State and Local Business Taxes Are Ordinary and Necessary Business Expenses and Should Be Fully Deductible

- A business income tax should allow deductions for all expenses of earning income. State and local business taxes ("business SALT") are ordinary and necessary business expenses, just like employee salaries or cost of goods sold, and are therefore properly deductible in computing taxable income.
- Denying a deduction for state and local income taxes would be a backdoor tax increase on millions of small and large American businesses and their owners and employees. Limiting the deduction for state and local business taxes is a tax hike on small businesses who operate as sole proprietorships, partnerships, subchapter S corporations and subchapter C corporations. Nearly 99% of companies taxed as corporations are small businesses with less than 500 employees.[1] More than 40% of these small businesses have business receipts of less than $100,000.[2]
- For more than 50 years, the Department of the Treasury and the Joint Committee on Taxation have recognized that state and local business taxes are appropriate tax deductions. In their published lists of tax preferences,[3] they distinguish between business and nonbusiness state and local taxes and have never treated the deduction of business SALT as a tax preference.[4] Limiting the deduction for business SALT would tax large and small businesses on more than 100% of their economic income.
- Denying the deduction for state and local corporate income taxes is equivalent to an increase in the corporate income tax rate of about 1.3 percentage points, putting the combined U.S. federal and state corporate income tax at 26.9% (up from 25.6%), well above the OECD average of 23.8%.
- A broader limitation on the deduction for SALT, including property and sales taxes would increase the average corporate income tax rate by about 5 percentage points. If the corporate SALT deduction were eliminated for state and local corporate income and property taxes, the average. corporate tax rate would increase by over 6 percentage points.
- Economists have found that corporate income taxes are the most harmful taxes for economic growth because they discourage investment in capital and productivity improvements.[5]
- Higher business taxes will harm economic growth and result in fewer jobs and lower wages, making it harder to control the long-run growth of the federal debt.
- According to the Treasury Department's own economic analysis, 37% of the tax burden of a corporate tax increase would be borne by households making less than about $300,000.[6]
- Limiting the deduction for state and local business taxes would affect all businesses and not just those headquartered in high-tax states. That is because most states a company's income is based in whole

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[1] U.S. Census Bureau, Statistics of U.S. Business, 2021 County Business Patterns, July 22, 2024, https://www.census.gov/data/tables/2021/econ/susb/2021-susb-annual.html.
[2] Internal Revenue Service, Statistics of Income Division, 2021, Publication 16, Table 3.3, September 2024, https://www.irs.gov/pub/irs-soi/21co33ccr.xlsx.
[3] Tax preferences are provisions of Federal tax law that allow a special exclusion, exemption, or deduction from gross income or provide a special credit, a preferential rate of tax, or a deferral of tax liability that result in revenue losses relative to a normal income tax. 2 USC 622(3).
[4] Both organizations distinguish between *business* and *nonbusiness* state and local taxes, and they classify the deduction of *nonbusiness* state and local taxes as not part of the baseline tax system. See for example, https://home.treasury.gov/system/files/131/Tax-Expenditures-FY2025.pdf and Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Year 2024-2028* (JCX-48-24), December 11, 2024, https://www.jct.gov/getattachment/765709fb-9a4b-430a-8f9e-4d342ec97f7e/x-48-24.pdf
[5] https://taxfoundation.org/blog/corporate-tax-hike-economic-growth/
[6] https://home.treasury.gov/system/files/131/Distribution-of-Tax-Burden-Current-Law-2025.pdf

or part on sales to customers located in their state (regardless of where the business has its headquarters). As a result, if the deduction for state corporate income taxes were repealed, even a company headquartered in a state with low or no corporate income taxes would face a tax increase if it sold goods or services to customers located in high-tax states.

Myths Surrounding Business SALT Deduction

- MYTH: Limiting the business SALT deduction would generate revenue that could be used to pay for other pro-growth tax policy changes.
  - FACT: Paying for pro-growth tax policy with anti-growth tax policy is hardly the best way to boost the economy.
- MYTH: SALT deductions should be limited by analogy to other expenses that are not deductible for policy reasons, e.g., lobbying expenses or expenditures in connection with illegal drug sales.
  - FACT: Limiting the deduction for expenses related to an activity under a company's control (e.g., lobbying expense) may be effective in reducing the amount of the activity, as would a similar fine or penalty. However, payment of SALT is not discretionary. Companies cannot avoid SALT by moving to a low-tax state, because most states allocate business income based on the location of sales.
- MYTH: Business SALT deductions should be limited by analogy to the limitation on the deduction for business interest expense.
  - FACT: Business interest expense is subject to limitation (1) to tax debt and equity finance on a more equal basis, (2) to discourage over-leveraging and the associated risk of bankruptcy, and (3) in recognition that recipients of interest expense may not be subject to U.S. tax (typically foreign related parties). Contrary to the rationale for limiting business interest expense, limiting the deduction for business SALT increases the effective income tax rate and <u>increases</u> the tax advantage of debt finance. Moreover, SALT expense, unlike interest expense, cannot be used to shift income offshore. While governments that receive SALT payments are not subject to federal income tax, government employees and contractors are subject to federal income tax on payments received out of state and local government budgets (and such payments are not deductible to these governments).
- MYTH: Business SALT deductions should be limited by analogy to the disallowance of deductions for expenses related to earning tax-exempt income.
  - FACT: To prevent companies from making investments that only are profitable due to tax arbitrage, tax rules limit the ability to deduct expenses related to earning tax-exempt income. It is argued that services received from government are a form of tax-exempt income. However, this argument does not justify eliminating the deduction for business SALT for three reasons: (1) If government services (e.g., trash collection) were purchased from a private company, they would be deductible to a firm as a cost of doing business even though the value of the services are not included in the payor’s taxable income, (2) to the extent government services benefit a business taxpayer they lower costs and result in an increase in taxable income, and (3) much of the budget of state and local governments is for wages and purchases of goods and services that result in taxable income to workers and vendors.

- MYTH: Business SALT deduction should be limited by analogy to anti-abuse tax rules.
  - FACT: Anti-abuse rules are designed to prevent taxpayers from engaging in transactions that generate tax benefits unintended by policymakers. By contrast, payment of SALT is not an abuse nor is it under the discretion of the taxpayer.
- MYTH: If the business SALT deduction were eliminated, states could allow a deduction for federal income taxes, rather than the reverse.
  - FACT: If states were to allow a deduction for federal business income taxes, they would need to increase their tax rates to offset the budgetary cost.
- MYTH: Limiting the business SALT deduction is analogous to limiting the deductibility of interest or imports under a destination-based cash flow tax ("DBCFT").
  - FACT: The DBCFT is more analogous to a consumption tax with a wage credit, not an income tax. Comparing the base of a consumption tax to the base of an income tax is an apples-to-oranges comparison.