states should be to replenish unemployment insurance trust fund losses caused by the pandemic. This action would prevent future tax increases on business payrolls that would be triggered by depleted trust funds.
- States can use Treasury's formula to calculate the Fiscal Year 2019 tax revenue baseline, creating space for states to implement tax reforms despite the tax mandate.
- Under the latest Treasury guidance, states can pursue pro-growth tax conformity changes without violating the FY 2019 revenue baseline. These include protecting businesses from the factory tax, eliminating the innovation tax, giving rapid tax deductions to businesses, and using new revenues for broad rate reductions. Many of these changes would benefit local businesses and spur economy recovery and innovation.

Related Treasury Guidance Documents:

Interim Final Rule (151 pages)
Fact Sheet Summary (8 pages)
FAQs

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American Rescue Plan Act: Allocations and Categories of Use

According to a previous State Policy Network analysis, the ARPA provided aid far in excess of state government costs and revenue losses sustained during the pandemic recession. In addition, state and local governments benefited from several tranches of aid in 2020, which went beyond patching any holes in their budgets.

The ARPA appropriated $350 million in aid to states and local governments, which breaks down into the following allocations:

- $195.3 billion to states and DC.
- $65.1 billion to counties.
- $45.6 billion to metro cities.
- $20 billion to tribal governments.
- $19.5 billion to non-entitlement units of local government.
- $4.5 billion to territories.

ARPA funds are authorized within five categories of use:

- Supporting the public health response to the pandemic (Interim final rule, Pages 10-23)
- Addressing the negative economic impacts caused by the pandemic (Interim final rule, Pages 23-45)
- Providing premium pay for essential workers (Interim final rule, Pages 45-51)
- Replacing lost public sector revenue (Interim final rule, Pages 51-61)
- Investing in water, sewer, and broadband infrastructure (Interim final rule, Pages 61-78)

Restrictions on use of the ARPA funds begin on Page 78. The restrictions entail that ARPA funding cannot be used to directly or indirectly offset a reduction in net tax revenue, and that the funding cannot be used to make deposits into pension funds.

It is critical for state and local governments to find productive, non-recurring expenses upon which to deploy this aid, and to consider every angle for tax relief within Treasury allowance. In addition, state policymakers should keep in mind that a ruling from the Southern District of Ohio already found the “tax mandate” in violation of the Spending Clause due to being unconstitutionally vague. Policymakers should bear in mind that their ARPA spending priorities can change as quickly as a court ruling.

Key Provisions for Tax Reform

Unemployment insurance

Treasury’s guidance (Page 32) explicitly allows states to use the ARPA funds to replenish their unemployment insurance trust funds up to their pre-pandemic balances as of January 27, 2020.

Furthermore, states are allowed to use ARPA funds to pay back Title XII Advances, which are essentially borrowings made by states from the federal government to continue paying out unemployment insurance claims during an economic downturn. States often borrow this money when their trust funds are depleted. Treasury justifies allowing states to use ARPA funds to replenish their unemployment trusts because of the close nexus of unemployment trust funds with the pandemic's economic impacts.

Treasury data indicates that 19 states and one territory have an outstanding advance balance of $51.4 billion in Title XII advances as of May 13, 2021, with another $6 billion of advances pending. **Repaying these advances and replenishing state unemployment trust funds should be a top priority for all states**. Unemployment rates rose across the country due to government pandemic orders that restricted business activity. States should take advantage of this opportunity to replenish their trust funds, and thus prevent pending tax increases on business payrolls that would otherwise be triggered by depleted trust funds.

To get a glimpse of trust fund depletion, compare the Department of Labor's 2020 State Unemployment Trust Fund Solvency Report with the same report in 2021. Florida's trust fund fell from $4.1 billion on January 1, 2020, to $866 million on January 1, 2021; Oregon's fell from $5.1 billion to $3.8 billion, and North Carolina's fell from $4 billion to $2.8 billion. **Backfilling these trust fund losses caused by the pandemic should be a top state priority.**

Fiscal Year 2019 tax revenue baseline

The Treasury guidance creates a formula to calculate a tax revenue baseline against which to measure options such as backfilling budget losses and reducing taxes. The baseline revenue level will allow a cushion for states to make tax reforms against organic revenue growth. Fiscal Year 2019 revenue, adjusted forward for inflation, is the baseline revenue that must be maintained without triggering a violation of the ARPA's tax mandate provision. Revenue reductions that do not dip below that threshold (with an allowance for a one percent safe harbor) will be considered tax reductions against organic revenue growth rather than tax reductions paid for with ARPA funds. Inflation is calculated with the Bureau of Economic Analysis' GDP implicit price deflator.

Suppose a state's baseline revenue was $100 in FY 2019. In addition, suppose that total inflation is six percent from FY 2019 to FY 2022, meaning that inflation-adjusted FY 2019 revenue is equal to $106 in FY 2022. If actual revenue is $111 in FY 2022, the state can make $5 in net tax reductions against organic revenue growth without triggering the "tax mandate" provision that restricts states from using ARPA funds for tax cuts.

This creates space for states (especially high-growth states) to make tax reforms despite the tax mandate.

Income tax conformity changes

Treasury's previous statement on April 7, 2021, opened the door to allowing income tax conformity changes without violating the ARPA's tax mandate. Income tax conformity occurs when a state adopts an updated version of the federal Internal Revenue Code.

For example, many states have recently enacted conformity updates and adopted 2020 federal tax relief, namely from the CARES Act, into their state tax codes. Conformity can also occur with individual sections of code, such as when a state adopts the federal provision for treatment of business net operating losses (NOLs).

The rule updates Treasury's previous statement on conformity:

Finally, Treasury has determined and previously announced that income tax changes – even those made during the covered period – that simply conform with recent changes in Federal law (including those to conform to recent changes in Federal taxation of unemployment insurance benefits and taxation of loan forgiveness under the Paycheck Protection program) are permissible under the offset provision.

This allowance makes sense, though unfortunately it requires more clarification, which is not provided in the accompanying FAQs. Treasury's rule does not define a date when qualifying "recent changes" were made to the federal code that states are allowed to adopt without violating the tax mandate. Do recent changes only include those made in 2020, or can they extend to changes made under the Tax Cuts and Jobs Act in late 2017? Both sets of changes are recent enough that states are still actively updating their tax codes with conformity laws to adopt and reject various provisions from each.

Furthermore, the guidance is unclear about whether "simply conform" means states can selectively conform to specific IRC provisions and decouple from other provisions. Or, does it imply that states can only make broad conformity updates by adjusting conformity dates and widely adopting federal changes?

It seems clear that states can update their tax laws to adopt federal tax relief from 2020. Beyond that, states can take a conservative approach that still allows for tax reform by making pro-growth conformity changes that keep them within the Fiscal Year 2019 revenue baseline with a one percent safe harbor. Below are pro-growth conformity changes for states to consider, many of which can be made without violating the FY 2019 revenue baseline.

1. Protect businesses from the factory tax.

Perhaps the most pro-growth change enacted in the 2017 Tax Cuts and Jobs Act (TCJA) was 100 percent bonus depreciation for business investments in machinery and equipment, also known as full expensing. This relieved manufacturers and other businesses of the so-called "factory tax."

Business income is defined as revenue minus costs, and that differential makes up the income tax base. Costs include things like payroll, insurance, and investments. The IRC imposes amortization schedules to depreciate investment costs over time instead of allowing the costs to be deducted all at once. This creates a bias against these types of investments because amortization prevents businesses from fully deducting the cost of their capital investments. Thus, companies pay higher taxes on their investments, and sometimes pay taxes on income that doesn't exist, resulting in less investment and growth. The TCJA corrected this problem for short-lived assets by providing 100% bonus depreciation for investments in machinery and equipment, covered in IRC Section 168(k) and Section 179. However, the IRC's 100% bonus depreciation begins to phase out in 2023.

States that already conform with Section 168(k) should decouple from the phase-out provisions that kick in starting in 2023. Since the tax relief implied by 168(k) conformity is already in their revenue baselines, decoupling from the phase-down of full expensing should not involve a net reduction of tax revenue relative to fiscal year 2019.

States that have not yet conformed to Section 168(k) and Section 179 should do so without adopting the phase-out of full expensing. This change improves the state's tax code by removing a bias against equity investment, and it helps states achieve stronger growth in capital-intensive industries like manufacturing.

2. Cancel the upcoming innovation tax.

Current federal law allows businesses to deduct research and development costs in the year they are incurred, as the US has done since 1954. However, the TCJA contained some tax increases to raise revenues, and one such change is the upcoming amortization of research and development costs. Business research and development (R&D) costs are a key ingredient in an innovation economy, and current federal law schedules these costs to be amortized beginning in 2022. Most states automatically conform with this provision from IRC Section 174 and will adopt the amortization of R&D expenses.

States should decouple from the federal law's pending amortization of R&D expenditures and make R&D costs permanently deductible in the year they are incurred. This would prevent a growth-reducing tax increase on the innovation economy and would not violate the "tax mandate" because it would reduce taxes relative to the FY 2019 baseline.

3. Provide more rapid tax rebates for businesses that experienced pandemic losses from 2018-2020.

The TCJA also made changes to business net operating losses (NOLs) that restricted business ability to achieve rapid tax rebates when they experience income losses. The changes included the following:

- Limiting NOL deductions to 80 percent of taxable income;
- Disallowing NOL carrybacks; and
- Lifting the 20-year limit on NOL carryovers.

However, in response to the pandemic, the federal CARES Act provided more generous treatment of NOLs by allowing five-year carrybacks for losses sustained in 2018, 2019, and 2020. This provision allows businesses to deduct losses sustained in 2018-2020 against income earned in the five preceding years to achieve a more rapid tax refund. The purpose of this change was to quickly provide liquidity to businesses that were struggling to stay afloat and make payroll during the pandemic.

States can adopt this short-term improvement to NOL treatment from the CARES Act through an allowed conformity update. States can then go further by permanently improving their treatment of NOLs as described below.

4. Use revenue from interest cost deduction limitation to lower business tax rates.

States should anticipate another change to the federal tax code that will increase revenues. Most states will adopt a limitation on business deductions for interest costs. This provision, covered in IRC Section 163(J), was paired with full expensing in 168(K) to reduce the tax code's bias for debt-financed investments over equity-financed investments. Most states have broad conformity to the federal treatment of business interest expenses. States can remain conformed to the 163(J) limitation on business interest costs, which will produce additional revenues in upcoming years, and then use the resulting revenue to make a pro-growth change such as reducing the overall business tax rate in a manner that is revenue neutral. Alternatively, states can use the revenue to pay for other conformity changes. Given that states will act in anticipation of new revenue, they will not risk violating their FY 2019 revenue baselines.

A window for state solutions despite federal overreach

Treasury's guidance further reveals powerful federal action to restrict state fiscal prerogatives. Whether the federal government can take such action without violating the Constitution will be subject to court decisions, such as the one from the Southern District of Ohio.

In the meantime, Treasury's guidance leaves a pathway for states to leverage the extraordinary amount federal aid to create tax relief. States can minimally replenish their unemployment trust funds, which would prevent a tax increase on business payrolls. States can also make conformity changes that provide tax relief, though the type and scope of such conformity changes is unclear. And states can make more ambitious conformity changes, and other tax changes, so long as they do not reduce own-source revenues below a FY 2019 inflation-adjusted baseline. States should plan to provide tax relief within the rule's constraints for the duration of covered years while remaining prepared to enact larger tax reforms should the court system invalidate the ARPA's "tax mandate."

