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by Andrea Muse

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In this 2025 installment of Board Briefs, *Tax Notes State* advisory board members discuss the potential impact of the One Big Beautiful Bill Act on states and state taxpayers and how states may react.

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The Impact of the OBBBA on State Taxation Of Foreign-Source Income

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Federal Tax Reform's Impact on State Corporate Income Taxes

Federal tax reform frequently has a different and unintended impact on businesses at the state level. The federal Tax Cuts and Jobs Act enacted in 2017 is a good example of this anomaly. One of the centerpieces of the TCJA was the reduction of the federal corporate income tax (CIT) rate from 35 percent to 21 percent. To partially offset the loss of revenue, the tax rate cut was combined with a number of CIT base broadeners (and some base narrowers).

However, the TCJA had the opposite impact on state CIT revenue. While state conformity with TCJA provisions varied significantly, no state conformed to the federal tax rate cut. In addition, only a minority of states conformed to federal CIT base narrowers, but most states conformed to some of the largest base broadeners, IRC section 163(j) and section 174.[1] The net impact was a sizable and unanticipated state CIT increase that contributed (along with robust business profits and economic growth) to the subsequent five-year increase in state CIT revenues of about 63 percent after inflation.[2]

The One Big Beautiful Bill Act (OBBBA, P.L. 119-21), signed by President Trump on July 4, extends and expands some of the CIT and personal income tax (PIT) reductions enacted in the TCJA and adds a few new tax cuts as well.[3] However, unlike the TCJA, there are few CIT base

[1] IRC section 163(j) limited deductions for net interest expense. IRC section 174 required amortization (instead of expensing) of research and experimentation expenditures. *See generally* Andrew Phillips and Steven Wlodychak, "The Impact of Federal Tax Reform on State Corporate Income Taxes," prepared for the State Tax Research Institute by EY (Mar. 2018), at ii; Karl A. Frieden and Stephanie T. Do, "State Tax Conformity to Key Taxpayer-Favorable Provisions in the CARES Act," *Tax Notes State*, Apr. 20, 2020, p. 303.

[2] Frieden and Douglas L. Lindholm, "Revisiting the Debate Over State Taxation of Foreign-Source Income," *Tax Notes State*, June 23, 2025, p. 807, at 810-811.

[3] Among the key CIT provisions in the OBBBA are: reviving and making permanent 100 percent bonus depreciation for equipment; reviving and making permanent domestic research and experimentation expensing; reviving and making permanent slightly more favorable interest expense limitation rules; and adding a new provision that allows expensing of factories through 2028. The OBBBA also made a number of taxpayer-favorable changes to the PIT relating to the TCJA, including extending and expanding PIT rate cuts and the standard deduction increase; extending and expanding the child tax credit increase; extending the section 199A passthrough deduction; providing a higher cap of $40,000 on the state and local tax deduction (which expires after 2030); and extending and expanding the estate tax cut. The OBBBA also added a number of new PIT reductions (effective through 2028), including: cutting taxes on tips and overtime; increasing the senior standard deduction; and establishing a deduction for automobile loan interest.

broadeners in the OBBBA that could increase state CIT revenues. Largely, the OBBBA's state CIT impacts are favorable to businesses in those states that automatically or proactively conform to the permanent expensing of equipment and spending on research and development and the temporary expensing of factories.[4]

From a state perspective there is at least one significant exception to the business-friendly provisions of the OBBBA: the treatment of foreign-source income (FSI) under the provision previously known as global intangible low-taxed income. The TCJA redesigned the federal taxation of FSI, switching from taxing all FSI on a deferred basis (when dividends were repatriated) to taxing a portion of FSI on a current basis (GILTI).[5]

After the passage of the TCJA, about two-fifths of the states conformed in part to the new GILTI provision, including between 5 percent and 50 percent of FSI (less the federal qualified business asset investment (QBAI) deduction for a 10 percent return on tangible property investments) in their state's CIT base.[6] The state impact of including a portion of GILTI in the CIT base is different from the federal outcome because states do not allow a foreign tax credit for taxes paid to other countries. Therefore, those states that tax GILTI include FSI in the CIT tax base whether it is low-taxed or high-taxed income.

In theory, state apportionment formulas applied to FSI approximate the impact of the FTC and serve as a proxy for isolating low-taxed from high-taxed FSI. In practice, most states that tax FSI include limited or no foreign factor representation (such as foreign sales) in the state apportionment formula, resulting in state taxation of GILTI that is largely disconnected from and more onerous than the federal tax outcomes.[7]

The OBBBA's Impact on GILTI/NCTI

The OBBBA makes changes to GILTI that exacerbate the differences between federal and state treatment of FSI, in a manner unfavorable to businesses. At the federal level, the OBBBA significantly broadens the potential FSI tax base by eliminating the QBAI deduction and reducing the IRC section 250 deduction from 50 percent to 40 percent. However, the OBBBA offsets these unfavorable changes by increasing the foreign tax credit from 80 percent to 90 percent and revising the rules for the allocation of interest and R&D deductions in a manner that increases the availability of FTCs. The OBBBA also renamed GILTI as net controlled foreign corporation tested income (NCTI).[8]

At the federal level, the net impact of these changes may be beneficial or detrimental to U.S. multinational corporations (MNCs), depending on the facts. At the state level, these changes are unfavorable to businesses. For any state that taxes a portion of GILTI and updates either through rolling conformity or by legislative linkage to the post-OBBBA NCTI provision, the inclusion of FSI in the CIT base expands significantly with the elimination of QBAI and the reduction of the IRC. section 250 deduction. Furthermore, because states do not conform to FTCs and generally provide no or only partial foreign factor representation, there is no corresponding offset to the increased FSI tax base. As a result, post-OBBBA, state taxation of FSI (through conformity with NCTI) is increasingly divorced from both the goals and intended tax base of federal taxation of FSI.[9]

[4] On current state CIT conformity to some of these provisions, see: Jared Walczak, "The OBBBA Gets Expensing Right. States Should Follow Suit," Tax Foundation, July 22, 2025.

[5] Under the TCJA's provisions, GILTI was designed to tax the "above routine" profits of U.S. MNCs' foreign subsidiaries by allowing a deduction from FSI for a deemed return of 10 percent on each foreign subsidiary's qualified business asset investment. A foreign tax credit of 80 percent of all foreign taxes paid on the GILTI amounts is allowed to ensure that the new federal approach targets only low-taxed FSI. Finally, a 50 percent deduction is allowed under IRC section 250 to create the initial federal effective tax rate of 13.125 percent on GILTI. Frieden and Barbara M. Angus, "Convergence and Divergence of Global and U.S. Tax Policies," *Tax Notes State*, Aug. 30, 2021, p. 955.

[6] Frieden and Lindholm, *supra* note 2.

[7] *Id.* at 818. The tendency of states that tax FSI to limit or exclude foreign factor representation has recently taken a turn for the worse, as both Minnesota (2023) and Illinois (2025) enacted statutes that include 50 percent of global FSI in the state CIT base with zero foreign factor representation. *Id.* at 817-820.

[8] P.L. 119-21, sections 70321 and 70323. *See generally*, Mindy Herzfeld, "The OBBBA's International Revenue Raisers, Losers, and Fixes," *Tax Notes Federal*, July 28, 2025, p. 523.

[9] The OBBBA NCTI provision is designed to include only low-taxed FSI in federal taxable income.

The Potential Competitive Disadvantage for U.S. MNCs

Over the last decade, a global consensus has developed that new national CIT rules are needed to address the problem of low-taxed FSI. The United States pioneered the new approach by enacting a global minimum tax (GMT) in the form of GILTI and later replacing it with NCTI. At the international level, dozens of countries have followed suit, adopting some or all of the provisions of the OECD's pillar 2 GMT.[10]

Although the U.S. and OECD initiatives take slightly different approaches to a GMT, they share the perspective that the problem of low-taxed FSI and profit shifting should be addressed at the national, not the subnational level. State conformity to GILTI and NCTI is particularly troubling given that U.S. states are virtually the only subnational governments in the world that include FSI in the state CIT base.[11]

The inclusion of FSI in both the national and subnational CIT bases in the United States risks placing U.S. MNCs at a competitive disadvantage compared with foreign MNCs. First, the United States has reached a tentative agreement with the G7 nations that excludes U.S. MNCs from most of the provisions of the pillar 2 GMT.[12] However, the agreement does not apply to the qualified domestic minimum top-up tax (QDMTT) rule.[13] The QDMTT allows a low-tax nation or a high-tax nation (with an abundance of credits and incentives) to impose a 15 percent GMT on MNC income sourced to that country.[14] A QDMTT can apply to both U.S. and foreign MNCs, but only the former are also subject to a subnational-level tax on FSI. If a low-tax nation imposes a QDMTT at the 15 percent GMT rate, the FTC for U.S. MNCs and the pillar 2 top-up tax rules for foreign MNCs will generally preclude an additional national-level tax in the MNC's home country. However, because U.S. states do not allow an FTC, a U.S. MNC could be subject to a QDMTT and a state CIT on NCTI, placing it at a competitive disadvantage compared with a foreign MNC that is not subject to a subnational CIT on its FSI.

Second, the change from GILTI to NCTI has aligned the U.S. GMT more closely to the pillar 2 GMT used by many other nations to tax the FSI of their own MNCs. The new NCTI has an effective tax rate of 14 percent compared with the pillar 2 ETR of 15 percent. But, due to the elimination of the QBAI deduction, the tax base of NCTI is now broader than the pillar 2 tax base. The pillar 2 GMT allows an FSI deduction for a normal return relating to both payroll expenses and capital investments.[15] There are other differences between the U.S. NCTI and pillar 2 GMT rules that complicate this comparison, including differences in aggregate (U.S. rule) vs. country-by-country (pillar 2) methods of calculation. Nonetheless, post-OBBBA, the tax on U.S. MNCs under the NCTI provision can exceed, equal, or be lower than the equivalent tax on foreign MNCs under the pillar 2 GMT. Levying a state CIT on GILTI or NCTI in addition to a federal tax on FSI could create a competitive disadvantage for U.S. MNCs compared with foreign MNCs that are not subject to subnational CITs on their FSI.

Conclusion

State taxation of FSI under GILTI, and even more so under NCTI, can result in a much less favorable result for U.S. MNCs than at the federal level. The state approach is inconsistent with both the design and goals of the federal provisions to include only low-taxed FSI in the federal CIT base. There is also the real potential for creating a competitive disadvantage for U.S. MNCs, because FSI is included in the national and subnational CIT bases only in the United States. Given the unintended and potentially uncompetitive outcomes, states that have not conformed to GILTI/NCTI should refrain from doing so. States that have conformed to GILTI should consider decoupling from GILTI/NCTI or at least reducing the unfavorable impact by lowering the share of GILTI/NCTI inclusion and providing full foreign factor representation.

[10] PwC's Pillar 2 Country Tracker.

[11] PwC, "Survey of Subnational Corporate Income Taxes in Major World Economies: Treatment of Foreign Source Income," prepared for the State Tax Research Institute (Nov. 2019).

[12] Specifically, the agreement addresses the income inclusion rule and the undertaxed profits rule. Treasury, "G7 Statement on Global Minimum Tax" (June 28, 2025).

[13] *Id.*

[14] Several dozen nations have already adopted or announced plans to adopt the QDMTT provision in pillar 2. PwC's Pillar 2 Country Tracker, *supra* note 10.

[15] Herzfeld, *supra* note 8.

The States' Reaction to the OBBBA

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The dust has barely settled on the One Big Beautiful Bill Act (OBBBA), and the pundits are already at work opining as to success and impact. When we drill down to the impact on state taxes, several conclusions can be made, and there is likely more activity to come.

It's Complicated

Most states have an annual or biannual budgetary process, with many states' fiscal 2025-2026 budgets already in place. States now need to forecast the impact on their apportioned share of taxpayers' federal taxable income. The key provisions of the OBBBA affecting states' business tax revenues are:

- adoption of 100 percent bonus appreciation for assets placed in service on or after January 20, 2025 (note the retroactive date);
- immediate expensing of tangible personal property and certain computer software (up to $2.5 million per taxpayer annually) placed in service on or after January 20, 2025;
- immediate expensing of qualified research and experimentation expenditures incurred on or after January 20, 2025;
- the ability to deduct the unamortized portion of qualified research and development costs incurred before January 1, 2025;
- an increase for business interest deductions to 35 percent of earnings before interest, taxes, depreciation, and amortization; and,
- a deduction for employees receiving overtime wages (up to $25,000 annually for married filing jointly/$12,500 for individual taxpayers).

States are also affected by changes to Medicaid and food assistance programs that will increase state costs by millions of dollars. Add to that the economic uncertainty and fiscal pressure caused by looming tariffs against some of the United States' largest trading partners, the states have budgetary pressures not seen since the recession. Michigan has already seen a significant decrease in Canadian visitors, who had often visited for the day to shop on the U.S. side of the border. This has affected sales tax revenues, as well as the stores' revenues.[16] So where are we?

State Budgets Are Impacted

Let's use my home state as a case study. The House Fiscal Agency previously announced that the impact of federal tax changes on the Michigan corporate income tax is expected to reduce revenues by $677 million in fiscal 2026, which begins October 1, 2025, and by another $613 million in fiscal 2027.[17] A more robust analysis was recently issued by the Citizens Research Council of Michigan, which aligned to the House's impact on corporate income tax, and predicts a $1.1 billion increase in state cost-sharing for Medicaid and the Supplemental Nutrition Assistance Program.[18] Keep in mind that Michigan corporate income tax revenues are generally in the range of $1.5 billion to $2 billion annually, so $677 million is a significant reduction. The biggest impact is from the immediate expensing of qualified research costs and the ability to expense prior unamortized costs.

More Likely Than Not We Will See State Responses

Even before the passage of the OBBBA, Michigan's Legislature had floated:

- an increase in the corporate income tax rate from 6 percent to 8.5 percent;
- a digital ad excise tax; and,
- a tax on delivery services, with the increased tax revenues being dedicated to road funding.

[16]The impact to Michigan has been estimated to be an 18 percent decrease in car traffic and an 11 percent decrease in border crossings for February and March 2025, as reported by Bridge Michigan citing U.S. Customs and Border Protection data. *See* Janelle D. James and Ron French, "Travel From Canada to Michigan Plummets Amid Tariffs, Border Scrutiny," Bridge Michigan, Apr. 24, 2025.

[17]House Fiscal Agency report issued July 22, 2015. Michigan House Fiscal Agency, "Fiscal Brief: The One Big Beautiful Bill Act of 2025" (July 21, 2025).

[18]Citizens Research Council of Michigan, State Budget Note 2025-1 (July 2025).

That certainly doesn't help the situation. As with IRC section 199 and the modified accelerated cost recovery system (for those who remember), the states will be forced to consider decoupling from the costliest federal provisions. But can they? Legislation to decouple from provisions in the OBBBA will need to pass both the Republican-controlled Michigan House and the Democrat-controlled Senate before being sent to Gov. Gretchen Whitmer (D) for signature. And keep in mind that many of the state's largest taxpayers strongly benefit from the federal changes and will be loath to give up benefits, given current and continued economic uncertainty.

Unrelated, but further complicating the state's analysis is a proposed ballot petition that will be gathering signatures to amend Michigan's long-standing flat income tax by doubling the rate (4.25 percent) on those with incomes over $500,000 for single filers and $1 million (joint filers). This would be an additional income burden on those businesses that are passthrough entities. The proponents contend that the increased taxes will be used for education purposes, although the proposal has no ability to direct the expenditures. If adopted, Michigan's top income tax rate would be the highest in the Midwest, and seventh highest in the nation. Proponents must collect 446,198 valid signatures in 180 days to qualify for the ballot.

Processing Will Be Impacted

Tax increases are challenging enough; if decoupling is an option, that will further complicate matters, given the looming deadline for developing the 2025 corporate income tax forms. Generally, there is a freeze put on system changes in mid-November for implementing legislative tax changes as the window to develop and test the 2025 forms is short — the 2025 filing season is anticipated to kick off in mid-January 2026.

Any legislative fixes will need to be swift, which in Michigan generally means legislation passed in the middle of the night. The current members of the Michigan House have pledged themselves to transparency, are unlikely to stray from the course, and will want to see the OBBBA benefits trickle down to their constituents — although never say never. What we can predict is continued stress on forecasts and consensus revenue estimates before decisions are made.

Let's Make a Deal

Helen Hecht is uniformity counsel for the Multistate Tax Commission.[19]

There comes a time when it is necessary for "one people to dissolve the political bands which have connected them with another."[20] For the American states, that was 250 years ago. Of course, as soon as they dissolved those old political bands, they found it necessary to form new ones. First among themselves, creating a "more perfect Union,"[21] and then with other countries.

Today, it seems the political bands between people are constantly being dissolved and reformed. It's become very transactional. And this is important for understanding the international tax provisions of P.L. 119-21.

The international tax system has long been broken. It relies on outdated notions of domicile, jurisdiction, asset location, and so-called arm's-length pricing under IRC section 482 to try and pin down territorial income. The recent rise of intangible assets, which are impossible to reliably value or locate, just makes the problem worse. Witness the IRS's continuing struggle to regulate and litigate the issues.[22] A recent article in this publication explains how IRS cost-sharing regulations can be exploited to possibly shift billions in U.S. profits offshore with little or no IRS detection or enforcement and also notes that it is typical in section 482 cases for each side to claim "that the regulations mean the exact opposite of what the other side said they mean."[23] Indeed, the system has spawned a whole industry of experts and practitioners.

The inescapable fact that this international system is broken has finally been acknowledged by just about everyone, including the OECD and other groups. One essential part of their proposed solution is the 15 percent minimum tax requirement, to prevent countries from becoming tax havens.

The administration asserts that the United States complies with this minimum tax requirement. The final reconciliation legislation, P.L. 119-21, continues to include IRC section 951A global intangible low-taxed income in the domestic tax base, effectively overriding the otherwise applicable sourcing rules. This income, now called net controlled foreign corporation tested income (NCTI), was tweaked somewhat. Among other things, the base is no longer reduced by qualified business asset investment, the old 50 percent foreign-derived intangible income deduction has now become the 40 percent foreign-derived deduction-eligible income, and the applicable foreign tax credit was raised from 80 percent to 90 percent. Still, the effective rate on NCTI is 12.6 percent (before considering the 90 percent FTC) which falls short of the OECD's 15 percent minimum. Maybe the administration also expects states to impose tax on NCTI.

It's not clear whether section 951A and related provisions will fix the problems with the international income sourcing system or just make that system even more complicated and unsustainable. And for states, the question is how to reconcile their long-established (and better working) formulary apportionment system with these federal sourcing provisions.

Of course, nothing in the U.S. Constitution, federal law, or tax treaties prevents states from opting out of this system and simply apportioning worldwide combined income of multinational entities. Our federal government has, at times, threatened to restrict this option, and the states have responded by conforming to the federal domestic tax base. But in retrospect, it seems clear

[19] Unless otherwise noted, I write for myself and not the Multistate Tax Commission or its members.

[20] The Declaration of Independence (1776).

[21] U.S. Const. pmbl.

[22] *See Facebook Inc. v. Commissioner*, No. 12738-18 (T.C. June 21, 2023) and *Medtronic v. Commissioner*, T.C. Memo. 2022-84 (2022) (both of which featured dozens of expert witnesses); *Coca-Cola Co. & Subsidiaries v. Commissioner*, No. 31183-15 (T.C. Nov. 18, 2020) (now before the Eleventh Circuit); *3M Co. & Subsidiaries v. Commissioner*, 160 T.C. 50, 160 T.C. No. 3 (2023) (which challenged various aspects of federal IRC section 482 regulations); and *United States v. Eaton Corp.*, No. 1:23-mc-00037 (N.D. Ohio May 16, 2024) (on appeal to the Sixth Circuit) (ongoing fights since 2013 over whether the IRS could cancel advanced pricing agreements and whether the taxpayer can comply with IRS documentation requirements without breaking foreign law).

[23] *See* Ryan Finley, "*Medtronic II*: Do the Transfer Pricing Regs Swallow Themselves?" *Tax Notes Federal*, June 2, 2025, p. 1339.

that federal opposition was not due to some disagreement over the problem or its effects. Rather, past administrations have simply been adverse to "dissolving the political bands" (including tax treaties) connecting the United States with its trading partners. But now that everything is more transactional, maybe that's also changed.

Of course, a purely transactional approach among governments raises big questions. Is any deal ever final? And — is there anything you won't trade?

When faced with such questions, my custom is to look to philosophers. But on the subject of dealmaking, views diverge. Machiavelli, for example, believed everything was negotiable, and no deal was final. But Goethe warned that some trading partners can't be trusted. That said, most agree that in dealmaking, as with most things: There is strength in numbers.

Opportunity Lost

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Congress had one big, beautiful opportunity to salvage the viability of P.L. 86-272[24] in the One Big Beautiful Bill Act (OBBBA), but alas, the Senate removed that provision from H.R. 1 on the way to President Trump's desk.

The battle over P.L. 86-272's extremely limited state income tax preemption has been raging for decades. In 1959 the U.S. Supreme Court handed down *Northwestern States Portland Cement*,[25] which held that the commerce clause of the U.S. Constitution did not prohibit states from taxing an interstate business's net income, so long as the income was fairly apportioned. After an immediate and alarming negative reaction from businesses,[26] Congress enacted P.L. 86-272 to create an extremely limited exception — a preemption to prohibit states from taxing businesses that sell tangible personal property if their only activities in the state involve soliciting orders for their products.

Over the years, states have made every attempt to whittle away the activities that can be included in the scope of what constitutes the solicitation of orders, but the Supreme Court has addressed the issue only once. In 1992 the Court handed down its only interpretive decision, *Wisconsin Department of Revenue v. William Wrigley Jr. Co.*,[27] in which the Court listed certain activities that were protected because they were ancillary to soliciting orders, including those involved in recruiting, training, and evaluating salespeople, intervening in credit disputes, and using homes or rental property to hold sales-related meetings.

[24] P.L. 86-272 (15 U.S.C. section 381) (1959).

[25] *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959).

[26] *See* Jerome R. Hellerstein, Walter Hellerstein, and Andrew D. Appleby, *State Taxation* para. 6.17 (discussing the background of P.L. 86-272).

[27] *Wisconsin Department of Revenue v. William Wrigley Jr. Co.*, 505 U.S. 214 (1992).

Although the Court also acknowledged a de minimis exemption for nonqualifying activities, a salesperson swapping out stale chewing gum for fresh gum was *not* de minimis.

Over the years, the Multistate Tax Commission has issued and revised proposed rules for states to formally adopt, listing what does and does not qualify as exempt activity ancillary to soliciting orders. However, the MTC's most recent revision covering internet activities, adopted in 2021, is so broad that, if adopted by states, it would eviscerate P.L. 86-272 protection. That is, under the MTC rules, even having an interactive website would destroy a company's reliance on the preemption.[28] To date, at least two states have adopted regulations conforming to the MTC's internet standards.[29]

Likely in partial response to the unpopularity of the MTC's 2021 template among businesses and other, more recent attacks to restrict P.L. 86-272, both the House and the Senate included a provision in the OBBBA that would greatly expand activities ancillary to the "solicitation of orders" to include:

> any business activity that facilitates the solicitation of orders, even if the activity could also serve some independently valuable business function apart from solicitation. [30]

But as noted above, the final, adopted version of the OBBBA did *not* contain this provision.

Although the MTC and the states lobbied for and praised Congress's removal of this antibusiness provision from the OBBBA, they fear that it may return in the form of future legislation. In a recent *Tax Notes State* article,[31] several commentators denounced the proposed expansion language for numerous reasons. Peter Enrich argued in the article that P.L. 86-272 has outlived its usefulness "in a world where so much substantial economic activity didn't require or involve any physical presence."[32] The commentators argued that the expansion language is ambiguous, would permit corporations to create nowhere income, and enable corporations to determine whether they should be taxable in a particular state, thus violating state sovereignty. They also noted that P.L. 86-272 and all proposed protective expansions are arguably unconstitutional. None of the commentators, however, had calculated the effect the proposal's passage would have had on state general revenues.

Accordingly, is all this fuss really much ado about nothing? According to the Tax Policy Center, 2021 total state corporate income taxes represented an average of only 2.2 percent of a state's general revenues,[33] so (assuming this statistic is accurate), corporate income taxes are not a significant source of state general revenue in the first place.

Nor would the proposed expansion of P.L. 86-272 protection necessarily create nowhere income, as suggested by the pro-state commentators. Given that every business has only one pie — that is, only one taxable federal income per year — the issue involves which states can tax a slice of each business's pie, but the pie does not get bigger. If the states are ultimately successful in eviscerating P.L. 86-272 protection through their adoption of the MTC's internet template, there likely would be some income tax *base* shifting among the states, but the total state income *taxes collected* by states may well be a wash.

Similarly, if the states' worst nightmare happens and P.L. 86-272 is dramatically expanded by Congress, each business will still have only one pie, but less compliance work and fewer states to fight over which ones get to tax it.

And what's so bad about that?

[28] MTC, "Adopting Resolution" (Aug. 4, 2021).

[29] New York (*see* N.Y. Codes R. & Regs. tit. 20, section 1-2.10, upheld by *American Catalog Mailers Association v. Department of Taxation and Finance*, Index No. 903320-24 (N.Y. Apr. 25, 2025) and New Jersey (*see* New Jersey Division of Taxation, Technical Bulletin TB-108 (Sept. 5, 2023) and Technical Bulletin TB-79(R) (Sept. 5, 2023).).

[30] Section 70301 of H.R. 1 (as passed by the House, May 22, 2025) and section 302 (as proposed by the Senate Judiciary Committee, June 12, 2025).

[31] Dan R. Bucks et al., "Outrageous P.L. 86-272 Expansion That May Return," *Tax Notes State,* July 24, 2025, p. 197.

[32] *Id.*

[33] Tax Policy Center, "How Do State and Local Corporate Income Taxes Work?" (last updated Jan. 2024).

All That Glitters . . .

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One of the ironies of the two most recent bouts of federal tax reform is that one of the oldest and (formerly) uncontroversial federal income tax deductions has become a political lightning rod — capping and then increasing the cap on the deduction for state and local tax (the SALT deduction). Here is a summary of the saga.

The SALT deduction was included as part of the first federal income tax, adopted by a Republican Congress and President Lincoln during the 1860s.[34] The tax expired in 1872 but was reinstated by President Cleveland and a Democratic Congress in the 1890s.[35] This second federal income tax was deemed unconstitutional by the U.S. Supreme Court in 1895.[36] Citizens of the United States remained income-tax-free until it was officially sanctioned by the 16th Amendment to the U.S. Constitution and took effect in 1913.[37] In all its iterations, the SALT deduction survived.

To be sure, there were some changes along the way, such as the enactment of a standard deduction and the limitation of the SALT deduction to state income, property, sales, and fuel taxes.[38] Also, itemized deductions, in general, were further reduced to 80 percent (for those who itemized).[39] However, none of these changes was controversial.

That all changed in 2017 with the enactment of the Tax Cuts and Jobs Act, adopted by a Republican Congress and signed by President Trump.[40] The TCJA capped the SALT deduction (the SALT cap) at $10,000 per year ($5,000 for married couples filing separately) and limited the deduction to state income and property taxes.[41] The impact of this SALT cap was primarily felt by wage earners in high-income-tax (and largely Democratic) states, such as California, New York, and New Jersey. The SALT cap as enacted was temporary and was set to expire in 2025. Congress and the president intended for the limitations to serve as a revenue raiser to offset other tax cuts. The Bipartisan Policy Center projected that the cap on the SALT deduction would generate $668 billion over a 10-year period.[42]

During the Biden administration, congressional attempts to lift or amend the SALT cap did not come to fruition. Upon the election of Donald Trump to a second term in 2024, the SALT cap became (again) a hotly debated item, especially because the Republicans held a narrow congressional majority. To get "blue states" on board, Congress increased the cap. Under the One Big Beautiful Bill Act (OBBBA, P.L. 119-21), signed by Trump on July 4, the SALT cap is increased to $40,000 for tax years beginning after December 31, 2024 ($20,000 for married couples filing separately) through tax years ending December 31, 2029. The higher SALT cap, however, is phased out based on a $500,000 income threshold ($250,000 for married couples filing separately). These SALT caps will increase by 1 percent annually through 2029, with the cap reverting to $10,000 in 2030, unless further extended.[43]

Just after enactment of the TCJA, states started adopting elective passthrough entity taxes (PTETs) in an attempt to ameliorate the impact of the SALT cap for businesses that passed their net income through to their

[34] Revenue Act of 1861.

[35] Wilson-Gorman Tariff of 1894.

[36] *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895).

[37] U.S. Constitution, Amendment XVI (Feb. 13, 1913).

[38] Revenue Act of 1964.

[39] IRC section 68 (1990).

[40] P.L. 115-97 (Dec. 22, 2017).

[41] *Id.* at section 11042.

[42] Andrew Lautz, "A Fiscally Responsible Path Forward on the SALT Deduction Cap," Bipartisan Policy Center (Mar. 3, 2025).

[43] P.L. 119-21 at section 70120.

owners.[44] Typically, PTETs operate in the following manner:

- a business owner or partner elects for the PTE to be taxed at the entity level;
- the PTE pays state income tax on its income directly to the state;
- the state tax payment is a deductible business expense on the entity's federal tax return, which lowers the PTE's income and thereby reduces the income passthrough to the owners; and,
- the states allow owners/partners to receive a credit or claim an exclusion on their state income tax returns, so that the income is not taxed two times by the state.

Importantly, the IRS gave its blessing to PTETs, meaning that state and local income taxes imposed on and paid by a PTE are deductible by the entity for computing its owner's passthrough income.[45] Note, though, that the limitation still applies to combined income taxes and real estate taxes and does not solve the limitation on the latter tax's deductibility.

Notably, the OBBBA did nothing to hinder the attractiveness of PTETs. Earlier drafts of the legislation sought to restrict deductibility related to PTETs, but those limitations were dropped from the final bill. A handful of states, like California, Colorado, and Illinois, made their PTETs temporary and will have to extend them.

Because the SALT deduction can be claimed only by taxpayers who itemize their deductions, the biggest beneficiaries of the increased cap are itemizing filers in the high-tax states. Taxpayers with income above the thresholds will not benefit from the increased cap — so nothing may have changed for these high-income folks. Here is an example of an itemizing filer with income in excess of $500,000 in a tax year:

> A married couple filing jointly with $550,000 in income in 2025 would exceed the $500,000 threshold by $50,000. Applying the 30 percent phaseout, $15,000 of the deduction would be disallowed. Starting from the $40,000 cap, the taxpayers would still be eligible to deduct $25,000 in SALT. This is a definite increase — but not the bonanza the couple had received before the enactment of TCJA (less, of course, the 80 percent limitation on all itemized deductions). As a result of the phaseout, the actual deduction available under the expanded SALT cap could be significantly diminished or even eliminated for high-income individuals. Despite this, the law still guarantees all taxpayers a minimum SALT deduction of $10,000, even if the income-based phaseout would otherwise reduce their allowable deduction below that amount.

Be careful what you wish for, lest it become true. While a large group of taxpayers will benefit from the increased SALT deduction cap, many taxpayers will remain at the $10,000 SALT deduction level and could face a significantly larger effective tax rate, paying more in tax. In fact, the phaseout could create a "SALT torpedo" — an artificially high tax rate — when modified adjusted gross income falls between $500,000 and $600,000. In a CNBC article published on July 11, 2025, Andy Whitehair, a CPA with Baker Tilly's Washington tax council practice, provided an example of how the "quirky" phaseout could boost the tax rate as high as 45.5 percent.[46]

Perhaps Shakespeare is right. Maybe "all that glisters is not gold."[47] But who feels sorry for the rich, anyway? Many less-affluent taxpayers would love to have such problems.

[44]PTET elections are enacted in 36 jurisdictions. Twenty-six states and localities, including Connecticut, New Jersey, and New York state and New York City, have enacted permanent PTET regimes and five states (Colorado, Iowa, Massachusetts, Michigan, and Minnesota) have regimes linked to the federal SALT cap. Consequently, these regimes will continue to be available with the passage of the OBBBA. However, four states (Illinois, Oregon, Utah, and Virginia) have PTET programs scheduled to sunset on December 31, 2025, and will need to pass legislation to extend these regimes. California's statute was similarly set to expire, but the state recently passed new legislation extending its PTET program for an additional five years. *See* Alan Goldenberg, "SALT Deduction Cap Under OBBBA: Key Takeaways for High-Income Taxpayers and Pass-Through Entities," Anchin, Block & Anchin LLP (July 14, 2025).

[45]Notice 2020-75, 2020-49 IRB 1453.

[46]If your income is $500,000 and you subtract $75,000 of itemized deductions (including $40,000 for SALT), your taxable income is $425,000. By contrast, $600,000 of income would drop the SALT deduction to $10,000, which reduces itemized deductions to $45,000 and raises taxable income to $555,000. When comparing taxable income for each example, the true difference is $130,000 with the $30,000 lost SALT deduction. If you multiply that by the 35 percent tax bracket, you get $45,500. In this simplified example, there is $45,500 more federal tax owed by earning $100,000 more, which is 45.5 percent, Whitehair said. *See* Kate Dore, "Trump's 'Big Beautiful Bill' Could Deliver 45.5% 'SALT Torpedo' for High Earners, Tax Pro Says," CNBC, July 11, 2025.

[47]William Shakespeare, *The Merchant of Venice*, act 2, scene 7.

States (and Taxpayers) Dodge a PTET Bullet

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One of the more interesting and under-the-radar aspects of the One Big Beautiful Bill Act (OBBBA, P.L. 119-21) is what *didn't* make it into the final legislation. So much of the discourse around the bill related to the state and local tax deduction cap, as many legislators from blue states like California and New York were insistent on reviving the deduction, or at the very least increasing the cap on the deduction ($10,000) to a much larger number. And ultimately, after different iterations of proposals from both the House and the Senate, a compromise was reached, with the cap going as high as $40,000 for taxpayers making less than $500,000, with 1 percent annual increases through 2029.

But in the initial bill issued by the House, there was a pernicious and problematic proposal calling for the elimination of the deductibility of state passthrough entity taxes (PTETs) that have been put in place by many states — and blessed by the IRS — as a legitimate workaround to the SALT cap. And that proposal extended only to taxpayers that did not qualify for the qualified business income (QBI) deduction, which would have only furthered the unfair treatment of many partnerships and S corporations performing specified services that lose out on the QBI deduction — including two of our favorites, accounting firms and law firms.

A change like that would have been devastating news for many states (and, for what it's worth, some partners in professional service firms), far outweighing any potential upside that the states might have seen for their residents who could benefit from a slight increase to the SALT cap. Indeed, the whole point of these PTET regimes was to curb the downside of the SALT cap by mitigating the loss of the SALT deduction for certain taxpayers in states that impose high income taxes. And if that wasn't enough, the House proposal also targeted other SALT taxes paid by a passthrough entity, making them also subject to the SALT cap, which could have included sales and use taxes, the New York City unincorporated business tax, California's tax on S corporations, the Texas margin tax, the Ohio commercial activity tax, and the Washington business and occupation tax. All these taxes are deductible under current law and have been for decades.

But the loss of the PTET benefit was the biggest concern and would surely have hastened the exodus of high-net-worth taxpayers from blue states, leading many California, Illinois, or New York residents to vote with their feet and follow their friends and colleagues who have already moved to Florida, Texas, or some other state that doesn't impose an income tax. Indeed, I received several calls when this was all going on from concerned New Yorkers who feared the loss of their PTET and wanted our advice on how to move.

A week or so after the House proposal came up, the saga took another turn when the Senate's initial version of the OBBBA came out. Under the Senate's proposal, the PTET was still on the chopping block, but only half of it: Passthrough entities would be allowed to deduct 50 percent of PTET paid. But that half-measure didn't last long. Shortly before the final version of the OBBBA was presented to the president for signature, and without much fanfare or explanation, all of the provisions related to the elimination or reduction of PTET programs quietly went away.

So, the somewhat backdoor attempt to take them out failed as quickly as it arose. Thus, for the foreseeable future, these PTET programs are here to stay. That likely means many taxpayers will also be willing to stay . . . in their high-tax states.

The Trickle-Down Effect of Federal Income Tax And Economic Policy Decisions

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The U.S. national debt is approximately $36.66 trillion, which translates to $107,150 *per person*.[48] With roughly 27 states also in the red, aggregate state debt is another $2.9 trillion.[49] The nonpartisan Congressional Budget Office estimates that the One Big Beautiful Bill Act (OBBBA, P.L. 119-21) will add another $3.4 trillion to the national debt over the next decade (another $10,000 of debt per person), as well as leave millions of people without healthcare coverage.

State income tax is a large revenue component of most state budgets. To promote compliance, reduce costs of compliance, and ease state income tax administration, most state income tax calculations start with federal taxable income or adjusted gross income for simplicity and uniformity for taxpayers and state income tax administrators alike, make adjustments the state deems necessary or appropriate, and then impose tax on the state's apportioned share of a taxpayer's aggregate net income. The adjustments cut against the simplicity and uniformity goals, so states generally balance the need for decoupling from federal income tax on certain items, often for financial reasons, against those goals that, if adhered to, provide a more attractive business climate.

This system works best when federal income tax is grounded in sound tax and economic policies, including a balanced budget, thereby reducing the need for decoupling. In this instance, many of the OBBBA's provisions reflect tax policies that are not universally viewed as sound. For example, if two workers make equal amounts, but only one worker's income reflects tip income, that worker may pay less income tax than the other worker. Is that good tax policy? Another example is the increase in the state and local tax deduction limit, subject to a phaseout that will disproportionately benefit taxpayers in higher-tax states and effectively reflect a subsidy by taxpayers in the lower-tax states. Is that good tax policy? But the bigger concerns are the budget shortfall, and the hidden costs associated with the loss of healthcare for millions of Americans. Those affected will have less money to spend, resulting in less revenues for states and businesses, and states will need to find ways to help those individuals, either at a cost to the state or to businesses within the state, or both.

The OBBBA reflects the new baseline for states. It sets the table. Do states conform to the OBBBA or decouple from it, and if they decouple, from which provisions do they decouple? If states conform, that may create or exacerbate state budget deficits. If states decouple from parts of the OBBBA, the nature of the decoupling will likely vary, and that inconsistency in the tax base from state to state will create additional complexities, and compliance costs, for taxpayers. In addition, the cost of the OBBBA to a state will likely affect the ability or willingness of the state to adopt other state tax policies that they feel they now can't afford.

To put the magnitude of this situation in some context, Mitch Daniels, former Indiana governor as well as former head of the U.S. Office of Management and Budget under President George W. Bush, said this *in 2011*: "We Hoosiers hold to some quaint notions. . . . We believe in paying our bills. . . . Our morbidly obese federal government needs not just behavior modification but bariatric surgery."[50]

The federal budget deficit in 2011 was $1.3 trillion, with a cumulative national debt of "only" $14.79 trillion.[51] Unfortunately, today's congressional budget hawks, like basketball referees in the last two minutes of a game, seemed to have swallowed their whistles when they voted for the OBBBA.

[48] Treasury, "Debt to the Penny" (last visited July 21, 2025); U.S. Census Bureau, "Population Clock" (last visited July 21, 2025).

[49] Truth in Accounting and the Daniels College of Business, "Financial State of the States 2024" (undated).

[50] Mitch Daniels, Keynote Speech to the Conservative Political Action Committee (delivered Feb. 11, 2011), Ronald Reagan Centennial Dinner, Washington, D.C.

[51] Congressional Budget Office, "The Federal Budget Deficit for 2011 — $1.3 Trillion" (Oct. 7, 2011); Treasury, "Historical Debt Outstanding" (last visited July 21, 2025).

States like Indiana that have exercised fiscal discipline in the past will be much better positioned to deal with this challenge, but they will still have to consider the pros and cons of aligning with various provisions of the OBBBA and weigh the costs of the OBBBA provisions against the cost of other state income tax provisions they might otherwise want to address.

This next round of state legislative sessions will certainly be interesting to watch.

The Tax Law of OBBBAndius

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Here is how I wanted to start this essay[52] on the One Big Beautiful Bill Act (OBBBA, P.L. 119-21): "Never before has so much been given to so few by so many and for so little reason."[53]

But I am not exactly starting this essay this way because the very first word — never — is not quite true. To be sure, this bill is notable in recent history for its regressivity,[54] mean-spiritedness,[55] and almost certain failure to accomplish anything worthwhile for most of us.[56] Yet has there "never" been a bill like this? Consider "The Monument Building to Dead Pharaohs Act of 2600 B.C.E." That one seems at least comparable in regressivity and cruelty, though arguably it did accomplish something lasting, unlike the OBBBA.[57]

The commentariat have been puzzled about what to think of the OBBBA.[58] It is sort of ordinary fare for a Republican tax-cutting bill,[59] but it also has all kinds of more unusual twists, like

[52] Apologies to Shelley for the title. The complete (short) poem is here. The key line is: "My name is Ozymandias, King of Kings; Look on my Works, ye Mighty, and despair!"

[53] Apologies to Winston Churchill. His original words are "Never in the field of human conflict was so much owed by so many to so few," and spoken after the World War II Battle of Britain.

[54] Emily Badger, Alicia Parlapiano, and Margot Sanger-Katz, "Trump's Big Bill Would Be More Regressive Than Any Major Law in Decades," *The New York Times*, June 12, 2025; Carl Davis, "Top 1% to Receive $1 Trillion Tax Cut From Trump Megabill Over the Next Decade," Institute on Taxation and Economic Policy (July 3, 2025).

[55] Lawrence H. Summers, "Lawrence Summers: This Law Made Me Ashamed of My Country," *The New York Times*, July 8, 2025.

[56] The Penn Wharton Budget Model has the OBBBA *reducing* GDP over 10 years. Given how much the OBBBA costs, this is kind of an accomplishment. See the next note.

[57] Maybe the apt analogy here is to compare the real Taj Mahal with the Trump Taj Mahal? *See* Wayne Parry, "Trump's Taj Mahal — The '8th Wonder of the World' — Sold for Pennies on the Dollar," *Chicago Tribune*, updated June 5, 2018.

[58] *See, e.g.*, Ross Douthat, "Conservatives Are Prisoners of Their Own Tax Cuts," *The New York Times*, July 5, 2025.

[59] The expansion of the qualified small business stock benefit stands out as an example but also may actually be more than a traditional Republican Congress might have dared. *See* Andrew Duehren, "How Republicans Supersized Silicon Valley's Favorite Tax Break," *The New York Times*, July 16, 2025.

throwing some crumbs to some workers (no tax on tips) while crushing many of the same people with cuts to healthcare and food assistance. Then there are promises that were apparently made to cut grants to disfavored programs on the fly — despite not being included in the law or any law.[60]

I think the way to think about this bill is, in the end, to go back to the pharaohs. For most of human history, as analyzed in the book *Violence and Social Orders: A Conceptual Framework for Interpreting Recorded Human History*, government has been run as an alliance of powerful interest groups that sought to use power, above all, to advance their own group interests.[61] Actually achieving broad prosperity was not the point of government — and, not surprisingly, these forms of government, though in some ways and times quite resilient, have done (and are doing) quite poorly at advancing the interests of the many. One reason for this is that broad growth requires the rule of law and that the powerful restrain their predation — and this, of course, is hard for the powerful to do even if it is in their enlightened self-interest to do so.[62]

Yet it turns out that regimes predicated on rule of law and freedom and advancing the general good, though fragile in some ways, tend to outcompete their spoil-system competitors. The rise of the United States was one very dramatic example of this. I would emphasize, loosely following the authors of *Violence and Social Orders*, three reasons for this success. First, the rule of law is good for business because it protects innovators from powerful members of the existing coalition. Second, norms adjacent to the rule of law, such as operating a tax system through broad principles, encourage resources to go where they are needed and not where the powerful want them. Third, because open-access orders are ruled by the public, they are more likely to invest in public goods that themselves create value, such as education.[63]

The way to think about this bill is that it is part of a regression from an open-access order to a historically more common limited-access order.

Looked at this way, there is no particular surprise at the fact that there is no credible way this bill serves the interests of most Americans. That is not what this kind of government does. Spoils for favored groups? Yes. Sticks for the disfavored,[64] policy be damned? Certainly — consider an energy policy that is all about energy independence, unless the energy is renewable.[65] Trample the rule of law to get the last votes and punish some more? Obviously.[66] Use a fox to guard the henhouse? Need I answer?[67]

A time will come — soon, I hope — when I will do my best to offer concrete advice to states, though much of it will come as no surprise: Don't automatically conform to this mess,[68] and try to use the mismatching pieces of this Frankenstein's monster of a bill to do some good, such as clawing back the qualified business income deduction (and other explosions of self-serving greed — exemptions for qualified small business stock gain!) and conforming to the new version of the global intangible low-taxed income provisions.[69] Even a mismatched finger can plug a dike.

[60] Kelsey Tamborrino and Josh Siegel, "Conservatives Say Trump Won Their Megabill Votes by Promising Crackdown on Renewable Energy Credits," *Politico*, July 3, 2025; Zack Colman and Siegel, "'Final Nail': Trump Administration Memo Could Strike Fatal Blow to Wind and Solar Power," *Politico*, July 18, 2025.

[61] The analysis that follows is drawn from a book by institutional economists Douglass C. North, John Joseph Wallis, and Barry R. Weingast, *Violence and Social Orders: A Conceptual Framework for Interpreting Recorded Human History* (2009). I reviewed the book in the following publication. *See* Darien Shanske, "How Should We Govern Ourselves at Home?" *J. L. Culture & Humans.* (Sept. 6, 2009).

[62] The example of the Russian oligarchs should be top of mind here: Nikhil Kalyanpur and Abraham Newman, "Elon Musk's Wealth May Become a Liability if Donald Trump Turns Against Him," The London School of Economics and Political Science blog (Jan. 15, 2025).

[63] *See, e.g.*, Claudia Goldin and Lawrence F. Katz, "Education and Income in the Early 20th Century: Evidence From the Prairies," Harvard University Department of Economics and National Bureau of Economic Research (1999).

[64] Including cruelty for the disfavored. *See* Heidi Altman, Tanya Broder, and Ben D'Avanzo, "The Anti-Immigrant Policies in Trump's Final 'Big Beautiful Bill,' Explained," National Immigration Law Center, July 8, 2025.

[65] Colman, "Trump Is Transforming the GOP's Energy Policies — And Not All Conservatives Are Happy," *Politico*, July 22, 2025. Or consider the fact that immigrants contribute in many ways, including revenue: *See* Davis, "Tax Payments by Undocumented Immigrants," ITEP (July 30, 2024).

[66] Tamborrino and Siegel, *supra* note 60.

[67] Jesse Drucker, "He Helped Big Companies Dodge Taxes. Now He's Writing the Rules," *The New York Times*, July 14, 2025.

[68] Shanske, "States Should Decouple From Federal Law, Including Regulations (And They Should Have Done So Yesterday)," *Yale J. on Reg.*, Apr. 26, 2025.

[69] For some other ideas, see Shanske and David Gamage, "Winter Is Coming: What States Should Do Now, Part I," *Tax Notes State*, May 5, 2025, p 297. For ideas relating to interstate initiatives, see Shanske, "Interstate Compacts and Interstate Organizations as Mitigation Strategy in an Age of Federal Contraction," 59 *U.C. Davis L. Rev.* 1 (Mar. 2025).

But in this short essay I want to take a broader view of advising the states. Limited-access orders seem very powerful and serious, but they are ultimately brittle and slow. They are, quite literally, like the dinosaurs: very intimidating unless confronted with the need to adapt creatively and quickly. There is, sadly, nothing assured about the ultimate victory of open-access orders — that they happened at all is a bit of a miracle. When one limited-access order falls, it is usually replaced by another, by a new set of power players trying to enrich themselves. Think of different organized crime families toppling one another.

Yet states do not need to recreate the miracle of open-access orders; they just need to sustain the one that we have had for a long time. A state that protects individual rights and the rule of law, that continues to invest in true public goods and does so using sound tax policy, such a state *has the advantage*. It is not the case that the states that follow the federal government in mortgaging their future, engaging in wanton cruelty, and doling out the goodies to incumbents have hit on some new clever plan. They have hit upon a very old plan and one that tends ultimately to fail most of the people most of the time.

The OBBBA — A New SALT World Order?

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The passage of the One Big Beautiful Bill Act (OBBBA, P.L. 119-21) last month creates a new world order in state and local tax in certain ways.

From the bonus depreciation provision, to full expensing of research and development costs, an increase in the section 179 expense cap, and reformation of U.S. taxation of foreign income under the global intangible low-taxed income and net controlled foreign corporation tested income (NCTI) regimes, the OBBBA makes monumental changes. But what about the rest of the story?

As to SALT, I believe the congressional "approval" of the passthrough entity tax (PTET) regime is the most noteworthy. Coupled with the increase in the SALT deductibility cap from $10,000 annually to $40,000, subject to givebacks and adjustments under varied circumstances, for the first time Congress has put its fingerprints all over the PTET workaround. I find this simply amazing. A strategy developed by high-tax jurisdictions to counter federal legislation enacted in late 2017, the PTET regime has grown to include 35-plus states. It was completely at risk during the legislative path of the act, but at the eleventh hour, the Senate stripped out all anti-PTET provisions from the House version, essentially cementing it as tax policy in the SALT structure.

Reflect on that for a bit: A structure that was "approved" by the Internal Revenue Service through a notice released in November 2020,[70] a mere one week after then-President Trump (who drove the $10,000 SALT cap) lost his reelection bid, with no subsequent guidance, such as implementing proposed or temporary Treasury

[70] Notice 2020-75, 2020-49 IRB 1453.

regulations, is now clearly entrenched in federal and state tax policy and law.

Never before, at least in my nearly four decades of private practice, has anything engineered and implemented at a purely local level with one goal — thwart a federal tax deductibility statute — become so overwhelmingly entrenched based on an IRS notice. Consider that for a moment.

More than 35 states implemented legislation to provide PTET treatment for their taxpayers based upon an IRS notice that, if you listen to the administrative lawyers out there, could be recalled almost as easy as sending an email and its guidance rescinded. But here we are. This is why I love what I do!

Putting aside all of the other significant issues and provisions in the OBBBA, to me, the PTET structure has to be the most significant piece of the OBBBA.

An Audit for Everyone!

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Much has been made of the big behemoth of a budget bill that made its way through Congress last month. For sure the bill will have significant impacts on innumerable aspects of American society and the national economy. As the federal government pulls back, Americans will turn to states to fill the void — whether that is in caring for our veterans, the unhoused, children, the disabled, or so many others.

The most profound state tax impact of the bill may not be in the specifics of its provisions, but rather in the fiscal pressure it places on state budgets. In conversations over the past two weeks with state revenue agency administrators — many of whom reflected on the aftermath of the Tax Cuts and Jobs Act and used that experience to forecast the effects of the One Big Beautiful Bill Act (OBBBA, P.L. 119-21) — a clear consensus emerged: States are bracing for extraordinary financial strain. And when states need money, they turn to the tools they already have.

From a state's perspective, what is one of the most immediate and effective tools already in their toolbox? Audits.

State tax audits have been trending over the last two years. That's no coincidence. Indeed, my colleagues and I have been expecting it. In the immediate aftermath of the *Wayfair* decision,[71] states had their work cut out for them implementing their new demands for compliance. They understandably first focused on getting remote sellers on board. After seven years, states now have full, normal audit cycles to review. And auditing they are. Every few months more states join the fray.

In the wake of the OBBBA, I fully expect a tsunami of audits to break. Think about it: With mounting demands on state resources and limited political appetite for raising tax rates or

[71] *South Dakota v. Wayfair Inc.*, 585 U.S. 162 (2018).

introducing new tax types, audits offer a politically palatable path to revenue. Audits are a means for states to raise revenues without raising rates or implementing new taxes. States that previously deprioritized audits may now reallocate resources to bolster their audit divisions.

They also may have a stronger appetite than in other periods for attempting to push the boundaries of their tax bases by pursuing more aggressive, out-of-the box arguments through the appeals process and litigation arising from those audits. We're already starting to see this. For example, two weeks ago, the Colorado Court of Appeals upheld an assessment against Netflix on the basis that the streaming services giant sold tangible personal property because the streaming content was perceivable by the senses.[72] After a passionate discussion about the impact of the OBBBA on the state — and asked point-blank whether they agree streaming is tangible personal property — the general counsel of New York's Department of Taxation and Finance expressed intrigue and interest in exploring how the creative logic of Colorado could apply in the Big Apple.[73]

Remote sellers and out-of-state businesses are especially vulnerable. They lack in-state presence and lobbying power, and don't draw on state services in the same way as local businesses — yet they're increasingly targeted to fill revenue gaps. Thanks to the OBBBA, I expect the trend of more audits of remote sellers in more states to build momentum. To paraphrase America's favorite former talk show host — "An audit for you! An audit for you! Everyone gets an audit!"

[72] *Netflix Inc. v. Colorado Department of Revenue*, No. 24CA1019 (Colo. July 3, 2025).

[73] Chester Cook et al., Presentation at the NYU School of Professional Studies Intermediate State and Local Tax Conference (July 23, 2025).

The OBBBA's Implications for California

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On July 4, President Trump signed the One Big Beautiful Bill Act (OBBBA, P.L. 119-21) into law. The OBBBA enacts significant changes that encompass the president's policy, politics, and commitments to voters at the time of his election. The issue for the states is not so much politics or policy as it is dollars and cents: Can they afford to pick up the provisions in the OBBBA? Leaving the policy or political issues out of the equation, in a state like California (which is looking at a $12 billion deficit), conformity to many of the provisions in the OBBBA is simply not financially feasible.

California Conformity

California conforms to the Internal Revenue Code as of January 1, 2015. California uses static conformity, which means the state does not automatically roll forward the date of conformity but rather moves forward the date of conformity by legislative enactment. A bill in the state Legislature (S.B. 711[74]) would update California's date of conformity to January 1, 2025, if enacted. But that change would not pick up the provisions of the OBBBA. For the bill to have any hope of getting through the state Legislature in this financially strained year, conformity must be very modest — leaving out many of the most significant provisions of the Tax Cuts and Jobs Act. Therefore, the impact of the OBBBA on California is very uncertain at this time, though one aspect of the new provisions in the OBBBA is certain: the extension of the cap on the state and local tax deduction. California has already updated its passthrough entity tax (PTET) election and extended the availability of the election to the 2026 through 2031 tax years.

[74] Currently in the Assembly Appropriations Committee.

What We Know About California Conformity to The OBBBA: California's PTET Election

Perhaps the most direct and significant change in the OBBBA that will have an impact on taxpayers in California is the extension of the SALT deduction cap and workarounds. Rev. & Tax. Code section 17052.11 is added to the statute by S.B. 132 (ch. 25-17; signed by Gov. Gavin Newsom (D) on June 27, 2025), which states that the passthrough entity workaround provision is extended for tax years beginning on or after January 1, 2026, and before January 1, 2031, as long as federal law imposes a cap on the SALT deduction (as is the case under IRC section 164(b)(6)). If IRC section 164(b) is repealed and a full SALT deduction is allowed on the federal return, California's PTET would be repealed for tax years beginning on or after January 1 of the year in which the SALT deduction limitation is repealed.

As most readers know, the OBBBA did not repeal the SALT cap but instead temporarily increased the deduction limit and introduced an income-based phasedown mechanism. Under the OBBBA, the SALT cap is increased to $40,000 for tax year 2025 and adjusted to $40,400 for 2026. For tax years 2027 through 2029, the cap is indexed upward annually. However, beginning in 2030, the cap reverts to the original $10,000 limit established under the TCJA.[75]

For taxpayers with modified adjusted gross income exceeding $500,000, the new SALT cap phases down by 30 percent of the amount by which the modified AGI exceeds the threshold, though it never drops below the original $10,000 limit. After 2029, the SALT cap reverts permanently to $10,000 for all taxpayers, eliminating any ongoing benefit from the temporary expansion. The OBBBA defines modified AGI to include income excluded under sections 911, 931, or 933 (such as foreign earned income and income from U.S. territories).

The amendments apply to tax years beginning after December 31, 2024, so the change will be effective for the 2025 tax year.

Although the temporary increase of the SALT cap in the OBBBA may benefit many taxpayers (particularly those in high-tax states like California), the OBBBA does not include any provisions addressing the deductibility of the PTET workarounds to the SALT cap. As a result, the current workaround enacted by about 30 states (including California) remains intact, at least for now.

S.B. 132 (ch. 25-17) made some significant changes to the California PTET workaround, making the election more user-friendly. For tax years before 2026, the taxpayer must make the following payments:

- First payment: On or before June 15 of the tax year, pay the greater of $1,000 or 50 percent of the elective tax paid for the prior tax year.
- Second payment: On or before the due date of the original return (without regard to extensions), pay the remaining balance. (Rev. & Tax. Code section 19904).

Under prior law, there was no exception to the payment requirements. Therefore, if the June 15 payments were not made (or the estimate paid on that date was short), then the entity was prohibited from making the election for that year. As a result of changes made by S.B. 132, effective with the 2026 tax year, passthrough entities will be able to make the election even if they do not make a timely election or make a payment that does not equal or exceed 50 percent of the elective tax paid the year prior. The late payment will be subject to a penalty, which will be a reduction of 12.5 percent of the credit awarded by the state to the taxpayer. So, if a partnership makes a payment after the June 15 date of $20,000, then the credit that the partner can claim on its 2026 tax return is reduced by $2,500 (sort of a late-payment penalty).

What We Don't Know About California Conformity to the OBBBA

What we don't know about California conformity to the OBBBA is everything else. In light of the budget deficit facing California, it is doubtful that the state will conform to most of the OBBBA's provisions (particularly those with a large price tag), such as:

- qualified tip deduction;
- qualified overtime pay deduction;

[75] IRC section 164(b)(6) and (7).

- deduction for interest on qualifying passenger vehicle loans;
- enhanced personal casualty loss deduction for disaster victims;
- senior personal exemption deduction;
- restored bonus depreciation full expensing;
- increased business interest expense limitation; and,
- amendments to the qualified small business stock exclusion.

Looks like many more conformity adjustments are coming to the California tax return. ■