State Taxes, Tax Reform, Trends, and Traps for the Unwary

Presented to:

The Interim Revenue Stabilization and Tax Policy Committee

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Principles of Good Tax Policy

The New Mexico Tax Research Institute is a non-profit, non-partisan member-supported organization dedicated to advancing the following principles of good tax policy in New Mexico:

Adequacy

- Revenues should be sufficient to fund needed services

Efficiency

- Interference with the private economy should be minimized

Equity

- Taxpayers should be treated fairly

Simplicity

- Laws, regulations, forms and procedures should be as simple as possible

Comprehensiveness

- All taxes should be considered when evaluating the system

Accountability

- Exceptions should be rare and should be carefully evaluated and justified

Corporate Income Tax

- Levied in 44 states.
- Accounts for just 5.4% of state tax collections and 2.7% of state general revenue.
- Since 2008, 15 states have reduced their corporate income tax rates.

Recent notable corporate income tax changes:

North Carolina - reduced corporate income tax rate from 4% to 3% as the final component of the multiyear phase-in of its comprehensive 2013 tax reform package. North Carolina now has the lowest rate of any state levying a corporate income tax, down from 6.9% in 2013.

Arizona – reduced corporate income tax rate from 5.5% to 4.9%.

New Mexico - reduced corporate income tax rate from 6.6% to 6.2%. The rate is scheduled to fall to 5.9% in 2018.

The District of Columbia - reduced its corporate income tax rate from 9.2% to 9%.

Indiana - reduced its corporate income tax rate from 6.25% to 6% on July 1, 2017. The rate will be reduced further to 4.9% by 2021.

Personal Income Tax

- Individual Income Taxes = 36% of State Raised Revenue
- General Gross Receipt/Sales Taxes = 31.3% of State Raised Revenue
- Selective Sales Taxes = 16.2% of State Raised Revenues
- 18 states and the District of Columbia have adopted individual income tax cuts since 2008.
- Several states have raised sales taxes in the past 2 legislative sessions, including Kansas, Louisiana, and South Dakota.
- Increased pressure to increase sales tax rates due to <u>base erosion</u> (as services, generally untaxed, assume an ever greater share of total transactions)

Gross Receipts Tax

- Gross receipts taxes are rarely used by states. Delaware, Nevada, Ohio, Texas, and Washington, have statewide gross receipts tax.
- The majority of states repealed their gross receipts taxes in the 1920s and 1930s and replaced them with retail sales taxes. States have recently begun to consider gross receipts taxes to help close budget gaps.
- In 2015, Nevada created its Commerce Tax, after a gross receipts tax failed on the ballot in 2014.
- In 2016, Oregon voters considered Measure 97, which would have established a gross receipts tax of 2.5 percent on all sales in excess of $25 million. Ultimately failed, but is still being considered by the legislature.
- In 2017, Louisiana, Oklahoma, Oregon, and West Virginia, have considered gross receipts tax proposals.

Institute

Marijuana Tax

- 7 States – Alaska, California, Colorado, Massachusetts, Maine, Nevada, Oregon, and the District of Columbia have legalized marijuana for recreational use. Tax revenue was a key component of legalization efforts.
- 29 states, the District of Columbia, Guam and Puerto Rico now allow for comprehensive public medical marijuana and cannabis programs.
- In 2016, four states passed legislation legalizing (and taxing) recreational marijuana.
- More than 20% of Americans now live in a state where recreational marijuana is legal.
- Marijuana tax collections in Colorado and Washington have exceeded initial estimates, and a nationwide legalization-and-tax regime could see states raise billions of dollars per year in marijuana tax revenue.
  Source: Tax Foundation

Transportation and Infrastructure

- Since 2013, 26 states and the District of Columbia have enacted legislation that will increase or may increase overall state gas taxes.
- in 2017, seven states—California, Indiana, Montana, South Carolina, Oregon, Tennessee and West Virginia—have passed legislation to increase fuel taxes
- Gas Tax Revenues have declined due to increased fuel efficiency and alternative fuel vehicles. A trend that will continue.
- Raising the gas tax is politically challenging.
- Are the feds paying their share?
- Is a Vehicle Miles Tax (VMT) the solution? What about Public-private partnerships?

E-Commerce

Quill Corp. v. North Dakota (1992)

Times have changed since 1992. The very first text message was sent in December 1992 in Finland.

For the last six years, e-commerce grew by 15% in each year and now accounts for 11% of all retail sales.

NCSL

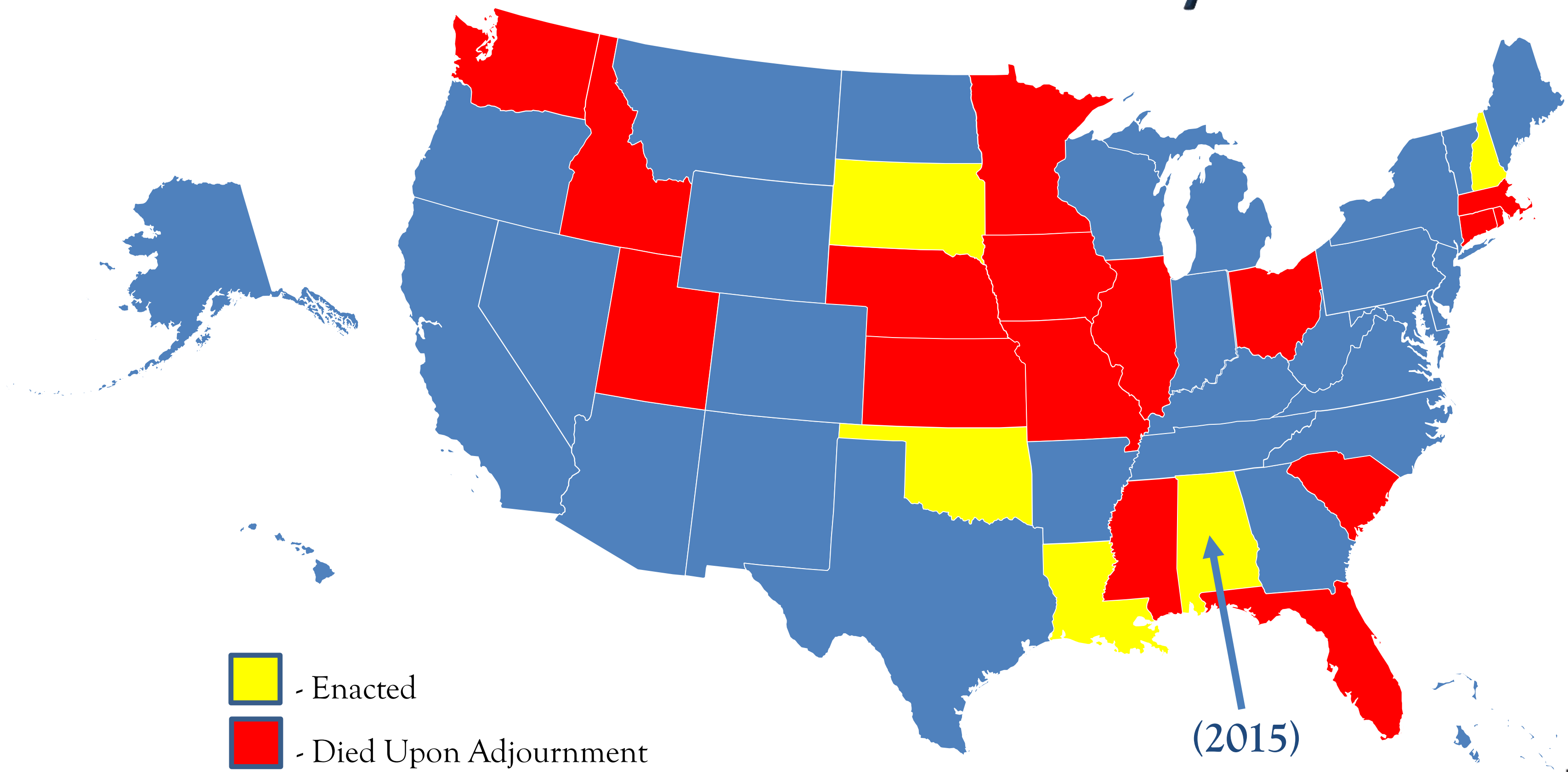
Remote Sales Tax Collection
States are No Longer Waiting for Congress

"Given these changes in technology and consumer sophistication, it is unwise to delay any longer a reconsideration of the Court's holding in *Quill*. A case questionable even when decided, *Quill* now harms States to a degree far greater than could have been anticipated earlier."

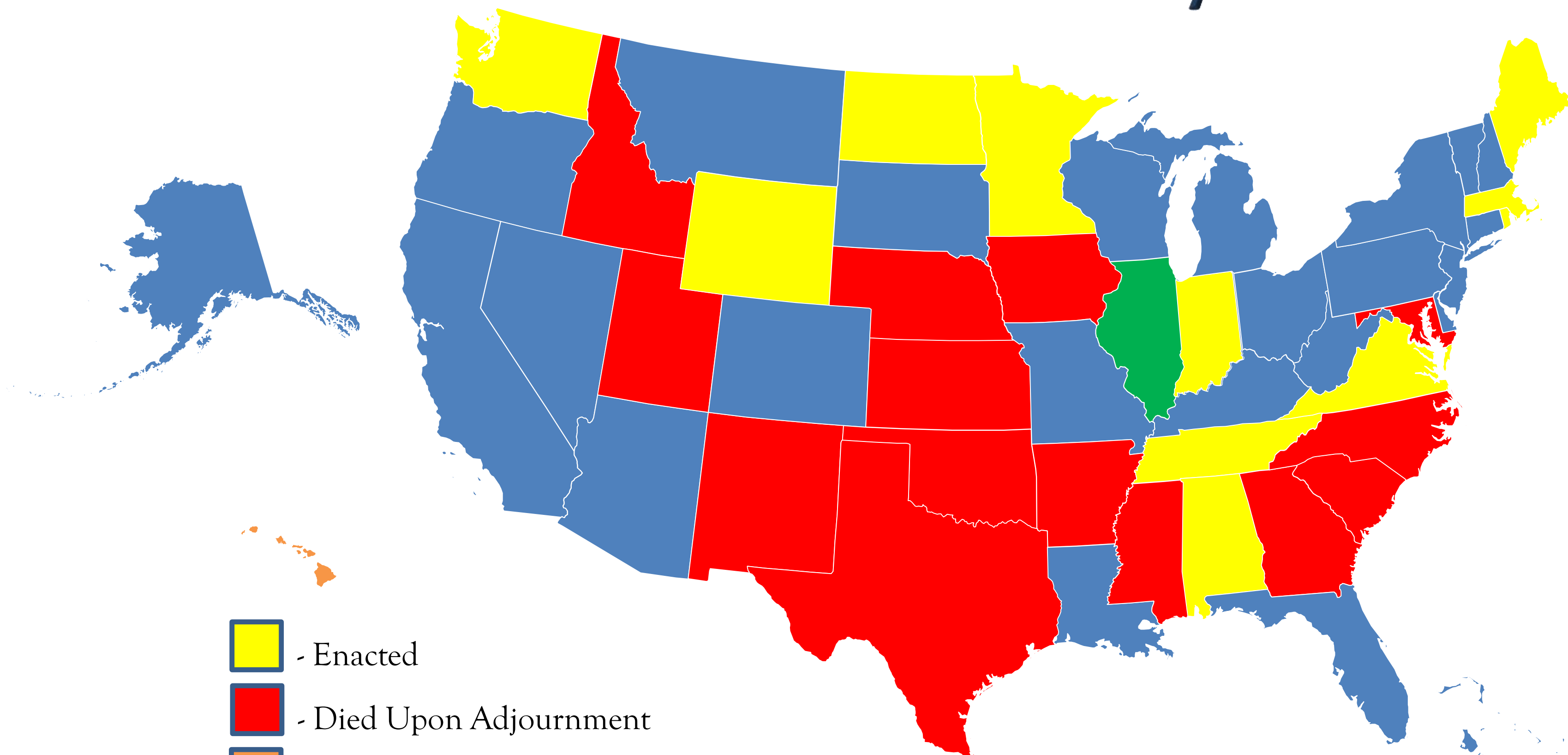
– Justice Kennedy in *DMA v. Brohl,* March 3, 2015

NCSL

2016 – State Remote Sales Tax Activity



2017 – State Remote Sales Tax Activity



NCSL

South Dakota S.B. 106

Requires an out-of-state seller to collect and pay tax as if the seller had a physical presence in the state, if the seller:

1) Generated more than $100,000 in revenues from sales into the state the previous calendar year, or

2) Had more than 200 separate transactions (sales) into the state the previous calendar year.

The law was challenged and has worked its way through the South Dakota court system. On Oct. 2, the state formally petitioned SCOTUS to hear the case.

NCSL

Effect of DMA Case on New Mexico

- The 10th Circuit ruled that the physical presence requirement of *Quill* applies only to the requirement of tax-collection, and not to any other state imposed requirement on out-of-states sellers.
- Because the New Mexico gross receipts tax does not require sellers to collect tax from purchasers, but only to pay the tax on the sellers' gross receipts, therefore, under the court's ruling (which applies in New Mexico), the state could assert that sellers must pay the gross receipts tax.
- New Mexico has assumed that *Quill* applied to the gross receipts tax. If it wanted to begin enforcing the tax on out-of-state sellers, it would need to revise regulations that indicate that there is a physical presence requirement.

Reforming the US Tax Code

- President Trump ran on a platform including tax reform
  - So have most of the majority members of Congress
  - Tax reform is difficult in any political environment and touches many constituencies
  - Unclear where priority for reform is overtaken by priority of expediency/check the box or simply cuts
    - Tax cuts are not necessarily tax reform

- House and Senate both introduce tax reform bills
  - House: H.R. 1 – "Tax Cuts and Jobs Act"
  - Senate: "Tax Cuts and Jobs Act"

Reforming the US Tax Code

- Tax reform ideas have had been evolving, and Trump offered thoughts. Notions such as the Border Tax Adjustment and eliminating all itemized expenses have been ejected
  - State organizations like the NCSL have expressed concern over the elimination of SALT deductions as well as for interest on state and local bonds.

- House and Senate both introduce tax reform bills
  - House: H.R. 1 – "Tax Cuts and Jobs Act"
  - Senate: "Tax Cuts and Jobs Act"
  - It's still too early to know what final form a proposal may take
  - Friday's Estimated Revenue Effects of the "Tax Cuts and Jobs Act" as ordered reported by the Committee on Finance is the latest revenue estimated on the most modifications to the Senate proposal.

Reforming the US Tax Code

The House and Senate Proposals in General: Individuals (Latest Senate Request details)

- Change Brackets/Rates
  - 7 brackets 10-38.5% (House had 4 +1)
- Eliminate personal exemptions
  - Retain modified child care credit ($2K, not indexed, 1K refundable, indexed)
- “Double” Standard Deductions
  - $12K S/$24K M/$18K HOH
- Eliminate some itemized expenditures
  - all SALT, home equity interest, non disaster casualties, tax prep, deferred repeal (2025) primary residence gain exclusion
- Repeals AMT

Reforming the US Tax Code

The House and Senate Proposals in General: Business (latest Senate request details)

- Change Brackets/Rates
  - Personal – creates a deduction of 17.4% of domestic non-service passthrough capped at 50% total wages
  - Corporate – creates top rate of 20%
- Limit Interest Deductions
  - 30% ATI
- Temporary (2022) Bonus Depreciation and Expanded Sec 179 (perm)
- Repeals AMT/DPAD

Implications to New Mexico of Federal Changes

State Personal and Corporate Income Taxes "Piggyback" on the Federal Personal and Corporate Income Tax Systems – That is They Use the Federal as a Base or Starting Point

- Generally rates are much different
- NM conforms fairly fully

Degree of Conformity Varies Among States

- Starting Point Can be Fixed/Static or Moving Point relative to Federal law
    - NM moves/fully incorporates most federal base changes
    - CA adopts federal law as of a certain date

Reasons for Conformity

- Starting Point
- Ease and Simplicity of Administration (for taxpayers and administrators)
- Predictability

Reasons for Decoupling

- No reason to mimic rates/brackets
- Budget/Revenue Stability
    - NOLs – almost no state allow carrybacks for budget purposes
    - Otherwise, mostly to insulate from federal changes

Implications to New Mexico of Federal Changes

- What State's Feel (in their budget)
  - Changes that determine taxable income
    - Exemptions
    - Deductions
      - Depreciation is where states vary the most based on degree of conformity
- What States Don't Feel
  - Rates/brackets vary widely among states but are not generally impacted by federal changes
  - Federal credits (business or personal) also do not generally impact state returns
  - Repatriation efforts/mechanisms not likely to create state taxable income
- New Mexico Conforms Closely with Feds
  - While mostly good, this leaves NM most sensitive to changes at the federal level

Implications to New Mexico of Federal Changes

- More Positive Changes Than Negative Appear to Flow to NM Returns
  - Implies Potential for increased GF revenue
  - Implies Tax Increases for NM taxpayers

- Potential Impacts are Greater on the Personal Income Tax Side, Rather than Corporate Income Tax
  - Personal income tax represents >10X GF revenue as CIT
    - The most significant changes to CIT are rate and one time changes escaping state taxation
  - Business tax changes that flow through to states appear less material and have more offsets than individuals

Implications to New Mexico of Federal Changes

- Most likely New Mexican's to see a state tax increase-people
  - Anyone who's current deductions exceed the proposed standard for their category (and what they leave in for itemizers)
    - Certain Itemizers
    - Those who's increased standard doesn't offset the loss of the personal exemptions (the Feds use non state impacting methods to offset)

Example: Sally and her two children

– Current:	Std (HOH)	9,300
	Exempt (3@4150)	12,450
	Total	21,750
– Prop:	Std (HOH)	18,000
	Total	18,000

Implications to New Mexico of Federal Changes

- Most likely New Mexico taxpayers to see a state tax increase - business
  - Any business benefiting from the domestic production activity deduction
  - Businesses with significant interest expense
- Most Likely New Mexico taxpayers to see a state tax cut:
  - Businesses benefiting from expanded Sec 179 or Bonus Depreciation
    - Timing difference
  - Non-itemizers with few dependents
  - Some taxpayers (resident or nonresident) with pass-through income
    - (House version had credit mechanism that would not cost state or benefit taxpayer on state return)

What Can the State(s) Do?

- Begin analysis of proposals using state-specific data
  - Wait until after Thanksgiving
  - Support your local tax agency and revenue estimators
- Potential options – short-term
  - Wait and see
    - Good chance nothing will happen
  - Decouple from federal rules
    - Triggers, phase-ins, contingent enactment clauses, etc.

Other Issues/Implications States Could See From Congressional Tax Reform Proposals

- Budget Reconciliation
  - Byrd Rule
    - Can Only Increase Deficit by $1.5 Trillion over 10 years; Otherwise;
  - Forced Cuts
    - Medicare
    - Medicaid
    - ACA Credits – potentially increasing premiums
- Personal property renditions are based, at least in part, on depreciable value of property, which would be impacted by further federal changes to depreciation rules.

Conclusion

It's too soon to know exactly what Congress will do (if anything), but the changes will:

- Not affect the states (e.g. federal rate cuts or certain foreign source income taxes imposed at the federal level),
- Increate the state tax base (by eliminating or limiting exemptions or deductions), or
- Decrease the state tax base (by increasing or creating exemptions or deductions).