November 28, 2016

MULTISTATE TAX COMMISSION

National Trends in State Income Tax Policy Legislative and Judicial Developments

Presented to the New Mexico Legislature
Revenue Stabilization and Tax Policy Committee

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The MTC is a multistate intergovernmental agency formed in 1967. The MTC assists states by providing analysis and support with complex multi-jurisdictional business tax issues including joint audits. New Mexico was one of the founding members of the MTC. Today, 48 states and the District of Columbia participate in MTC activities.

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Background

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- Income taxes in 2015 were 42% of total taxes state-level taxes collected (sales and use taxes were 47%).
- State income taxes are generally tied to federal income taxes (so that the state income tax calculation starts with the federal tax base)
- Many states do not review or audit “above the line” but depend upon the IRS to do audits – and they will make related adjustments if a taxpayer is audited

Overview

- Personal Income Taxes
  - Legislative Developments
  - Judicial Developments
  - Federal Developments
  - Future Developments?
- Corporate Income Taxes
  - Legislative Developments
  - Judicial Developments
  - Federal Developments
  - Future Developments?

Personal Income Taxes Legislative Developments

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- "Millionaire Taxes" – Surtax on high-income individuals (examples) –
  - Passed in 2012 and recently extended in California
  - A constitutional amendment to impose a tax on millionaires passed the Massachusetts legislature in 2016
  - Proposed in New York
  - Approximately 12 states have increased taxes on the top bracket (not necessarily over $1 million) since 2009 – some temporarily

(Source: The Pew Institute and others)

Personal Income Taxes Legislative Developments

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- Tax cuts enacted (examples):
  - Mississippi – 2016 – reducing personal income tax and phasing out corporate income tax
  - Tennessee – 2016 – phase-out of state tax on income from stocks and bonds
  - Arkansas – 2015 – reduced personal income tax rates
  - Missouri – 2014 – reduced tax rates contingent on revenue growth (and rates were not reduced in 2016 because the growth was not achieved)
  - North Carolina – effective 2014
  - Maine – effective 2012
  - Kansas, Ohio, and Wisconsin – effective 2013

Personal Income Taxes Legislative Developments

- Earned Income and Similar Tax Credits:
  - Rhode Island's state EITC was increased from 12.5 to 15 percent of the federal credit.
  - Oregon's state EITC was increased from 8 to 11 percent for taxpayers with one or more dependent under 3 years of age.
  - Hawaii lawmakers made slight changes to the state's child and dependent care tax credit, expanding the credit by altering the method for determining the percentage of qualifying expenses.
  - Colorado made the state's 10 percent state EITC refundable on 2015 state tax returns.
  - Minnesota also expanded the EITC
  - Oklahoma lawmakers made the state's 5 percent EITC non-refundable.

(Source: Institute on Taxation & Economic Policy and others)

Personal Income Taxes Judicial Developments

- U.S. Supreme Court Ruling in *Maryland v. Wynne*:
  - Court held that if a state taxes income on both residency and source basis, it must give a credit to residents for taxes paid in another state on source basis.
  - Test – if every state had the same tax system, would income be subject to duplicative tax.
  - Credits are permissible mechanism to prevent double-tax (even though they are not perfect)
  - May see future challenges:
    - Do states have to give credits for local income taxes paid and vise versa
    - Does the credit apply only to the extent the income was taxed in the same way

Personal Income Taxes Federal Developments

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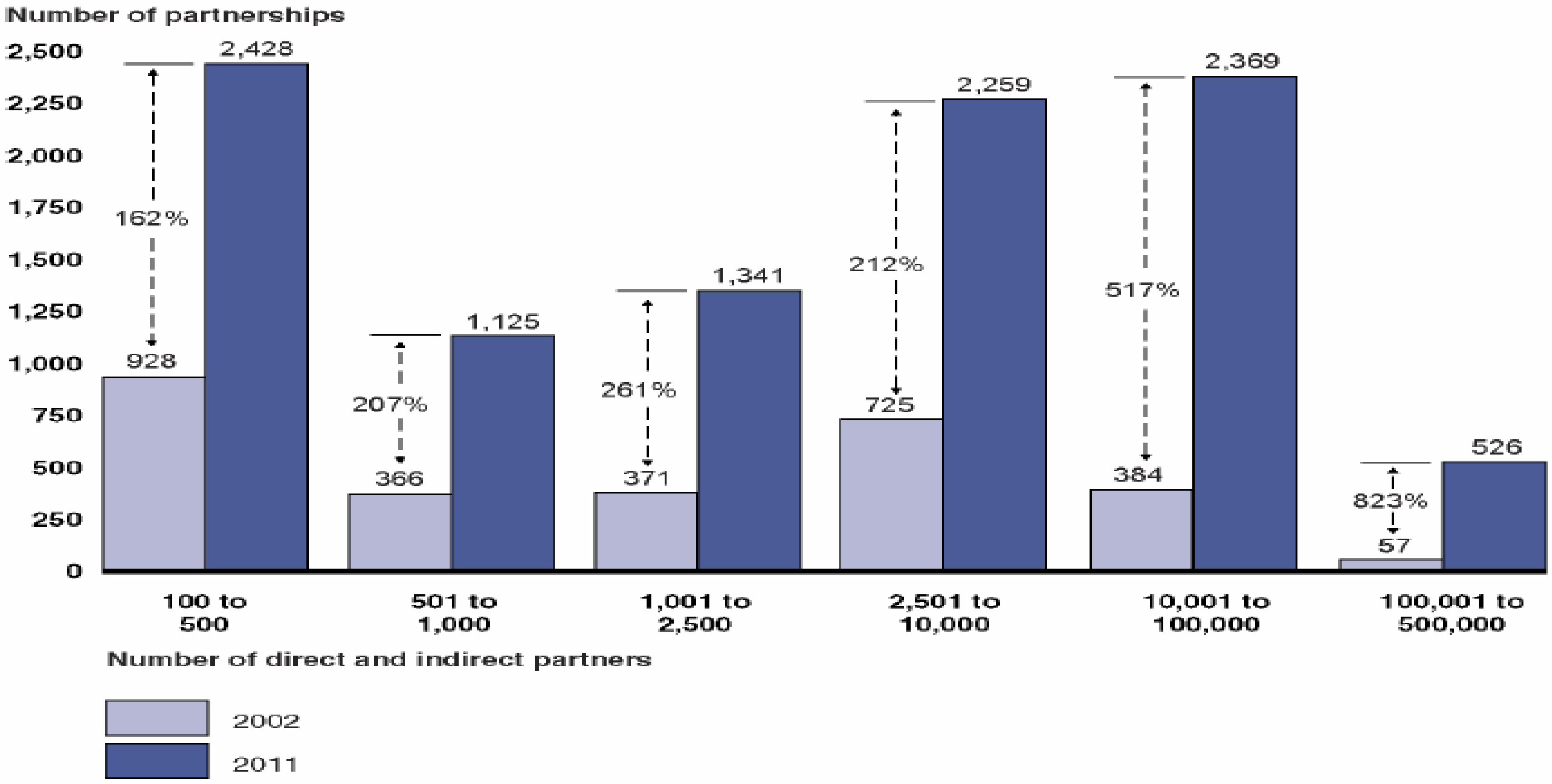
- Unincorporated Business Income
  - More business income is now reported by entities filing taxes as pass-through entities (partnerships and S corporations) than as taxable C corporations
  - More of these pass-through entities are complex structures with multiple layers or tiers of pass-through entities
  - IRS has had trouble auditing and enforcing tax on partnership income because of the lack of transparency in the structures
  - States may have separate issues, such as the ability to tax non-resident owners of pass-through entities (*Corrigan v. Testa* case)

Personal Income Taxes
Federal Developments

Figure 6: Number of and Percentage Increase in Large Partnerships, by Direct and Indirect Partners, Tax Years 2002 and 2011



Personal Income Taxes Federal Developments

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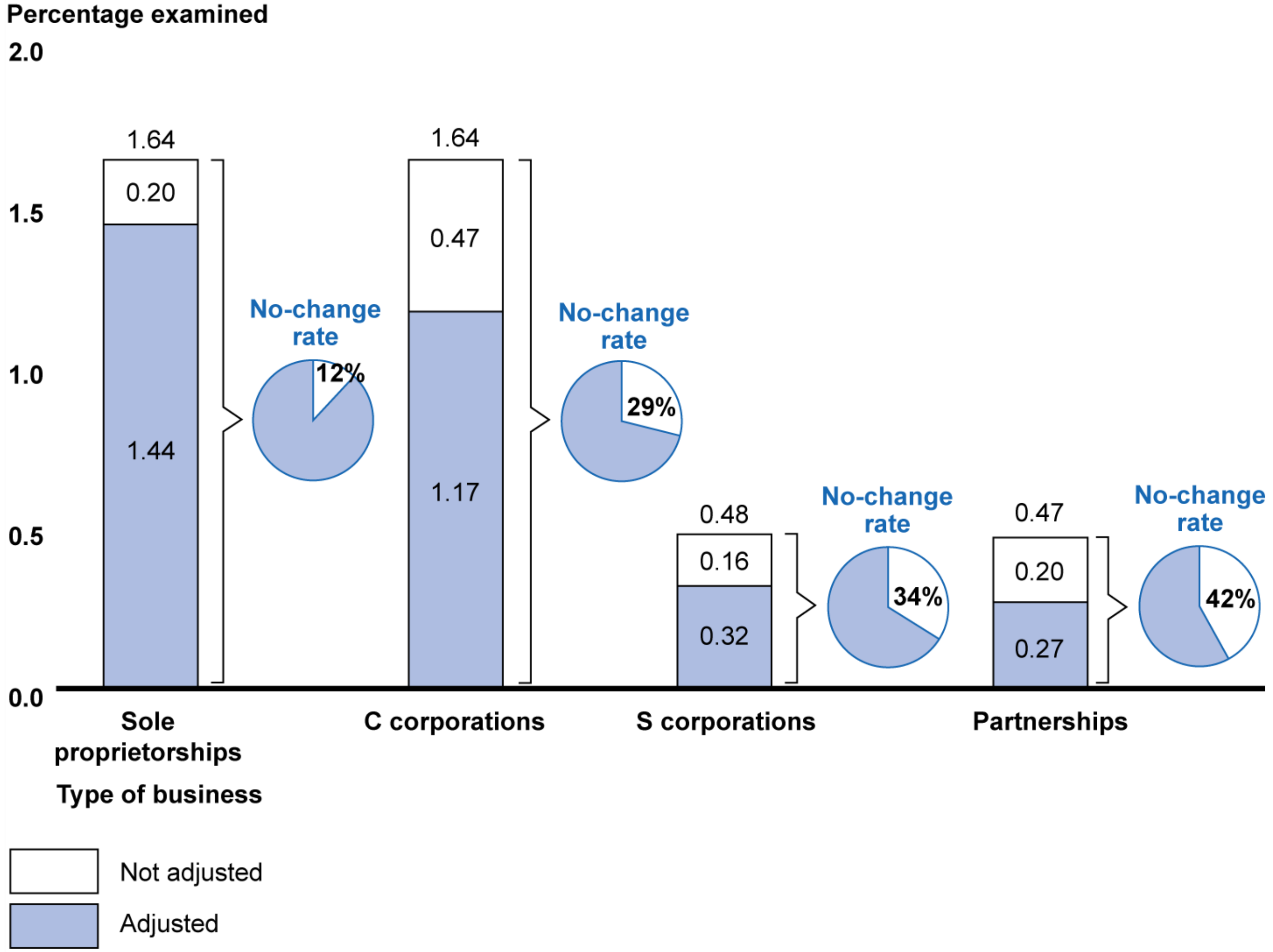
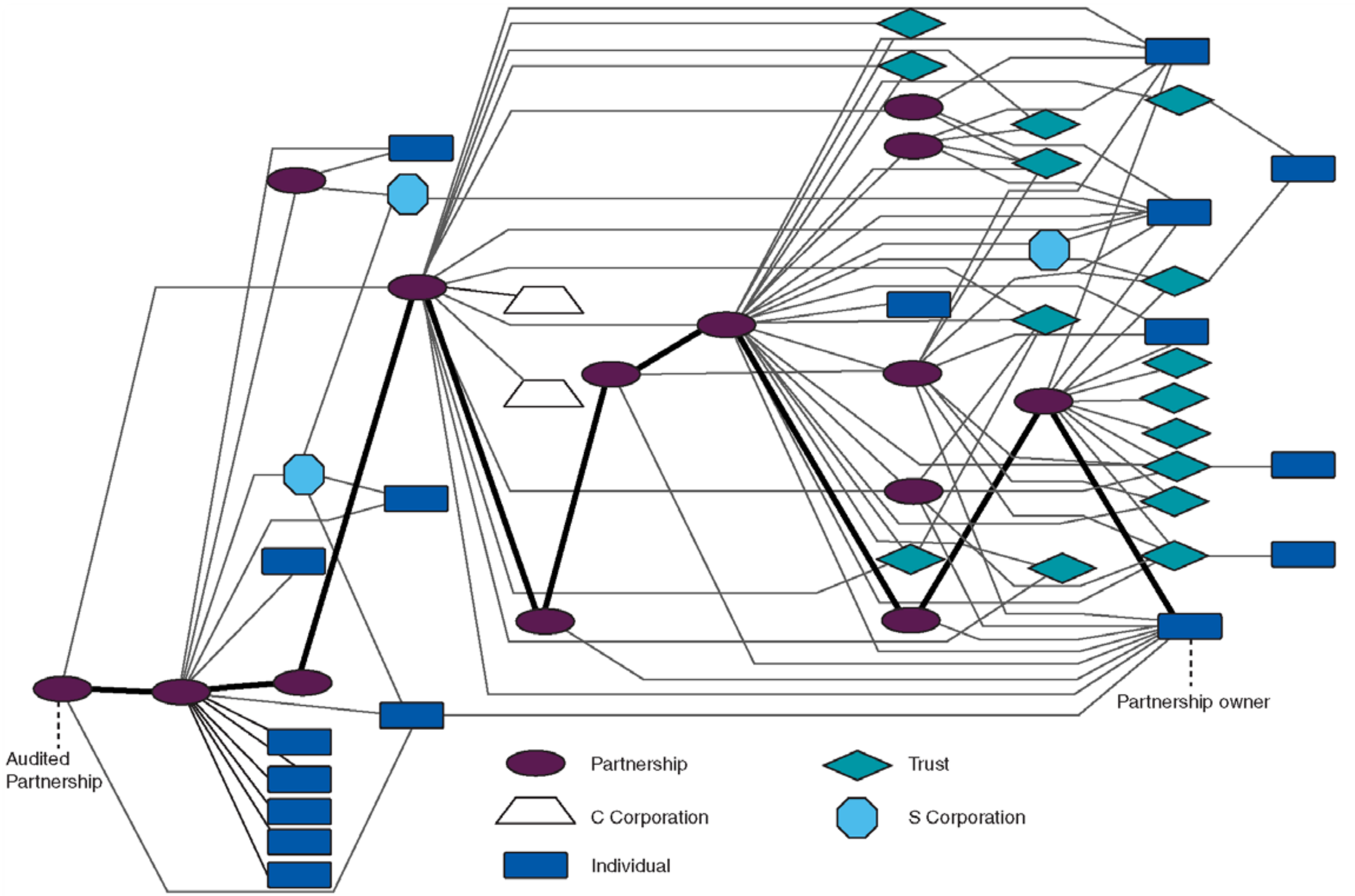


Source: IRS.

Personal Income Taxes Federal Developments



Source: GAO analysis of IRS documentation. I GAO-14-732

Personal Income Taxes Federal Developments

- Changes to federal audit and adjustment process:
  - Audits will be conducted at the partnership level
  - Adjustments will be made at the partnership level
  - Partnerships have three options:
    - Get partners to file amended returns and pay the tax
    - Pay the tax
    - "Push out" the adjustments to the partners who must pay the tax in the year of adjustment
- State taxes related to the audit adjustments will have to be provided for by state legislation and regulatory changes

Personal Income Taxes Future Developments

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- Federal tax reform – most likely state impacts:
  - – Most proposals would lower the rate and broaden the base
    - This would also broaden the state tax base
  - – Most proposals (in broadening the base) would get rid of the federal deduction for state taxes
    - This would increase the effective cost of state income taxes since taxpayers would not get an off-setting federal tax benefit

Corporate Income Taxes Legislative Developments

- Biggest trends in the last 10 years:
  - Combined filing – where related entities that are part of a unitary business file as though they were a single taxpayer
  - Movement from a three-factor apportionment formula (property, payroll and receipts) to a single-factor formula (receipts)
  - Use of "market-sourcing" to source the receipts from services and intangibles for purposes of the receipts (or sales) factor

Corporate Income Tax Legislative Developments

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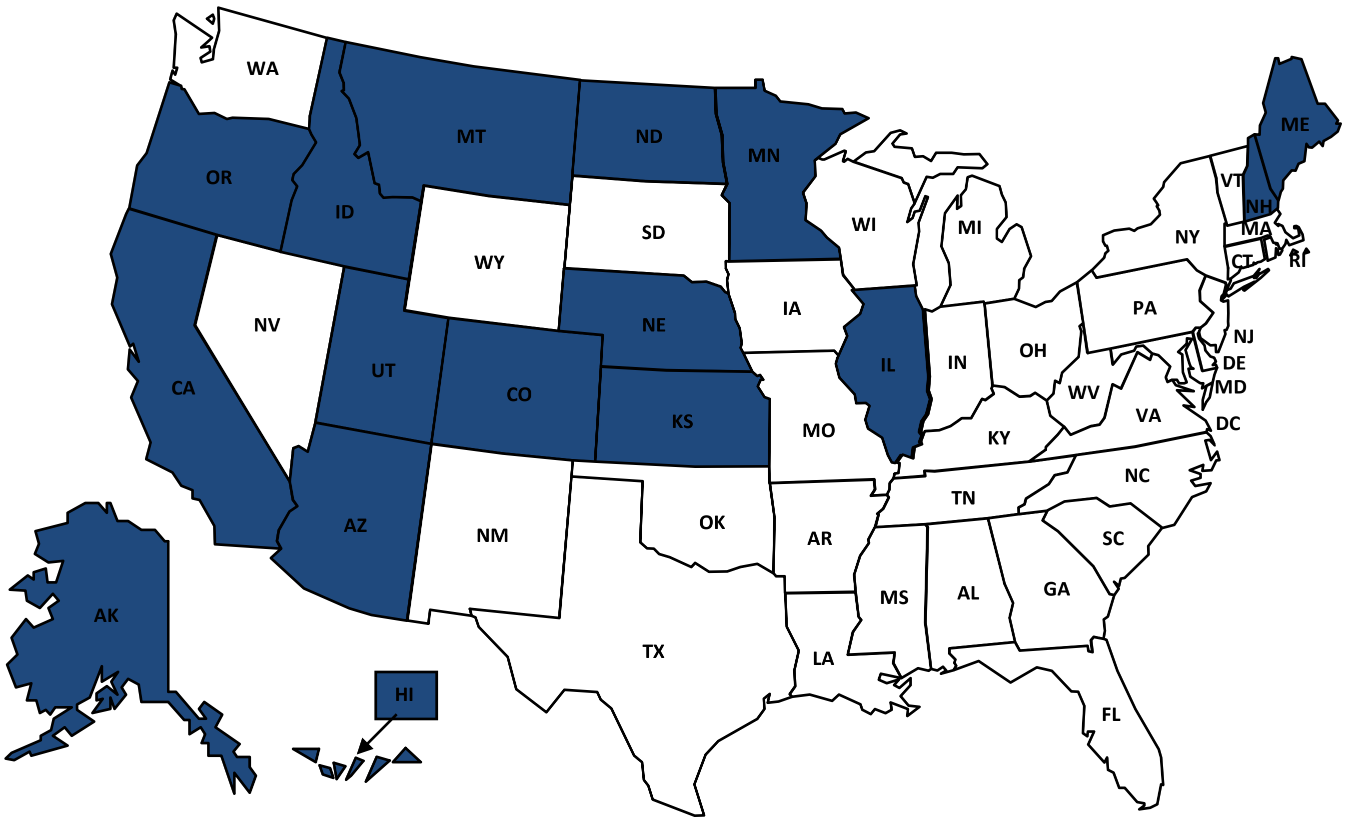
States with Combined Filing (in blue) - 2001



Corporate Income Tax Legislative Developments

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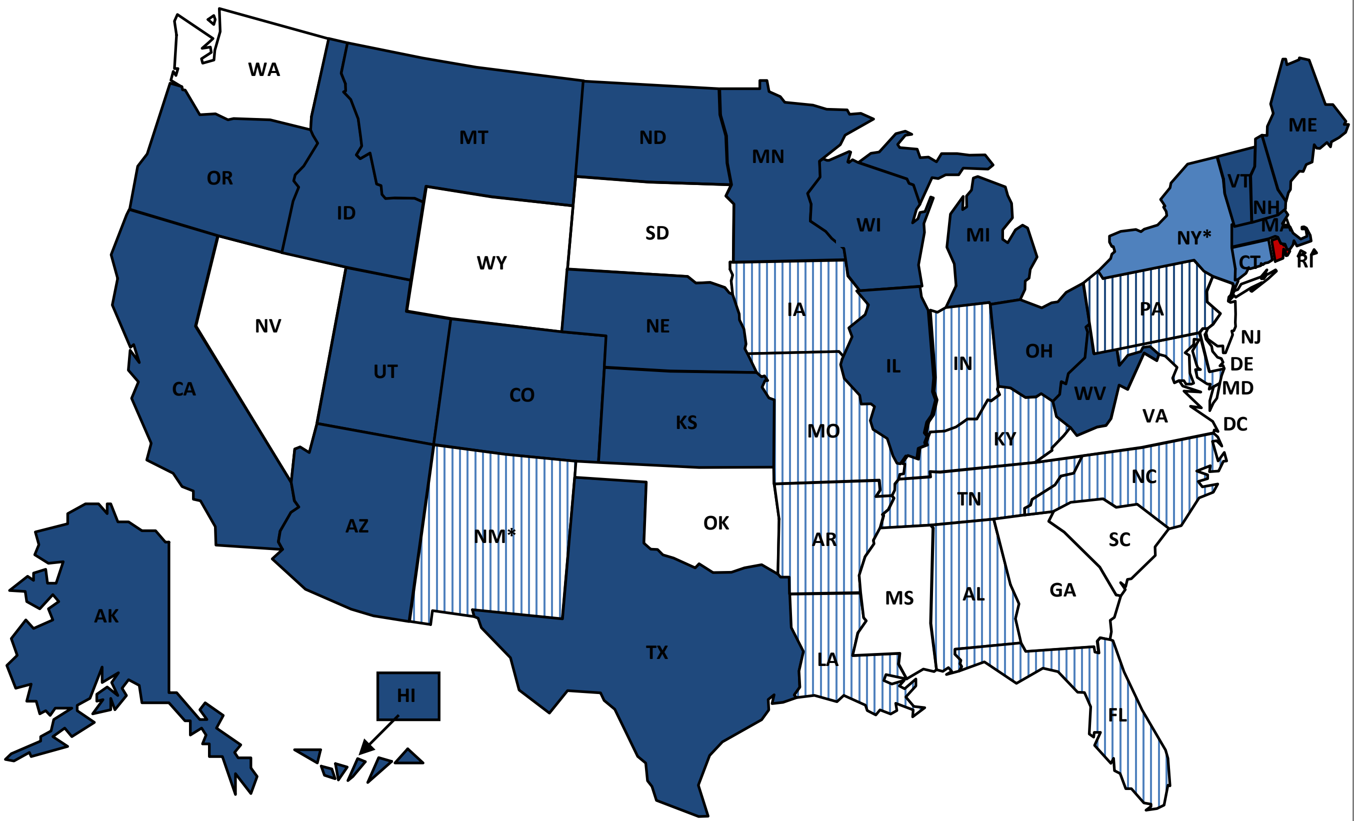
States with Combined Filing or proposals (shaded) - 2016



Corporate Income Tax Legislative Developments

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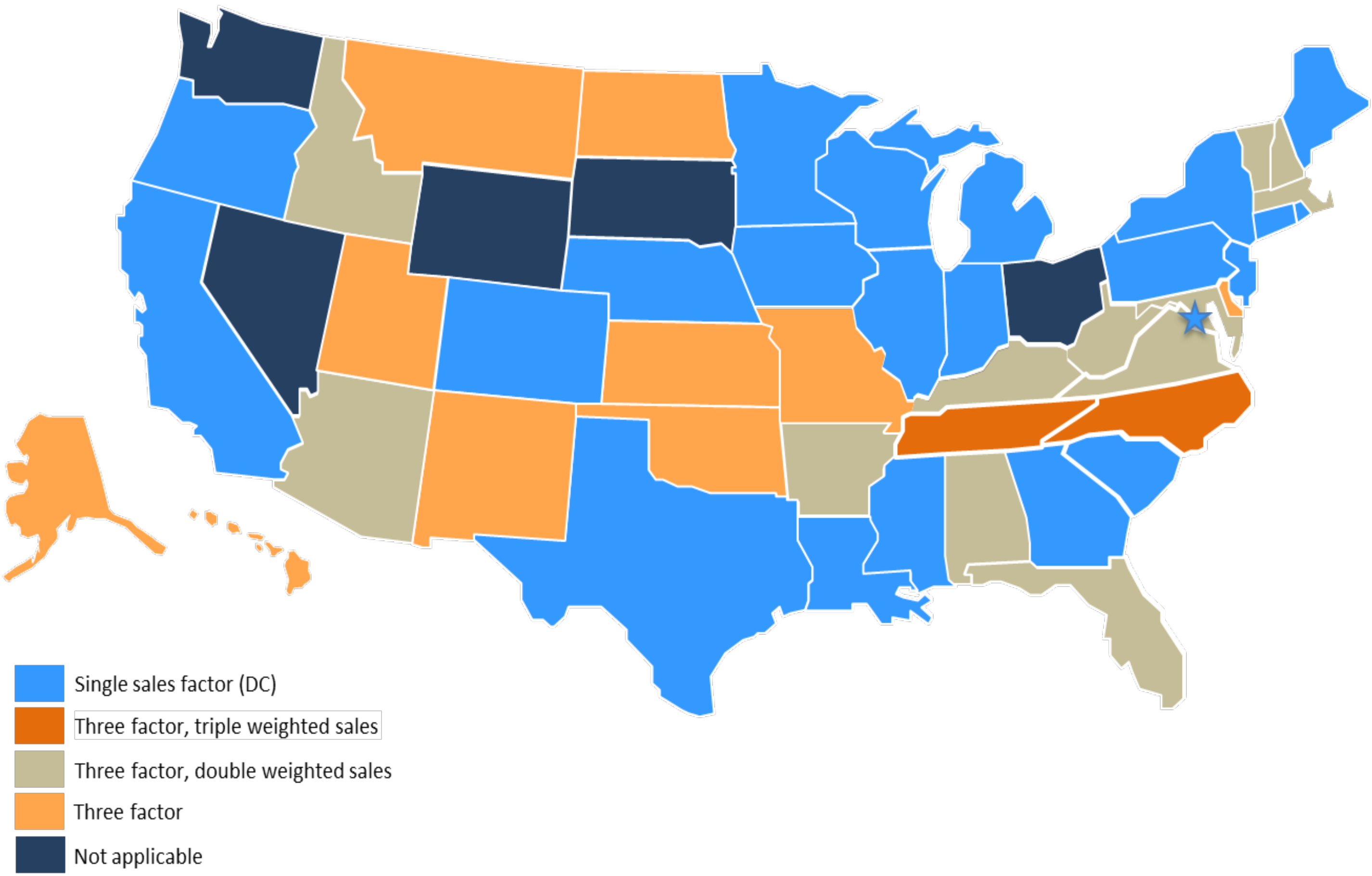
Differences in States Apportionment Formulas



* Based upon general sourcing rules.

Corporate Income Tax Legislative Developments

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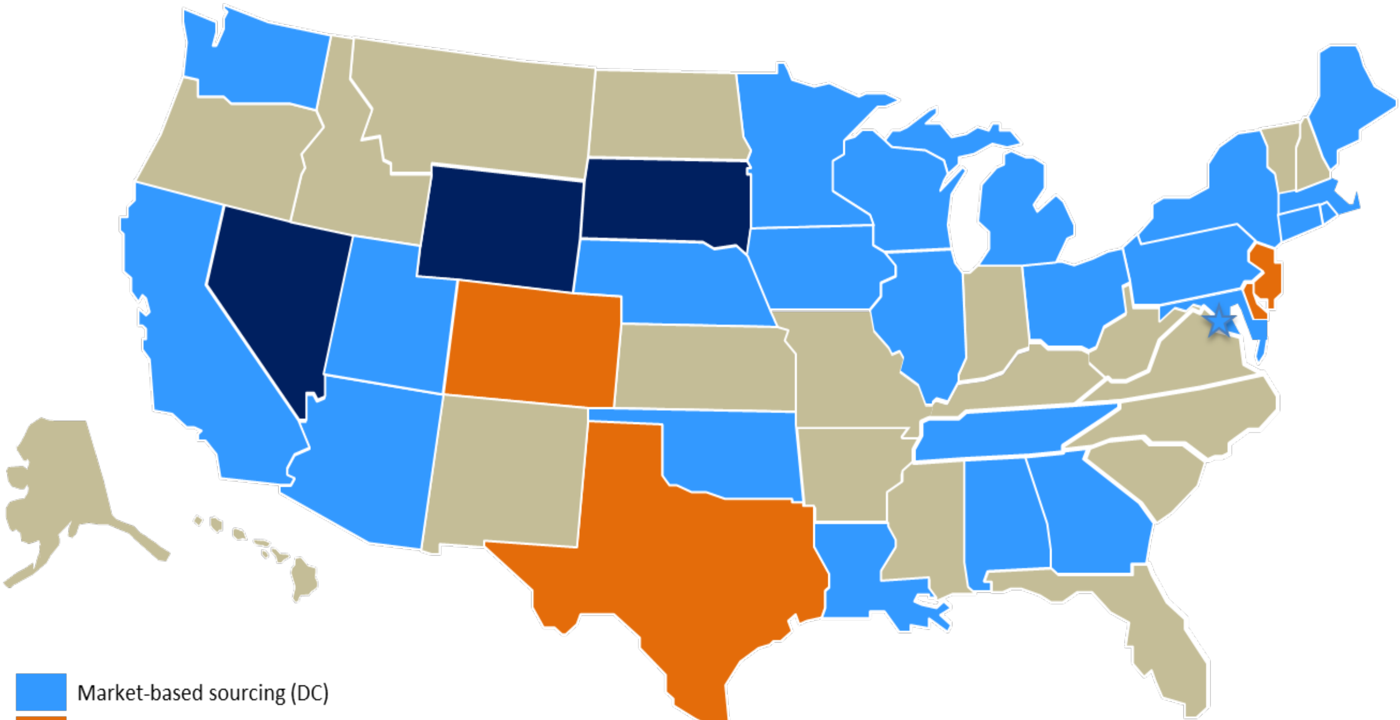
Differences in Sourcing Receipts for Receipts Factor



- Market-based sourcing (DC)
- Service performed sourcing
- Income producing activity / cost of performance sourcing
- Not applicable

* Based upon general sourcing rules.

Corporate Income Taxes Judicial Developments

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- Treatment of intercompany transactions
  - Particularly affects states that use separate entity filing
  - Also affects combined-filing states because of multi-national entities and entities that are not combined
  - Courts are now testing legislative and administrative solutions to the problem
    - “Economic” nexus – states asserting jurisdiction to tax the out-of-state affiliate
    - Economic substance rules – states asserting that intercompany transactions must have real substance
    - Add-back statutes – requiring deductions for inter-company expenses be added back
    - Tax-haven legislation – requiring affiliates in overseas tax havens be included in the combined group
    - Anti-distortion remedies including transfer pricing

Corporate Income Taxes Judicial Developments

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- Intercompany transactions (with foreign entities) is also the biggest issue for federal corporate income tax enforcement and litigation
- State litigation on intercompany transaction and transfer-pricing issues has grown –
  - Taxpayers are investing in litigation – consultants, lawyers and experts – because of the money at stake in each particular case
  - States are considering working together to share information, resources, and best practices
  - MTC has a State Intercompany Transfer Advisory Service (SITAS) program to train and provide information to states

Corporate Income Tax Federal Developments

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- IRS regulations concerning whether intercompany transfers are lending/debt vs. contribution/equity (IRC Sec. 385)
- Why does it matter – tax treatment differs – e.g. –
  - interest is deductible by the debtor – but there is no similar deduction if the transfer is equity, and
  - "repayments" are treated differently – repayments of debt versus dividends
- States have similar issues (especially separate filing states) and may also look to these federal regulations

Corporate Income Taxes Future Developments

- State legislative – states looking at gross receipts taxes
  - Washington’s B&O tax
  - Ohio – replaced corporate income tax
  - Nevada – recently passed
  - Oregon – considered
- Federal legislative – possible tax reform
  - Lowering rate and expanding base
  - “Repatriation holiday” – to allow income held overseas by US corporate groups to be used in the US without the full tax otherwise owed

Contact Information

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