



# Eight Tax Reforms for Mobility and Modernization

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## Key Findings

- The post-pandemic economy will be characterized by greater mobility and new ways of living and doing business. States must take this opportunity to modernize their tax codes to reflect economic changes and to improve their competitive posture. Because the reality is that businesses that find their upward mobility constrained have more opportunities than ever to respond with geographic mobility.
- Robust revenue growth puts states in a strong position to adopt meaningful tax reform; failing to do so could leave them at a competitive disadvantage compared to their more reform-minded peers.
- Within individual income tax codes, states should consider adopting inflation indexing to avoid unlegislated tax increases; raising filing and withholding thresholds to avoid unduly burdening taxpayers who only spend a few days in a state; repealing convenience rules to eliminate the double taxation of remote workers; and replacing federal deductibility with more competitive rates.
- Corporate income tax codes can be improved by meeting or exceeding the federal standard for the treatment of net operating loss provisions and repealing throwback and throwout rules.
- States can reduce the penalization of business investment by repealing capital stock taxes and eliminating remaining inventory taxes.
- Each of these reforms better positions states for success by making them more attractive for increasingly mobile employers and employees alike, and by responding to economic changes like higher inflation and the rise of remote work.

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## Introduction

Lexicons have changed these past two years. From “coronavirus” and “PCR test” to “Zoom” and “Slack,” our changing vocabulary reflects a changed world. Another word has taken on new significance as well, and that word is “mobility.”

There is nothing new about mobility, of course, in any of its senses. But if one word describes the new world in which we find ourselves, and with which policymakers must grapple, this might be it. Mobility because individuals and businesses are suddenly freed of many of their former geographic constraints, as work can increasingly be performed anywhere with a high-speed internet connection—what we might call, in this context, their *outward* mobility. But mobility, too, in people’s trajectories, as people reexamine career plans and life goals as we emerge from the COVID-19 pandemic, and, with enhanced geographic mobility, become increasingly empowered to choose to live in a place that enables their *upward* mobility.

Our economy is changing, but state tax codes have failed to keep up. States are unprepared for the ongoing shift to remote and flexible work arrangements, or for the industries and activities of today, to say nothing of tomorrow. Ossified tax codes stifle innovation, misdirect investment, and constrain the choices of individuals and businesses. But mobility fosters competition, so states have not only the opportunity but the necessity of catching up—of transforming their tax codes to make them more neutral, more competitive, and consequently more pro-growth.

Tax codes should not interfere with people’s upward mobility, and in this new environment, individuals and businesses have the enhanced outward, geographic mobility to find states that will not get in the way of their success.

Modernizing state tax codes and designing them for mobility are two sides of the same coin. Outdated tax bases, impediments to modern working arrangements, high compliance costs, and policies that put a thumb on the scale in favor of legacy industries or politically favored investments all cry out for modernization, and all stand in the way of mobility and economic growth. Competitive reforms like rate reductions and reducing or eliminating punitive taxes on business investment unleash opportunity while allowing a modern economy to flourish.

Policymakers can choose to see geographic mobility as a blessing or as a curse—as an opportunity to attract individuals and businesses through robust state competition, or as a threat as people decamp for greener pastures. What they cannot do is wish this increased mobility away.

The world has changed, whether policymakers like it or not. Individuals and businesses have newfound mobility and are not giving it up. The only question is how lawmakers will respond to it: will they dig in their heels with outdated, uncompetitive tax codes or will they embrace the opportunity to adopt tax codes reflective of the dynamism of a new economy?

Within the realm of tax policy, policymakers who choose to see mobility as an opportunity have no shortage of options to improve their state's tax competitiveness, designing a modern tax code that attracts employers and employees with newfound flexibility, and which gives residents—old and new alike—the freedom to reach their own potential. What follows is a short list, far from exhaustive, of tax reforms lawmakers should consider to align their tax codes for growth and opportunity—in other words, to embrace mobility and modernization.

## The Reforms

Each of the eight reforms considered in this paper help states respond to the new economic landscape. They help remove impediments to new living and working arrangements, enhance states' attractiveness for increasingly mobile employers and employees, and respond to greater economic uncertainty and rising inflation.

All but five states have significant room to improve on at least one of these eight factors. Since many of these reforms deal with individual and corporate income taxes, it is unsurprising that three of the states which score perfectly on these metrics—Nevada, South Dakota, and Washington—go without individual or corporate income taxes, and the two other states which forgo both—Texas and Wyoming—only have meaningful room to improve on one metric each. Arizona and Maine are the only states to impose income taxes but score well across each of the eight areas of reform considered in this paper.

Of course, these eight provisions are far from the only measures of a state's overall tax competitiveness, and states like Washington, with its high-rate gross receipts tax and other punitive taxes on business investment, have substantial room for improvement elsewhere.

Additionally, the focus here has not been on absolute perfection but on addressing substantial deviations from best practices. For instance, we highlight states with net operating loss (NOL) provisions inferior to the federal standard as in need of reform, but some states offer provisions that are *better* than those provided at the federal level. States conforming to federal NOL provisions could further improve their tax codes by modeling those states with superior provisions, but they are not called out here as in particular need of reform.

Fortunately, states are in a strong position to implement tax reform, with most experiencing dramatic revenue gains and projecting robust revenues in coming years as well. Now is a good time to make an investment in a better tax code, whether that means implementing improvements that require a net tax cut, or, in other cases, simply taking advantage of their current revenue buffer to offset transition costs associated with reforms.

Four of the reforms considered here deal with individual income taxes:

- **Inflation Indexing.** With rising levels of inflation, now is a particularly auspicious time for states to add cost of living adjustments to their income tax codes to avoid “bracket creep,” which yields unlegislated tax increases as nominal incomes rise but real incomes do not.

- **Higher Filing and Withholding Thresholds.** Many states theoretically require individuals to withhold, or to file a tax return, in a state if they work there for even a single day—a highly unrealistic expectation in an era of greater mobility and increased workplace flexibility. States should raise thresholds to avoid costly compliance burdens for taxpayers with little or no actual liability in a nonresident state.
- **Convenience Rule Repeal.** Five states impose income taxes where a worker’s office is, whether or not the employee works out of that state. Other states rarely provide credits for taxes paid to other states under a convenience rule scenario, leading to double taxation of remote workers’ income. States should scrap these discriminatory taxes that stand in the way of remote work arrangements, and which could drive away employers who value the ability to offer remote work flexibility.
- **Ending Federal Deductibility.** While well-intentioned, the handful of states that offer a deduction for federal taxes paid not only make up for it by higher statutory tax rates than they would require otherwise, but they inadvertently turn their own tax code into an inversion of the federal one, penalizing what the federal tax code favors (having children, for instance, contributing to charity, or making business investments) while rewarding activities that result in higher federal tax liability. States should replace federal deductibility with lower-rate income taxes.

Two additional reforms for mobility and modernization would improve the competitiveness of states’ corporate income taxes:

- **Net Operating Loss (NOL) Improvements.** To ensure that corporate income taxes are imposed on net profitability over time, states allow losses in one year to be applied against gains in others. Some states, however, are stingy with NOLs, leading many companies to face unduly high effective tax rates and making it harder for them to recover after economic downturns. States should, at a minimum, match federal NOL standards.
- **Throwback Rule Repeal.** Some states impose so-called throwback or throwout rules designed to tax out-of-state corporate income if it is not taxable in the destination state. This is not only nonneutral and punitive but also uncompetitive for states imposing such rules, as it tends to drive certain activity out of state. A highly mobile environment and budget surpluses that can help offset temporary transition costs make this an excellent time to repeal these uncompetitive rules.

Finally, two reforms address the taxation of business investment:

- **Capital Stock Tax Repeal.** Sixteen states—soon to be 13—tax business’s net worth under capital stock or franchise taxes. These taxes hit businesses even when they experience losses, and particularly target capital-intensive, low-margin enterprises. They are an impediment to an investment and are an antiquated tax overdue for repeal.

- **Inventory Tax Repeal.** Twelve states tax business inventory, which can exacerbate supply chain issues and penalizes inventory-intensive businesses, like large manufacturers and retailers, which are forced to pay property taxes on the value of the inventory they keep in stock. Businesses seek to avoid these taxes by keeping as much inventory as possible out of states with these taxes until the last possible moment, an inefficient practice that states should not encourage with their tax codes.

Table 1 on the next page indicates where each state has room for improvement in these areas, and in the following pages, each reform is discussed at greater length.

## Individual Income Tax Reforms

### Inflation Indexing State Tax Codes

Inflation is often called a hidden tax, but in many states it yields a far more literal tax increase as tax brackets fail to adjust for changes in consumer purchasing power. This phenomenon, known as “bracket creep,” calls out for modernization.<sup>1</sup> States began implementing policies to eliminate these unlegislated tax increases in the 1970s, during the “Stagflation” era, but many have yet to finish the job—and some have never begun. The return of higher rates of inflation (if still far less than experienced in the late '70s) accentuates the need for these cost-of-living adjustments in state tax codes, a modernizing effort that ensures that the competitiveness of a state’s income tax system does not erode over time.

When tax brackets, the standard deduction, or personal exemptions are not inflation-adjusted, they lose value due to inflation, raising tax burdens in real terms. Bracket creep occurs when more of a person’s income is in higher tax brackets because of inflation rather than higher real earnings.

Imagine, for instance, a Delaware resident who made \$60,000 in taxable income in 2019, and made \$64,000 in 2021. Due to inflation, she has not seen an increase in real income: her \$64,000 in 2021 has about the same purchasing power as her \$60,000 in 2019. But if her state’s income tax brackets are not inflation-indexed, whereas her top marginal rate was previously 5.55 percent (on income between \$25,000 and \$60,000), she now has \$4,000 taxed at the higher rate of 6.6 percent. Her tax bill rises by \$264 even though her purchasing power remained constant.

Forty-one states and the District of Columbia tax wage income, while New Hampshire taxes just income and dividend income. Of these, 15 states and D.C. fail to adjust brackets for inflation, 10 states leave their standard deduction (if they have one) unadjusted, and 18 have an unindexed personal exemption. Taken together, 22 states and the District of Columbia have at least one major unindexed provision. Thirteen states fail to index any relevant major component. (In some cases, they may forgo a standard deduction or personal exemption, but all relevant provisions are unindexed.) They are Alabama, Connecticut, Delaware, Georgia, Hawaii, Kansas, Louisiana, Mississippi, New Jersey, New York, Oklahoma, Virginia, and West Virginia.

<sup>1</sup> For a more extensive treatment of inflation indexing, see Jared Walczak, “Inflation Adjusting State Tax Codes: A Primer,” Tax Foundation, Oct. 29, 2019, <https://www.taxfoundation.org/inflation-adjusting-state-tax-codes/>, from which this short synopsis is adapted.

TABLE 1.

**Reforming State Tax Codes for Mobility and Modernization***Areas Where States Can Improve Their Tax Codes in an Increasingly Mobile Era*

State	Indexing	Conv. Rule	Withholding	Fed. Deduct.	NOLs	Throwback	Capital Stock	Inventory	Needs
Alabama	✓		✓	✓	✓		✓		5
Alaska						✓		✓	2
Arizona									0
Arkansas	✓		✓		✓	✓	✓	✓	6
California			✓		✓	✓			3
Colorado			✓			✓			2
Connecticut	✓	✓					✓		3
Delaware	✓	✓	✓				✓		4
Florida						✓			1
Georgia	✓						✓	✓	3
Hawaii	✓		✓			✓			3
Idaho			✓			✓			2
Illinois					✓	✓	✓		3
Indiana	✓		✓						2
Iowa	✓		✓						2
Kansas	✓		✓			✓			3
Kentucky			✓					✓	2
Louisiana	✓					✓	✓	✓	4
Maine									0
Maryland	✓		✓					✓	3
Massachusetts	✓		✓			✓	✓	✓	5
Michigan			✓		✓	✓		✓	4
Minnesota					✓	✓			2
Mississippi	✓		✓			✓	✓	✓	5
Missouri			✓	✓		✓			3
Montana			✓		✓	✓			3
Nebraska		✓	✓			✓	✓		4
Nevada									0
New Hampshire					✓	✓			2
New Jersey	✓		✓						2
New Mexico	✓					✓			2
New York	✓	✓	✓						3
North Carolina	✓		✓		✓		✓		4
North Dakota						✓			1
Ohio			✓						1
Oklahoma	✓		✓			✓	✓	✓	5
Oregon			✓	✓	✓	✓			4
Pennsylvania		✓	✓		✓				3
Rhode Island			✓		✓	✓			3
South Carolina			✓				✓		2
South Dakota									0
Tennessee					✓	✓	✓		3
Texas								✓	1
Utah						✓			1
Vermont			✓		✓	✓		✓	4
Virginia	✓		✓					✓	3
Washington									0
West Virginia	✓							✓	2
Wisconsin	✓		✓			✓			3
Wyoming							✓		1
District of Columbia	✓		✓			✓			3

The impact of inflation can be seen in capital gains income. Imagine that a taxpayer purchased \$10,000 worth of shares in 2001 and sold them for \$20,000 at the start of 2021. Both the federal and state government would treat this as capital gains income of \$10,000. The federal government offers preferential rates on long-term capital gains, while most states do not, instead taxing the gains at the ordinary rate. In real terms, however, the gain is far less than \$10,000 because cumulative inflation during that period was nearly 55 percent, making the real gain \$4,502. Note that inflation indexing of tax codes alone cannot solve the problem of overtaxation of capital gains income, but it can help, and this problem is illustrative of the broader issue.

The following table shows which provisions in each state are indexed for inflation. Adopting inflation indexing is more salient now than it has been for years, should states wish to avoid imposing unlegislated tax increases. It is a modernization measure that ensures that the state's tax code does not become less competitive over time, losing ground against peers. Notably, many states inflation-adjust their motor fuel taxes, ensuring that the state does not generate less revenue in real terms over time due to inflation. Taxpayers themselves deserve the same consideration.

### Raising Filing and Withholding Thresholds for Nonresidents

States impose income taxes both where people live and where they earn income. Accordingly, when a taxpayer spends time in a state other than their state of residence, they often incur tax liability there. This is an eminently reasonable expectation if they spend a significant amount of time in the nonresident state, as was the case with many temporary relocations during the first year of the pandemic, or when called to spend months or even full-time working out of state. It is, however, much more burdensome when the obligation to file a tax return arises after working only a short period in another state—often as little as a day. These rigid rules are incompatible with today's economy, creating substantial compliance costs for taxpayers and administrative costs for state governments even in situations where the filer has little or no liability in the nonresident state.

In most cases, these filing and payment obligations do not result in double taxation, since the taxpayer's domiciliary state provides a credit for taxes paid to another state. It can, of course, increase overall tax liability if the individual spends time in a state with higher taxes than their home state, but the principal objection is not this increased liability due to higher rates or different brackets, but rather the compliance burdens, which are often vastly disproportionate to the taxes owed. Either taxpayers ignore the filing obligation, and their employers disregard any withholding requirements, or they dutifully comply with costly requirements that net very little for the inbound state.

Tax codes should be enforceable—and generally enforced. Very few taxpayers file an income tax return when they only spend a day in another state, and states cannot reasonably expect them to do so. Provisions only enforced in the breach are bad policy, as are provisions that cost about as much to administer—in addition to their substantial burdens on taxpayers—as they raise in revenue.

States should establish meaningful thresholds for the number of days an individual must spend in the state before incurring income tax liability there. Best practice would be 30 days or more, which is consistent with several previous federal proposals to standardize these thresholds across states, as well as with the efforts of the Mobile Workforce Coalition, a group which promotes less onerous tax

TABLE 2.

## State Indexation of Major Features of the Individual Income Tax

State	Brackets	Standard Deduction	Personal Exemption
Alabama	--	--	--
Alaska		No Income Tax	
Arizona	Indexed	Indexed	Indexed
Arkansas	Indexed	--	--
California	Indexed (a)	Indexed	Indexed
Colorado	Flat Tax	Conforms to Federal	n/a
Connecticut	--	n/a	--
Delaware	--	--	--
Florida		No Income Tax	
Georgia	--	--	--
Hawaii	--	--	--
Idaho	Indexed	Conforms to Federal	n/a
Illinois	Flat Tax	n/a	Indexed
Indiana	Flat Tax	n/a	--
Iowa	Indexed	Indexed	--
Kansas	--	--	--
Kentucky	Flat Tax	Indexed	n/a
Louisiana	--	n/a	--
Maine	Indexed	Conforms to Federal	n/a
Maryland	--	Indexed	--
Massachusetts	Flat Tax	n/a	--
Michigan	Flat Tax	n/a	Indexed
Minnesota	Indexed	Conforms to Federal	Conforms to Federal
Mississippi	--	--	--
Missouri	Indexed	Conforms to Federal	n/a
Montana	Indexed	Indexed	Indexed
Nebraska	Indexed	Indexed	Indexed
Nevada		No Income Tax	
New Hampshire	Flat Tax (b)	n/a	--
New Jersey	--	n/a	--
New Mexico	--	Conforms to Federal	n/a
New York	--	--	n/a
North Carolina	Flat Tax	--	n/a
North Dakota	Indexed	Conforms to Federal	n/a
Ohio	Indexed	n/a	Indexed
Oklahoma	--	--	--
Oregon	Indexed (a)	Indexed	Indexed
Pennsylvania	Flat Tax	n/a	n/a
Rhode Island	Indexed	Indexed	Indexed
South Carolina	Indexed	Conforms to Federal	Indexed
South Dakota		No Income Tax	
Tennessee		No Income Tax	
Texas		No Income Tax	
Utah	Flat Tax	Percentage of Federal	n/a
Vermont	Indexed	Indexed	Indexed
Virginia	--	--	--
Washington		No Income Tax	
West Virginia	--	n/a	--
Wisconsin	Indexed	Indexed	--
Wyoming		No Income Tax	
District of Columbia	--	--	n/a

(a) California and Oregon do not fully index their top brackets.

(b) New Hampshire taxes interest and dividend income only.

Sources: State statutes; Tax Foundation research.

treatment of nonresidents.<sup>2</sup> The single-day states are particularly egregious, setting an impractical and inefficient standard.

Frequently, moreover, withholding requirements can result in tax being withheld even when an employee has no tax obligation in a state, requiring them to file an amended return to obtain a refund for tax improperly withheld on their behalf. This can happen because, due to deductions and exemptions, even if a state requires nonresidents to pay taxes beginning with the very first dollar of taxable income, modest earnings in a state will often not be enough to exceed deductions and yield taxable income. Accordingly, while both filing and withholding thresholds should be raised, the withholding thresholds are often the most salient.

While, ideally, all states would adopt a threshold of 30 days or more, for purposes of this analysis, we identify as prime candidates for reform those states where withholding is required with less than two weeks of work, or under \$3,000 of nonresident income. Only 12 income-taxing states meet or exceed these thresholds, not counting New York, which technically requires 14 days before employers are required to withhold but aggressively requires taxpayers to file after a single day regardless of liability.

There was a time when most people worked from only one worksite, and where travel was often limited and brief. That time had long passed even before the pandemic, but it seems particularly outmoded now. States are slowly catching up to this reality, with Illinois enacting a 30-day threshold in 2019,<sup>3</sup> Kansas considering (but ultimately not adopting) one in 2020, and Louisiana<sup>4</sup> and West Virginia<sup>5</sup> adopting 25- and 30-day thresholds in 2021. The remaining states should establish realistic filing, withholding, and payment thresholds that do not impose outsized burdens on those briefly passing through.

## Dropping Convenience Rules

States can tax income where people live and where they work—but five states also seek to tax income even when someone neither lives nor works there, an aggressive posture that poses a significant impediment to a post-pandemic normalization of remote work. These five states adopt what are confusingly termed “convenience of the employer” rules, which stipulate that an individual’s income is subject to tax if their office is located in the state, even if they both lived in, and performed the work, elsewhere.<sup>6</sup>

Ordinarily, states can tax their residents’ income from all sources, and the income of nonresidents when that income is earned in the state. Every state with an income tax also provides a credit for taxes paid to other states to avoid double taxation. Under convenience rules, however, remote employees can be taxed in their employer’s state (provided they have at least minimal contacts with the state, like spending a day there). To the taxpayer’s detriment, their home state may not offer them

2 Mobile Workforce Coalition, <https://www.mobileworkforcecoalition.org/>.

3 Illinois Senate Bill 1515 (2019).

4 Louisiana Senate Bill 157 (2021).

5 West Virginia House Bill 2026 (2021).

6 For a lengthier treatment of convenience rules, see Jared Walczak, “Teleworking Employees Face Double Taxation Due to Aggressive ‘Convenience Rule’ Policies in Seven States,” Tax Foundation, Aug. 13, 2020, <https://www.taxfoundation.org/remote-work-from-home-teleworking/>.

TABLE 3.

**Most States Require Nonresident Withholding on the First Day of Work***Thresholds of Days Worked or Income Earned Before Withholding Is Required*

State	Day Threshold	Income Threshold
Alabama	1	\$0
Alaska	n.a.	n.a.
Arizona	60	\$0
Arkansas	1	\$0
California	1	\$1,500
Colorado	1	\$0
Connecticut	15	\$0
Delaware	1	\$0
Florida	n.a.	n.a.
Georgia (a)	23	\$5,000
Hawaii	60	\$0
Idaho	1	\$1,000
Illinois	30	\$0
Indiana	1	\$0
Iowa	1	\$0
Kansas	1	\$0
Kentucky	1	\$0
Louisiana	25	\$0
Maine (b)	12	\$3,000
Maryland	1	\$0
Massachusetts	1	\$0
Michigan	1	\$0
Minnesota	1	\$12,500
Mississippi	1	\$0
Missouri	1	\$0
Montana	1	\$0
Nebraska	1	\$0
Nevada	n.a.	n.a.
New Hampshire	n.a.	n.a.
New Jersey	1	\$0
New Mexico	16	\$0
New York (c)	14	\$0
North Carolina	1	\$0
North Dakota	21	\$0
Ohio	1	\$0
Oklahoma	1	\$1,200
Oregon	1	\$0
Pennsylvania	1	\$0
Rhode Island	1	\$0
South Carolina	1	\$0
South Dakota	n.a.	n.a.
Tennessee	n.a.	n.a.
Texas	n.a.	n.a.
Utah (d)	60	\$0
Vermont	1	\$0
Virginia	1	\$0
Washington	n.a.	n.a.
West Virginia	30	\$0
Wisconsin	1	\$1,500
Wyoming	n.a.	n.a.
District of Columbia	n.a.	n.a.

(a) In Georgia, nonresident withholding is required if the employee is in the state for more than 23 days, or if \$5,000 or more, or 5 percent or more of total income, is attributable to the state.

(b) Maine requires that both the 12-day and \$3,000 thresholds be met before withholding is necessary.

(c) While New York has a 14-day withholding threshold, taxpayers must file after the first day in the state.

(d) Utah's threshold is for whether the employer, not the employee, does business in the state for more than 60 days.

Sources: State statutes; state revenue departments; Tax Foundation research.

a credit for taxes paid to other states (since, according to their own income-sourcing rules, the income was not actually earned in another state), yielding true double taxation.

These policies are innately unfair, but as a more practical bottom-line concern, convenience rules will force businesses which care about offering remote and flexible work opportunities to their employees post-pandemic to make some decisions that may hurt the states imposing them. If working remotely from another state means double taxation, a remote work benefit is not much of a benefit. Accordingly, companies that prioritize remote work may either shift some of their functions out of state (providing an out-of-state office to which to assign out-of-state workers) or even move their operations outright.

Convenience rules sever whatever tie exists between a tax and the government services it funds. While most taxes (unlike some fees) fund a broad array of services and cannot be understood as a strictly user-pays arrangement, there is at least some connection between the taxpayer and the expenditure of the funds. Taxpayers pay for the governance of the area where they work—a place from which they derive some direct benefit. Taxing people who barely set foot in a state, under a vague and inconsistently applied notion that they are availing themselves of the state’s market simply because their company has an office there, is bad tax policy.

States have broad latitude to tax in-state activity as they wish, subject to a few constitutional constraints. Aggressive tax structures which seek to tax activity that takes place wholly or almost entirely beyond the state’s borders, however, were bad tax policy before the pandemic and pose a significant threat to the emerging economy and its greater mobility.

Two states have repealed such income-sourcing rules. Massachusetts allowed a pandemic-related sourcing rule to expire, while Arkansas lawmakers eliminated a convenience rule that had been implemented regulatorily.<sup>7</sup> Five states, however, continue to impose them: Delaware, Nebraska, New York, Pennsylvania, and in Connecticut, which has a “retaliatory” convenience rule, levied only against those who reside in other states with their own convenience rule. What was bad before the pandemic is even more objectionable now.

## Ending Federal Deductibility

Five states offer a deduction for federal taxes paid, an antiquated provision that introduces unnecessary distortions and complexity to state tax codes. With two of these states in the process of eliminating this anachronistic provision, and Louisiana having just done so, the time is ripe for the last three holdouts—Alabama, Missouri, and Oregon—to modernize their tax codes, eliminating a well-intentioned but flawed tax provision that penalizes everything from having children to investing in a business and thus stands in the way of economic mobility.<sup>8</sup>

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7 The Tax Foundation submitted written testimony on this legislation. See Jared Walczak, “Testimony: Convenience Rules and Remote Work in Arkansas,” Tax Foundation, Apr. 14, 2021, <https://www.taxfoundation.org/arkansas-remote-work-convenience-rule/>.

8 This section is largely borrowed from Jared Walczak, “Federal Deductibility Is Distorting Tax Liability in Six States,” Tax Foundation, Nov. 1, 2021, <https://www.taxfoundation.org/federal-deductibility/>.

Alabama,<sup>9</sup> and Iowa<sup>10</sup> offer full policies of federal deductibility under their individual (and, in Alabama and Louisiana, corporate) income taxes, while Missouri,<sup>11</sup> Montana,<sup>12</sup> and Oregon<sup>13</sup> provide the deduction exclusively for individual income taxpayers and cap the benefit. Additionally, Missouri and Oregon phase out the deduction entirely for high earners. However, Louisiana is slated to repeal the provision in 2022, followed by Iowa in 2023<sup>14</sup> and Montana in 2024.<sup>15</sup>

TABLE 4.

### States with Federal Deductibility

State	Federal Deductibility Provisions	Pending Reforms
Alabama	100% Deductibility	None
Iowa	100% Deductibility	Repeal in 2023
Louisiana	100% Deductibility	Repeal on 2021 ballot
Missouri	\$5,000 deductibility cap with income phaseout	None
Montana	\$5,000 deductibility cap (\$10,000 joint filer)	Repeal in 2024
Oregon	\$6,950 deductibility cap with income phaseout	None

Sources: State statutes; Tax Foundation research.

The intentions behind federal deductibility are undoubtedly pro-taxpayer. Policymakers wanted to avoid a tax on a tax, so they allowed taxpayers to deduct their federal tax liability in calculating state liability in the same way that the federal government has allowed taxpayers to deduct their federal liability. (The implementation of these provisions avoids circularity.) There is reason to believe this concern is misdirected, but most taxpayers would not argue with the intended result of lowering their state tax liability.

Unfortunately, that is not what happens in practice. Tax liability is not reduced. It is distorted.

The anachronistic state policy of federal deductibility ties states' tax codes to federal policy in unexpected and often undesirable ways. When federal taxes go down, state taxes go up. When the federal government provides preferential treatment of something—from the child tax credit to research incentives—states with federal deductibility penalize it.

This unintentionally perverse arrangement even threatened to ensnare the rebate checks provided under the Coronavirus Aid, Relief, and Economic Security (CARES) Act since they were structured as an advance on a one-time tax credit, and thus reduced federal tax liability.<sup>16</sup> The affected states, none of which wished to tax COVID-19 relief checks, generally acted to avoid doing so, but the averted tax hit was just one particularly salient example of a phenomenon that happens every day in the six states with federal deductibility.

9 Ala.Const. Art. XI, § 211.03-04.

10 I.C.A. § 422.7.

11 V.A.M.S. § 143.171.

12 MCA § 15-30-2131(1)(b).

13 O.R.S. § 316.680(b).

14 Iowa S.F. 619 (2021).

15 Montana S.B. 399 (2021).

16 Jared Walczak, "These States Could Tax Your Recovery Rebates," Tax Foundation, Apr. 8, 2020, <https://www.taxfoundation.org/cares-act-rebate-state-tax-rebate/>.

The federal deduction tends to be regressive, though not uniformly; it may be more accurate to refer to its effects as chaotic. Still, high earners, because they have higher federal effective tax rates, tend to see their state tax liability reduced the most, while low-income filers, because they have little or no federal tax liability, get scant benefit from the deduction. The result, applied to the graduated rate structures in all six of these states, is not a flatter tax, just a more distorted one.

Few would argue that every deduction, credit, exemption, or other preference in the federal tax code is good or desirable, but it would be even more difficult to argue that we would be better off with the *inverse* treatment. Federal deductibility is like a funhouse mirror, inverting and distorting the federal code in ways that fail to achieve the state's policy goals. It increases state tax liability when small businesses invest, when families have children or adopt, or when people give to charity. Federal deductions for education or health-care expenses are partially offset by higher state taxes, and part of the benefit of tax-advantaged investments like IRAs is eroded because states with federal deductibility boost a taxpayer's liability when their federal tax burden declines.

Federal deductibility also ties states to federal tax rates, and not just federal tax bases. Conformity with the federal tax code is generally a good thing, promoting certainty and simplicity for taxpayers and tax administrators alike. But states tend not to follow federal *rates*, to say nothing of creating an inverse relation with them. There is no reason why a federal tax cut should result in an unlegislated state tax increase, nor why higher federal taxes should deprive states of revenue. Changes in state revenue potential of this nature should be the prerogative of lawmakers, not the consequence of a policy like federal deductibility.

Repealing federal deductibility is a bipartisan priority. In Iowa, it is part of a Republican-led tax reform package; in Louisiana, it featured in bipartisan reform; and the liberal Institute on Taxation and Economic Policy (ITEP) has long called for the deduction's elimination, albeit not necessarily in a revenue-neutral fashion.<sup>17</sup>

Simply repealing federal deductibility is, unequivocally, a tax increase. States should not see the elimination of this inadvertently perverse policy as a revenue raiser. Instead, they should replace this well-intended but ineffectual policy with something better, and easier to understand: lower tax rates.

In Alabama (and Louisiana before repeal in 2022), federal deductibility is available under the corporate income tax as well. This was also true of Iowa until recently, but while repeal of the provision for individuals was predicated on future revenues, the tax reforms of 2018 eliminated the deduction for corporate taxpayers immediately. Similar inversions of incentives occur here. The depreciation of assets yields higher state tax liability. State corporate taxes go up when a company carries forward losses or takes advantage of research and development incentives, while declining when federal tax liability rises, for instance if more of a multinational corporation's activity is taxed under the Global Intangible Low-Taxed Income (GILTI) provisions of federal law.

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17 Dylan Grundman O'Neill, "Why States That Offer the Deduction for Federal Income Taxes Paid Get It Wrong," Institute on Taxation and Economic Policy, May 1, 2017, <https://itep.org/why-states-that-offer-the-deduction-for-federal-income-taxes-paid-get-it-wrong-2/>.

Caps on federal deductibility limit the pernicious effects of the deduction, but it still causes unnecessary distortions while adding to the complexity of state tax codes. With Iowa and Montana eyeing futures without federal deductibility, and Missouri only recently (in 2018) adopting its high earner phaseout, the time may have come to clear this deadwood out of state tax codes altogether.

In Alabama, the only state where a constitutional amendment would be necessary to repeal federal deductibility, the elimination of deductibility for all taxpayers would best be offset by a commensurate across-the-board rate cut. In Missouri and Oregon, where the provision is much smaller and does not substantially benefit high earners, even if it is simultaneously very poor at providing meaningful and intelligible relief to low earners, the best approach would either be to reduce rates in the bottom brackets or to increase the standard deduction. Through such reforms, policymakers can take the pro-taxpayer intentions behind the ill-considered deduction and turn them into reality.

## Corporate Income Tax Reforms

### Improving Net Operating Loss Provisions

Net operating losses (NOLs) occur when a company's tax-deductible expenses exceed revenues. Corporate income taxes are intended to fall on net income, but business cycles do not fit neatly into tax years. Absent NOL provisions, a corporation which posted a profit in years one and three but took significant losses in year two would not be taxed on its net income over those three years, but rather on the profits of years one and three, without regard to the losses in year two.<sup>18</sup>

To address this problem, federal and state tax codes permit NOLs to be carried into other tax years. Under prior federal law, they could be carried forward up to 20 years and backward up to two years. The Tax Cuts and Jobs Act (TCJA) of 2017 eliminated NOL carrybacks but allows indefinite carryforwards. The amount of losses that can be taken in a given year, however, may not exceed 80 percent of tax liability, ensuring that NOL carryforwards cannot eliminate a company's tax liability.

Nineteen states and the District of Columbia match the new federal provision, while another 13 states use the old federal standard of 20 years of uncapped loss carryforwards; the annual loss deduction cap (losses carried forward may not reduce current tax liability by more than 80 percent); the unlimited number of years to which losses can be carried forward; and the prohibition against carrying losses back to offset previous years' tax liabilities.

Thirteen states do not conform to the federal provisions, because they limit carryforward years to 20 and impose no cap on loss deduction.<sup>19</sup> In these states, businesses may use losses to offset up to 100 percent of the year's tax liability for 20 years provided they have enough losses to carry forward.

<sup>18</sup> For a lengthier treatment of net operating loss provisions, see Timothy Vermeer, "Net Operating Loss Provisions: State Treatment and The Economic Benefits," Tax Foundation, forthcoming.

<sup>19</sup> These are Arizona, Connecticut, Idaho, Indiana, Iowa, Louisiana, Massachusetts, Mississippi, Missouri, Nebraska, New Jersey, New York, and Wisconsin.

At present, California has suspended its carryforward provisions for three years, a response to fears of revenue losses due to the COVID-19 pandemic. While the state has instead posted extraordinary surpluses, the NOL suspension has yet to be lifted.

In addition to California (which ordinarily offers a 20-year carryforward), an additional 12 states restrict carryforwards below the 20-year threshold, sometimes well below. Five states—Alabama, Minnesota, North Carolina, Oregon, and Tennessee—permit losses to be carried forward for up to 15 years. Illinois allows unlimited losses for 12 years; Michigan, Montana, New Hampshire, and Vermont, 10 years; Arkansas for eight years; and Rhode Island for five years.

Additionally, two states set limits to the amount of loss a company can carry forward. Pennsylvania limits a firm's total carryforward amount to 40 percent of the given loss, deductible over a maximum of 20 years. New Hampshire limits the carryforward amount to \$1 million deductible over a maximum of 10 years. All told, this makes 14 states with NOL provisions substantially inferior to those offered by the federal government.

Failure to provide robust NOL carryforwards undermines investment and discourages entrepreneurial activity. Businesses do not experience profitability consistently. Some businesses' revenues are highly correlated with the business cycle, and most new or transitioning businesses experience years of losses before they post a profit. By allowing businesses to use losses in one year to offset taxable income in another year, NOLs address the tax treatment of a business's losses, ensuring that taxes are on long-term profitability and reducing the tax code's adverse impact on economic growth. Stingy NOL provisions undercut innovation and increase the chance of business failure.

**TABLE 5.**  
**States with Stingy NOL Provisions**

State	Years Limit	Low Cap
Alabama	15	--
Arkansas	8	--
California	0	--
Illinois	12	--
Michigan	10	--
Minnesota	15	--
Montana	10	--
New Hampshire	10	\$1 million
North Carolina	15	--
Oregon	15	--
Pennsylvania	20	40%
Rhode Island	5	--
Tennessee	15	--
Vermont	10	--

Source: State statutes; Tax Foundation research.

## Eliminating Throwback and Throwout Rules

When C corporations conduct business in multiple states, it is necessary for states to apportion that income for tax purposes. That means they must determine what share of their income is taxable in each involved state.<sup>20</sup> Currently, states can use three factors in their apportionment formulas: the share of total property, payroll, and sales that a firm has located in each state. Historically, most states weighted these factors evenly. However, there is a pronounced trend toward giving greater—or even exclusive—weight to the sales factor. Doing so generally benefits in-state companies while exporting some of the tax burden to companies with sales, but less of a physical presence, in that state.<sup>21</sup>

Businesses sometimes make sales into states with which they lack sufficient connection (called “nexus”) to be subject to corporate taxation, with the potential that the income earned in that state will not be subject to any state’s corporate income tax. Twenty-five states and the District of Columbia have adopted throwback or throwout rules intended to expose income from outbound sales to their own corporate income taxes if, for whatever reason, it is not taxable in the destination state.

In states where firms have no nexus for taxation, either because of apportionment rules or lack of jurisdiction, a firm’s sales to that state result in “nowhere income.” Throwback rules are designed to reclaim “nowhere income,” from a state that has no legal authority to tax it and give that income back to a state with jurisdiction over the taxpayer. Under a throwback rule, sales of tangible personal property are figuratively “thrown back” across state lines and incorporated into the numerator of the origin state’s sales factor—even though the state would not otherwise be able to claim that income.<sup>22</sup>

Importantly, throwback rules do not apply in cases where a state voluntarily chose not to tax corporate income. Throwback rules ask whether the corporation *is* taxable in the destination state, not whether it *was* taxed. A company’s income from one state cannot be thrown back to another if the firm can demonstrate that the good was subject to a net income, franchise, or capital stock tax in the destination state, or if that state possessed jurisdiction to levy a tax on the company but opted not to impose corporate taxes.

While throwback rules were created to avoid the perceived under-taxation of corporate income, they can lead to double taxation and frequently impose tax burdens high enough to make states unattractive for businesses. The goal of throwback and throwout rules is 100 percent taxability of corporate income, but the result is a complex, uncompetitive system that can drive businesses out of some states by yielding high—sometimes astronomically high—in-state tax burdens. Indeed, throwback rules have such an effect on business activity that multiple studies find that their adoption drives out enough business to offset the revenue gains that would otherwise be anticipated from taxing additional business income, to the detriment of those states’ economies.

20 Only business income is apportioned. Nonbusiness income, e.g., income arising from investments or property ownership, is typically allocated in its entirety to a specific state where the company is domiciled or the property is located. See Charles McLure Jr., “Understanding Uniformity and Diversity in State Corporate Income Taxes,” *National Tax Journal* 61:1 (March 2008), 147.

21 For a brief synopsis of developments in formula apportionment, see generally, Joann M. Weiner, “Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level,” U.S. Department of the Treasury, OTA Paper 83, April 1999, <https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-83.pdf>.

22 For a more comprehensive treatment of throwback and throwout rules, see Jared Walczak, “Throwback and Throwout Rules: A Primer,” Tax Foundation, July 2, 2019, <https://www.taxfoundation.org/throwback-rules-throwout-rules-2019/>, from which this section is adapted.

Throwback rules function by incorporating any sales that are not taxable in a destination state into the sales factor numerator of the origination state. A company's income from one state cannot be thrown back to another if it can demonstrate that it is subject to a net income, franchise, or capital stock tax in the destination state, or if that state possesses jurisdiction to levy a tax on the company but opts not to impose corporate taxes.

If, by way of example, a company had its sales divided evenly among five states (including the origin state), but lacked taxable nexus in two of those states under P.L. 86-272, then instead of three states each claiming 20 percent of the company's sales in their numerators and two claiming none, the origin state would claim 60 percent—picking up the shares of the two states unable to impose their own taxes.

Another approach is called the throwout rule. Under a throwout rule, instead of out-of-state sales being added to the numerator (sales attributable to the taxing state), those sales are excluded from the denominator (all sales). In the above throwback example, the origin state threw 40 percent of sales back into the numerator in addition to its own 20 percent, yielding a sales factor of 60/100, or 60 percent. If instead the destination state threw the untaxable sales out of its denominator, its sales factor would be 20/60, or 33.3 percent.

Throwout rules also exist for sales of services and other intangible property, whereas throwback rules apply exclusively to sales of tangible property. For apportionment purposes, tangible property is always sourced to the destination state in the absence of throwback, whereas sourcing rules for intangible property vary.

Throwback and throwout rules involve “levying the wrong tax at the wrong rate in the wrong state,”<sup>23</sup> and they make the origin state's effective tax rate on in-state activity so high that the economic literature suggests that these rules fail to raise any revenue in the long run, and may even cost states revenue, since most of the activity subject to the rule will shift out of state—and employment and other tax revenue with it.

Of course, repealing throwback rules will result in a modest short-term revenue hit even if the long-term trajectory is positive, because the businesses that *do* incur additional burdens will no longer experience that additional liability, while companies that have either shifted activity out of state or have not located in-state will not change their business practices overnight. However, with companies more mobile than ever, and with states flush with additional revenues that can be used as a buffer for any modest transition costs, there has never been a better time to repeal these rules.

Missouri repealed its throwback rule in 2020, and Alabama and West Virginia followed suit by repealing theirs in 2021. Vermont lawmakers are exploring the possibility of repeal in 2022, and Louisiana lawmakers, who considered repeal as part of their 2021 tax reform package, may take the matter up again soon. The remaining states with throwback or throwout rules should join them sooner rather than later.

23 David Sawyer, “Re: COST’s Opposition to House Bill 1051, ‘Throwback’ of Sales for Corporate Income Tax,” Council on State Taxation Testimony to the Maryland House Ways and Means Committee, Feb. 28, 2018.

**TABLE 6.**  
**States with Throwback and Throwout Rules for Tangible Property**

State	Throwback Rule	Throwout Rule
Alaska	✓	
Arkansas	✓	
California	✓	
Colorado	✓	
Hawaii	✓	
Idaho	✓	
Illinois	✓	
Kansas	✓	
Louisiana		✓
Massachusetts	✓	
Mississippi	✓	
Montana	✓	
New Hampshire	✓	
New Mexico	✓	
North Dakota	✓	
Oklahoma	✓	
Oregon	✓	
Rhode Island	✓	
Utah	✓	
Vermont	✓	
Wisconsin	✓	
District of Columbia	✓	

Notes: Kentucky has a throwback rule that only applies to sales to the federal government and is not typically counted as a throwback state. Maine replaced its throwback rule with a throwout rule in 2010 but continues to use throwback for sales to the federal government. New Mexico's throwback rule, counted here, only applies to businesses opting to be taxed under single sales factor apportionment.

Sources: State statutes; Tax Foundation research.

## Business Asset Tax Reforms

### Repealing Capital Stock Taxes

Only 16 states levy a capital stock tax, a tax on the net worth of a business. These taxes—which many states call “franchise taxes”—are often levied at a low percentage on the assets or value of a firm, in contrast to corporate income taxes, which are imposed on profits. As such, the capital stock tax tends to penalize investment and requires businesses to pay regardless of profit margins, or even whether businesses have posted a profit at all. In broad economic terms, capital stock taxes are destructive because they disincentivize the accumulation of additional wealth, or capital, which distorts the size of firms, discouraging investment.

**TABLE 7.**  
**State Capital Stock Tax Rates**

State	Rate	Cap
Alabama	1.75%	\$15,000
Arkansas	3%	Unlimited
Connecticut	0.26%	\$1,000,000
Delaware	0.035%	\$200,000
Georgia	Payment Schedule	\$5,000
Illinois	0.10%	\$2,000,000
Louisiana	0.30%	Unlimited
Massachusetts	0.26%	Unlimited
Mississippi	0.175%	Unlimited
Nebraska	Payment Schedule	\$30,000
North Carolina	0.15%	Unlimited
Oklahoma	0.13%	\$20,000
South Carolina	0.10%	Unlimited
Tennessee	0.25%	Unlimited
Wyoming	0.02%	Unlimited

Note: Capital stock tax structures vary substantially; for additional details, see Janelle Cammenga, “Does Your State Levy a Capital Stock Tax?” Tax Foundation, Mar. 24, 2021, <https://www.taxfoundation.org/state-capital-stock-tax-2021/>.

Sources: State statutes; state revenue departments; Bloomberg Tax.

Frequently, capital stock taxes are not always limited to C corporations, either; different states have different laws regarding the types of businesses that fall under a capital stock tax. Regardless of which entities are subject to the tax, however, the impact is the same: disincentivizing capital accumulation.

While exact formulas and methodologies vary from state to state, capital stock taxes are usually levied on a firm’s net assets, with rates ranging from a low of 0.02 percent in Wyoming to a high of 0.3 percent in Arkansas and Louisiana. Among the states that levy a capital stock tax, half place a cap on the maximum liability a business may be required to pay; the other half does not have a limit. Among the seven states with a cap, Georgia’s is the lowest at \$5,000, while Illinois’ is the highest at \$2 million.

In Connecticut and Massachusetts, the capital stock tax functions similarly to an alternative minimum tax, where firms calculate both their corporate income tax liability and their capital stock tax liability and pay whichever amount is greater. In Georgia and Nebraska, the capital stock tax is based on a fixed dollar payment schedule, rather than on a percentage of net assets, with tax rates decreasing as taxable capital increases.<sup>24</sup>

24 Janelle Cammenga, “Does Your State Levy a Capital Stock Tax?” Tax Foundation, Mar. 24, 2021, <https://www.taxfoundation.org/state-capital-stock-tax-2021/>.

As legislators have increasingly recognized the damaging effects of capital stock taxes, many states have reduced them or repealed them altogether. Kansas completely phased out its capital stock tax prior to tax year 2011, followed by Virginia and Rhode Island in 2015 and Pennsylvania in 2016. New York intended to finish its phaseout in 2021 but postponed its elimination due to the pandemic. Mississippi is in the process of phasing out its capital stock tax, which should be completely eliminated by 2028. Connecticut is also phasing out this tax by 2024, and Illinois had initially planned to do so as well, though that phaseout has been canceled. These actions will leave only 13 states with capital stock taxes still on the books—and if states want to establish a reputation for encouraging business relocation and in-state investment, those remaining states will act as well.

## Phasing Out Inventory Taxes

Most states tax business tangible property, but only 12 states—Alaska, Arkansas, Georgia, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Mississippi, Oklahoma, Texas, and Vermont—tax some or all business inventory. Taxes on inventory are nonneutral, as businesses with larger quantities of inventory, like manufacturers and retailers, are disproportionately burdened by such taxes. Businesses with little to no inventory escape this form of property taxation even if they use the same amount of government services as businesses with larger inventory tax bills.

In addition to being nonneutral, inventory taxes are highly distortionary, forcing companies to make decisions about production or stocking that are not entirely based on economic principles but rather on how to pay the least amount of tax on goods produced or held for sale. Inventory taxes also create strong incentives for companies to locate inventory in states where they can avoid these harmful taxes. In a time when supply chains are already strained, these incentives to avoid locating inventory in its otherwise most economically efficient location add to the friction that is frustrating businesses and consumers alike. Even in ordinary times, moreover, they impose high compliance costs for businesses, which are required to track and value their inventory for reporting and tax remittance purposes, while raising their cost of doing business.

Because inventory taxes are a type of property tax, local governments receive the majority of revenue from such taxes. This adds a layer of complexity to any plans of limiting or repealing such taxes, as an immediate repeal could strain local government finances. Some states have responded by providing a state tax credit against locally levied inventory tax liability. This approach, while better than nothing, has several shortcomings.

First, if the credit is against a business's income tax liability, then a low-margin or unprofitable business—precisely the type hit hardest by an inventory tax—may be unable to recoup the tax. Second, unless adequate protections are established, localities may be able to raise their inventory taxes without consequence (at least for select firms), and some businesses may even give aid to their local governments by overpaying local taxes—or at least demonstrating indifference in their calculation of liability—knowing that they will receive recompense from state government. And third, the tax credit approach does not eliminate the deadweight losses associated with complying with and administering the tax. A better approach, if states are to offset local revenue losses due to the repeal of inventory taxation, is to provide enhanced aid to localities by formula in exchange for the elimination of the tax.

## Conclusion

The reforms considered above are far from exhaustive. In particular, because they are focused on structurally deficient or antiquarian elements of state tax codes which are ill-suited for the new economy, they do not include things like rate reductions, which clearly play an important role in enhancing states' tax competitiveness as employees and employers are increasingly empowered to relocate without risking their job or their access to a qualified workforce. Sixteen states enacted or implemented income tax rate reductions in 2021, the most such rate cuts in decades, and this trend is likely to continue in 2022. States with high income taxes cannot afford to ignore the ways their peers are making themselves more attractive to taxpayers.

What this paper does provide, however, is a road map for reforms uniquely suggested by the changing economy. Some approach this era of enhanced workplace mobility with enthusiasm and others with trepidation, but the waters are out and no state can stem that tide. It remains only for policymakers to decide whether they will embrace this new reality with policies that modernize tax codes and respond to these new competitive demands, or whether they drag their feet and render themselves less appealing for taxpayers more empowered than ever to make their own destiny in a place of their choosing.

Taxpayers deserve a tax code that does not stand in the way of their upward mobility—and if it does, they may increasingly take advantage of their outward mobility by voting with their feet and finding a state that better prioritizes competitiveness and economic opportunity.