

# What taxes will states turn to next?

By Philip M. Zinn

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**They've tackled the wealthy, corporations, tobacco and alcohol. Now some strapped states may be forced to confront tax system overhauls.**

States faced record budget shortfalls in 2009, but wholesale changes to the state tax framework remained rare. Instead, states returned to some predictable measures: "sin taxes," tax increases on the wealthy, and corporate tax increases—both direct rate increases and indirect so-called "loophole closers." It's a formula seen in recessions past, and, unfortunately, one that has failed to spare the states painful cuts in services.

In 2010, with continued weakness in tax collections, over-optimistic revenue projections, and structural fiscal imbalances, states are likely to go to the well once again. This does not mean that they won't also look to chart a new course that involves fundamental overhauls of their tax systems. It just may take prolonged fiscal crises—beyond 2010—to get there.

## **Past is prologue.**

In 2009 states looked to predictable sources for additional funds. States once again turned to sin taxes as a means of targeting what some may view as socially irresponsible behavior to both suppress the activity and raise revenues. This approach is paradoxical, since a decline in the activity being disproportionately taxed will reduce the anticipated revenue from these taxes in the short term and potentially negate the benefit to the state in the long term. Regardless, 2009 saw a continuation of increased levies on items such as tobacco (Rhode Island increased its tax by \$1 per pack, up to a national high of \$3.46), alcohol (including a 90% increase in the liquor tax in Illinois), and candy and soft drinks (consider, again, Illinois, which will now tax these items at the same rate as general merchandise, instead of the preferential rate for food).

Another common tactic of the states, despite plummeting individual income tax receipts, was to increase revenues through greater levies on high-income individuals (e.g., California, Connecticut, New Jersey, New York, North Carolina and Wisconsin). These levies varied widely in terms of the rate of the increase and the definition of a "top" earner. For example, Connecticut's 1.5% increase applies to married taxpayers with taxable income over \$1 million, while North Carolina's 3% "surtax" applies to married taxpayers with taxable income over \$250,000. Such states are increasing their reliance on an unstable revenue source, which will further exacerbate budget difficulties during future economic slowdowns. For example, in New York City a significant percentage of the tax base comes from a small percentage of high-wage earners, many of whom work in the financial sector. Although

those who work in this industry may represent a small percentage of the state's and city's overall population, when the financial industry took a downturn in 2009, the impact on the state's and city's coffers was great.

In addition to raising individual income tax rates, states have also looked broadly to increasing sales and use taxes (Massachusetts, for one, raised its general sales-and-use tax rate from 5% to 6.25%, effective Aug. 1, 2009).

Another trend, driven solely by state revenue needs and without regard for sound tax policy, is the acceleration of estimated tax payments and increased withholding. For example, California's main response to its FY 2010 budget gap in terms of tax law changes was to raise wage withholding requirements by 10% and to accelerate individual and corporate estimated tax payments. The net effect was to move additional funds into the 2010 fiscal year. Of course, shifting the estimated tax burden results in a one-time benefit that is irreversible until fiscal conditions permit a return to a more even weighting—and increased withholding is merely borrowing from taxpayers, resulting in over collections and subsequent refunds to the taxpayers.

States continue to use Internal Revenue Code nonconformity as a means to safeguard their

income tax revenue streams from potential leakage resulting from federal changes. Common items for “decoupling” include a renewal—and extension—of bonus depreciation under IRC Sec. 168(k), expanded expensing under IRC Sec. 179, and deferral of certain discharge of indebtedness income under IRC Sec. 108(i). These changes were enacted in the Economic Stimulus Act of 2008 (P.L. 110-185) and the American Recovery and Reinvestment Act of 2009 (P.L. 111-5). States also continue to enact variances from federal net operating loss treatment, a trend likely to accelerate with the allowance of a five-year net operating loss carryback election in the Worker, Homeownership and Business Assistance Act of 2009 (P.L. 111-92).

Finally, tax amnesties once again exploded on the state legislative landscape. At least a dozen states held amnesties for major taxes in 2009, and more are scheduled or proposed for 2010.

### **Corporate tax trends**

The trend toward rate increases also continues with respect to corporate taxes. Connecticut, for example, in addition to its personal income tax hike, imposed a corporate surcharge of 10% for income years beginning in 2009–11. New Jersey coupled its individual income tax increase with an extension of its

4% corporate surcharge for another year; the surcharge was due to expire July 1, 2009. North Carolina imposed a 3% corporate surcharge for the 2009–2011 tax years. And, in a recent example, Oregon voters on Jan. 26 approved individual income and corporate excise tax increases that were enacted in 2009 but subsequently challenged by referendum.

Of special concern to corporate taxpayers has been the slow but steady movement by states east of the Mississippi toward combined corporate reporting (as opposed to separate company filing). Wisconsin adopted mandatory unitary combined reporting as expected, effective for tax years beginning on or after Jan. 1, 2009. Further, the District of Columbia adopted a measure providing that the city council “shall pass” legislation to require combined reporting.

Apportionment (the dividing up of corporate income among the states) continued to be another area of activity. California, for example, effective beginning in 2011, adopted an elective single-sales factor, under which property and employees are excluded from the apportionment formula. Because in-state businesses would benefit from this election, decreasing state revenues, opponents have sought to repeal this election via the initiative process. Along with the

single sales factor, California also adopted market-based sourcing. With market-based sourcing, in-state businesses no longer source sales of services and intangibles based on their in-state costs (capital and labor), but rather to their national customer base. Out-of-state taxpayers, meanwhile, see their sales factor increase, because such sales are included as in-state sales regardless of where the services are performed or the intangibles are developed or managed.

Taken together, the apportionment changes discussed above have the overall effect of assigning a greater proportion of the income of out-of-state companies to the state while reducing the amount of income of in-state companies that is subject to tax.

These changes would be detrimental to the states' corporate income tax receipts if it were not for the continued movement of states toward an economic nexus standard. Under an economic nexus standard, states assert jurisdiction over out-of-state firms even if they do not have property or employees present in the state. Rather, the states base their jurisdiction to tax solely on the level of sales by the out-of-state firm to in-state customers. California is a major example of a state that in 2009 adopted an economic nexus standard (effective in 2011), based on a mere \$500,000 in California sales.

### Looking to the future: Could major changes be in store?

As Rahm Emmanuel, President Obama's chief of staff, stated in early 2009, "You never want a serious crisis to go to waste." Perhaps a continued decline in state revenues will create a crisis environment such that states will begin to re-evaluate and make necessary changes to 20th century tax regimes.

While states continue to look to a variety of measures to plug budget gaps, some are looking for a longer-term approach to head-off similar problems in the future by ensuring a more stable revenue stream. California Governor Arnold Schwarzenegger established the Commission on the 21st Century Economy, which in September 2009 recommended wholesale changes to the state's tax structure, including the repeal of the corporation franchise tax and state general-purpose sales-and-use tax, a significant reduction in personal income taxes, and imposition of a new business tax, titled the "business net receipts tax," or BNRT. This new tax, which would be phased in between 2012 and 2016 at a rate not to exceed 4%, would be imposed on the gross receipts of any form of entity doing business in the state, minus the entity's purchases from other firms.

### "If you always do what you always did, you always get what you always got."

With the states facing record budget deficits, state legislatures in 2009 enacted a mixture of tried-and-true revenue-raising measures to meet the needs of funding government. However, many of these measures have the effect of further shifting to reliance on increased personal wealth and corporate profits, resulting in greater volatility in tax revenues and exacerbating future budget difficulties. As states face mid-year FY 2010 budget gaps and shortfalls for FY 2011 and beyond, likely without the same level of federal assistance, they are more likely to look past the short-term fixes that have proven ineffective in the past. While the short term is likely to reflect a continuation of recent trends as states grapple with further deterioration of their finances, the call seems to be strengthening for more fundamental tax reform.

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