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Taxing Times — A State Perspective

by Patrick Duffany, CPA, JD, Partner

Every day we hear about how bad the economy is doing. Every day we hear about the number of home foreclosures and how many people are struggling to survive. We have all seen our investments, whether that be our home or our 401k plans, significantly shrink in value. Since the recession began, the national economy has lost more than 8.4 million jobs. In response to these tough economic conditions, households and businesses have curtailed their spending. So what is going on at the state level?

Most states receive the majority of their revenue, approximately 74 percent, from three tax types: sales/use ("SUT"), personal income ("PIT"), and corporate income ("CIT").[1] These taxes accounted for approximately 31 percent, 36 percent, and 7 percent, respectively, of the $781 billion in tax collected during 2008.[2] During 2009, state tax revenues decreased, as compared to the same period in 2008, by 11.6 percent in Q1 2009, 16.4 percent in Q2 2009, and 10.9 percent in Q3 2009[3] and early results show that the state tax revenue decrease continued, albeit at a slower rate of 4.1 percent, in Q4 2009.[4] Table 1 reflects, by major tax type, the percent change in state tax collections as compared to the same quarter in the prior year[5] and the total tax collected in each quarter.[6]

Over the twelve month period ending September 30, 2009, state tax revenues totaled $694 billion, while state tax revenues for the twelve month period ending September 30, 2008 totaled $782 billion, a reduction of approximately $88 billion.[7] This is the sharpest decline in state tax revenues in more than 50 years of recorded data.[8] Although many states have proposed a number of tax increases, some of which are discussed herein, the states are not doing enough to balance their budgets, so it is likely that these budget gaps will repeat for at least the next several years.

Table 1. Percent Change in State Tax Collections, as Compared to Same Quarter in 2008

Quarter Ended	SUT	CIT	PIT	Total
Q4 - 2009	(4.2)	(5.8)	(4.5)	(4.1)
Q3 - 2009	(8.9)	(22.6)	(11.8)	(10.9)
Q2 - 2009	(8.8)	0.7	(27.0)	(16.4)
Q1 - 2009	(8.3)	(20.1)	(17.5)	(11.6)

So, what are states doing in response to this significant revenue reduction? Many are enacting "tax amnesty" programs to raise revenue, proposing budget cuts, furloughing employees, using rainy-day funds, and relying on accounting tricks (such as accelerating estimated tax payments) to help close budget gaps. States are also increasing taxes, some of which are only temporary, and imposing new taxes. States have already enacted roughly $24 billion in state tax increases for their FY2010 revenue year, with roughly half of these changes relating to increases in personal income taxes[9]. These actions, however, are insufficient to close the projected budget gaps.

At least nine states increased their 2009 personal income taxes, some with significant tax rate increases: Connecticut increased its highest marginal income tax rate by 30 percent (from 5 percent to 6.5 percent), New York eliminated most itemized deductions for certain taxpayers and increased their highest marginal income tax rate by 29 percent (from 6.95 percent to 8.97 percent), and New Jersey increased its highest marginal income tax rate by 20 percent (from 8.97 percent to 10.75 percent). With personal income taxes accounting for more than one-third of all state tax collections, many of us can expect to see an increase in our state income tax liabilities (not to mention the looming Federal individual income tax increases that are likely forthcoming).

States are also significantly increasing their sales tax rates, with California increasing its state sales tax rate by nearly 14 percent (from 7.25 percent to 8.25 percent), Massachusetts by 30 percent (from 5 percent to 6.25 percent), and North Carolina by nearly 28 percent (from 4.5 percent to 5.75 percent). We've also seen Colorado, New York, North Carolina, and Rhode Island pushing economic nexus filing requirements for sales tax purposes to new extremes. These states may be short-sighted, however, as Amazon and Overstock terminated all web-marketing relationships with

[1, 2] U.S. Bureau of the Census, State Government Tax Collections: 2008.
[3] Boyd, Donald J. (2010). *Recession, recovery, and state-local finances*, The Nelson A. Rockefeller Institute of Government.
[4, 5] Dadayan, Lucy (2010). *Final Quarter of 2009 Brought Still More Declines in State Tax Revenue.* The Nelson A. Rockefeller Institute of Government.
[6, 7] U.S. Bureau of the Census, National Totals of State Tax Revenue, By Type of Tax, through Q3 2009.
[8, 9] Boyd, Donald J., *supra* note 3.

companies within each of these states, causing at least an initial negative impact on such states' economies.[10] Amazon and Overstock also threatened to terminate their relationships with California and Hawaii web-marketing firms if those states adopted similar economic nexus rules. This topic is a discussion for another day.

With respect to corporate income taxes, Massachusetts and Wisconsin have recently adopted unitary tax legislation (whereby a group of affiliated companies, provided certain intercompany relationships exist, is treated as a single company for corporation income tax purposes). In reality, however, with many corporations generating little taxable income, we don't expect such changes to raise significant state revenue for the current state budgets.

We've also seen one significant new tax: The New York "Metropolitan Commuter Transportation Mobility Tax," a new payroll tax on employers with employees working in and around New York City.

More new taxes are likely on the horizon. Many economists believe the U.S. economy is strengthening,[11] though as we work our way through the most pronounced and protracted recession in 70 years, and as many state budgets remain in turmoil as demands rise and revenues fall, the worst is probably still to come from a state tax perspective. In fact, the Center on Budget and Policy Priorities projects that, by the time the 2010 and 2011 fiscal years' end, states will have addressed budget shortfalls of up to $375 billion for the 2010 and 2011 fiscal years.

The only way to combat these shortfalls is through a combination of spending reductions and tax increases and, as history shows, there are no easy, universally agreeable fixes to the problems that lay ahead. Although the states are starting to realize the significance of their budget shortfalls, most are not acting quickly or judiciously enough to effectively close these gaps. Clearly, we are living in interesting times. Unfortunately, they will likely be very taxing times as well. ■

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[10] Henchman, Joseph (2010). *"Amazon Tax" Laws Signal Business Unfriendliness and Will Worsen Short-Term Budget Problems.* The Tax Foundation.
[11] Dadayan, Lucy (2010). *Final Quarter of 2009 Brought Still More Declines in State Tax Revenue.* The Nelson A. Rockefeller Institute of Government.