MEMORANDUM

TO: Members of the United States Congress

FROM: Neil L. Bradley, Executive Vice President and Chief Policy Officer

Watson M. McLeish, Senior Vice President, Tax Policy

DATE: April 30, 2025

RE: Key Reasons to Preserve the Deduction for State and Local Business Taxes

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In December 2017, Congress passed the landmark Tax Cuts and Jobs Act ("TCJA"), the most comprehensive tax reform legislation since 1986. The TCJA reduced and simplified the federal tax burden on American families and workers, and it substantially modernized America's approach to taxing business income.

Among other important reforms, the TCJA lowered the corporate tax rate from 35% to 21%, introduced a new 20% deduction for pass-through business income, and lowered the top marginal individual rate. Recently, however, some policymakers have expressed support for significantly weakening these pro-growth reforms by disallowing or otherwise limiting the deduction for state and local business taxes ("B-SALT deduction").

Here are four key reasons why it's imperative that Congress preserve the B-SALT deduction:

Limiting the B-SALT Deduction Would Tax Employers on Phantom Profits They Haven't Earned, Distorting the Federal Income Tax System

Regardless of the legal form of organization (e.g., sole proprietorship, partnership, S or C corporation), the same general principles apply in the computation of taxable business income—realized gross receipts reduced by allocable costs and expenses.[1] Net income rather than gross revenue has long been viewed as the appropriate tax base, both to accurately measure economic well-being and to avoid distortions of economic activity.[2] The federal income tax system reflects this view and generally allows an uncapped above-the-

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[1] *See, e.g.*, Staff of J. Comm. on Tax'n, 118th Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2024–2028*, JCX-48-24, at 7 (Dec. 11, 2024).

[2] Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax*, 82 Va. L. Rev. 413, 461 (1996).

line deduction for state and local business taxes,[3] which are but one of the many ordinary and necessary expenses incurred in carrying on a trade or business.[4]

The allowance for these deductions makes perfect sense. State and local business taxes are not optional. Rather, they are the quintessential ordinary and necessary business expense. Fully deducting these expenses is necessary to compute *net* income, and thus necessary to correctly tax businesses.[5] **If firms were ever precluded from deducting their state and local business taxes for federal income tax purposes, it would amount to taxing them on *phantom* income**—a counterproductive policy for many businesses, but a potentially existential threat to small and midsize businesses operating on tight margins. In short, the B-SALT deduction is an indispensable element of the federal income tax system and should not be curtailed.

Limiting the B-SALT Deduction Would Be the Same as Increasing Business Tax Rates

Because limiting the B-SALT deduction would tax employers on phantom income, it would have the same practical effect as increasing income tax rates on businesses.

To illustrate, consider a corporation that under current law has $100 in net income (profit) for the taxable year. The company would pay a 21% federal income tax on that profit, or $21. The company would have paid approximately $6 in state and local corporate income taxes (reflecting the average state/local corporate income tax rate of 5.86%, rounded up). If the company were unable to deduct those taxes on its federal income tax return, however, it would face 21% tax on $106 of income or $22.26 in federal tax liability. But since the company had only $100 in actual profit, this would be the functional equivalent of raising the corporate tax rate by approximately 1.25 percentage points—from 21% to 22.25%.

[3] Under existing law, C corporations may claim an uncapped above-the-line deduction for state and local property taxes, income taxes, and other taxes incurred in carrying on a trade or business or an activity to produce income (collectively, "business taxes"). Similarly, an uncapped above-the-line deduction is available for state and local business taxes imposed on pass-through entities, like partnerships and S corporations, that are reflected in a partner's or S corporation shareholder's distributive share or pro rata share of income or loss on a Schedule K-1 (or similar form). *See* H.R. Rep. 115-466, at 260 n.172 (2017); Staff of J. Comm. on Tax'n, 115th Cong., *General Explanation of Public Law 115-97*, JCS-1-18, at 67 n.289 (2018).

[4] *See generally* I.R.C. §§ 62, 164. The deductibility of these taxes has been a feature of the federal income tax throughout its history. *See, e.g.*, Daniel J. Hemel, *Easy on the SALT: A Qualified Defense of the Deduction for State and Local Taxes*, Public Law and Legal Theory Working Paper No. 652 at 4 (2017), https://chicagounbound.uchicago.edu/public_law_and_legal_theory/836/.

[5] This principle is reflected in annual reports of the Office of Management and Budget and the Joint Committee on Taxation, which generally classify the itemized deduction for state and local income, property, and sales taxes as a "tax expenditure" while classifying the above-the-line deduction for state and local *business* taxes as part of the "normal" income tax structure. *See, e.g.*, Off. of Mgmt. & Budget, Exec. Off. of the President, *Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 2021*, at 148 (2020); Staff of J. Comm. on Tax'n, 116th Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2020–2024*, JCX-23-20, at 2–3 (2020).

Because the foregoing example looks only at state and local corporate income taxes, however, it likely underestimates the potential effective tax rate increase on the typical employer under a B-SALT cap. Most employers pay significant amounts of other state and local business taxes like property taxes, sales and excise taxes, and payroll taxes. If any of these taxes were also non-deductible, it would raise the employer's effective income tax rate commensurately.

This is important, because low marginal tax rates promote capital formation and minimize the effects of other distortions in the tax code, all of which contribute to the economic growth that creates well-paying jobs and raises the standard of living for all Americans. Consider, for example, the TCJA's historic reform to the corporate tax rate, which it lowered by 14 percentage points—from 35% to 21%. In conjunction with the law's other pro-growth reforms, studies now show that reducing the corporate income tax significantly boosted domestic investment while increasing economic growth and workers' wages.[6]

But even with the TCJA's historic reforms, U.S. corporations remain subject to an average combined federal–state statutory tax rate of 25.63%—higher than the current Organisation for Economic Co-operation and Development ("OECD") average rate of 23.85%.[7] It is critical, therefore, for policymakers to understand that *any* proposal to raise the current corporate tax rate—either directly or indirectly—would put U.S.-based companies at a further disadvantage relative to their foreign-based competitors and increase the relative cost of business investment in America. But the harm would not stop there. The latest research shows that raising the corporate income tax would not only reduce economic output and wage growth but also increase consumer prices.[8]

Even if a B-SALT deduction cap were designed narrowly to limit only state and local corporate income taxes, it would still increase the average combined federal–state corporate tax rate to approximately 27%. That would cause the United States to become the tenth highest-taxed country in the OECD—ceding our current competitive advantage over the Netherlands, France, Canada, and South Korea. This would seriously undermine the

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[6] *See, e.g.*, Gabriel Chodorow-Reich et al., *Tax Policy and Investment in a Global Economy*, NBER Working Paper No. 32180 at 1 (Mar. 2024), https://conference.nber.org/conf_papers/f191672.pdf.

[7] According to OECD data, the current U.S. federal statutory corporate income tax rate less deductions for state and local corporate income taxes is estimated to be 19.77% and the average combined state and local statutory corporate income tax rate is estimated to be 5.86%, which produces a combined federal–state statutory corporate income tax rate of 25.63%. OECD, *Corporate Income Tax Statutory and Targeted Small Business Rates* (updated Sept. 2024).

[8] Recent economic research shows that just over half (52%) of the cost of higher corporate taxes is borne by consumers in the form of higher prices, with another 28% borne by workers in the form of lower wages and the remaining 20% borne by shareholders (including retirement savings accounts) in the form of lower returns. Scott R. Baker et al., *Corporate Taxes and Retail Prices*, NBER Working Paper No. 27058 (rev. March 2023), https://www.nber.org/system/files/working_papers/w27058/w27058.pdf.

historic pro-growth reforms of 2017 and contravene fundamental principles of sound tax policy.[9]

Capping the B-SALT Deduction Would Impose a Significant Tax Increase on American Businesses of all Sizes and Create Other Harmful Economic Effects

According to a recent analysis by the Tax Foundation, disallowing the B-SALT deduction for state and local corporate income taxes would raise approximately $223 billion in new revenue over 10 years.[10] Applying this limitation to state and local property taxes would raise an additional $209 billion over the same period.[11] And eliminating the deduction for state and local business taxes imposed on pass-through entities, like partnerships and S corporations, would saddle those businesses with more than $226 billion in additional taxes.[12] But where would these hundreds of billions in additional tax revenues come from? Ultimately, businesses have only three options to pay for higher taxes: they can raise prices; reduce costs; or lower returns to investors. In reality, they do a combination of all three.[13]

Limiting the B-SALT Deduction Would Not Foster More State Tax Competition

Some proponents of limiting the B-SALT deduction have suggested that it could be a means of fostering greater tax competition among states and localities by encouraging businesses to relocate to lower-tax jurisdictions. While it is certainly true that state and local tax policies can impact decisions about where employers make investments, limiting the deductibility of state and local business taxes would not meaningfully impact state tax competition.

State and local business income taxes are imposed by "apportionment," the process for determining the percentage of a firm's profits subject to a given jurisdiction's corporate income or other business taxes.[14] States apportion business profits based on some combination of the percentage of company property, payroll, and sales located within their

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[9] It would also have the perverse effect of treating *foreign* business taxes more favorably than those paid to U.S. states and localities, with the former remaining eligible for deduction or the foreign tax credit.

[10] Jared Walczak & Garrett Watson, Tax Found., *Policymakers Should Tread Carefully When Weighing New Corporate SALT Deduction Limits* (Mar. 3, 2025), https://taxfoundation.org/blog/corporate-tax-deduction-c-salt/.

[11] *Id.*

[12] Garrett Watson & Daniel Bunn, Tax Found., *Growth Should Be a Key Consideration if Corporate SALT Is Limited* (Mar. 24, 2025), https://taxfoundation.org/blog/corporate-salt-deduction-limitation/.

[13] See *supra* note 8.

[14] Garrett Watson & Daniel Bunn, *supra* note 12.

borders.[15] Thus, firms cannot avoid a given state's high business tax environment by simply locating their facilities in a lower-tax jurisdiction.

The almost certain result of limiting the B-SALT deduction would not be more competition among states to attract employers through better tax policies, but rather higher federal income taxes for all businesses.

Conclusion

The B-SALT deduction is neither a "tax expenditure" nor a "loophole," but rather a bedrock feature of the federal income tax system. And while proposals to disallow or otherwise limit the B-SALT deduction would raise revenue, that revenue would come at the cost of higher prices for consumers, lower wages for workers, and lower returns to shareholders—inevitably leading to reduced economic output. Policymakers must therefore reject any attempt to raise the corporate tax rate—either directly or indirectly—as part of their ongoing efforts to address the 2025 tax cliff.

[15] *See, e.g.*, *MeadWestvaco Corp. v. Ill. Dep't of Revenue*, 553 U.S. 16, 19 (2008) (explaining that a state may "tax an apportioned share of the value generated by the intrastate and extrastate activities of a multistate enterprise if those activities form part of a 'unitary business'").