



The Great Recession of 2009 How Are States Responding?

TAX

AUDIT • TAX • ADVISORY

Federation of Tax Administrators
Denver, Colorado
June 1, 2009



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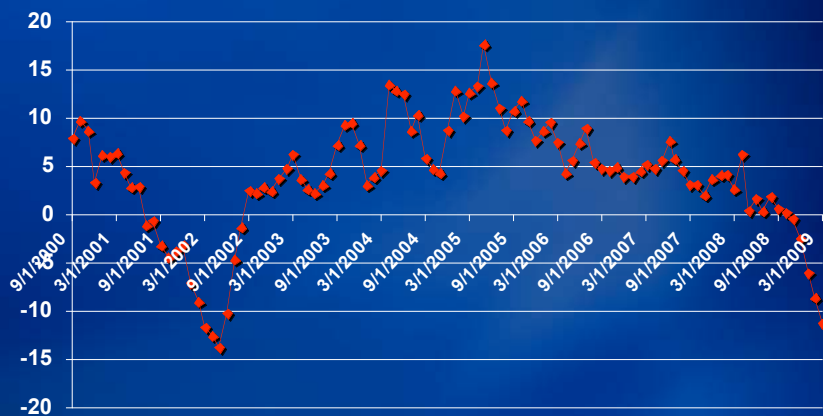


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State Revenues – Total Taxes

Year over year change on a monthly basis – 3-month moving average



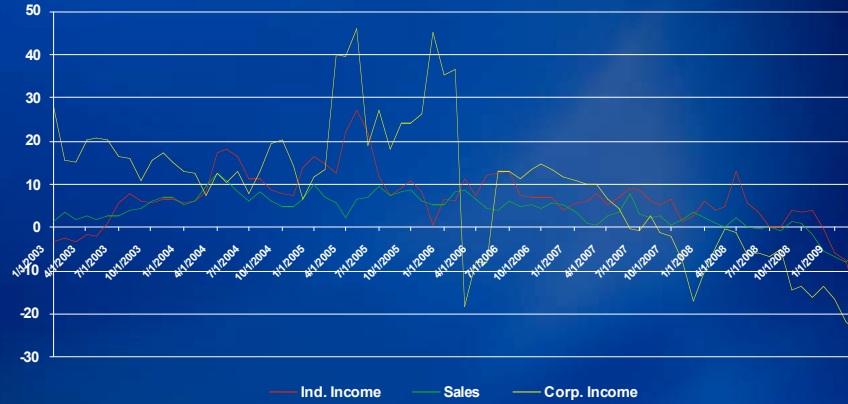
Source: Federation of Tax Administrators



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Breaking it Down By Source

Year over year change on a monthly basis – 3-month moving average



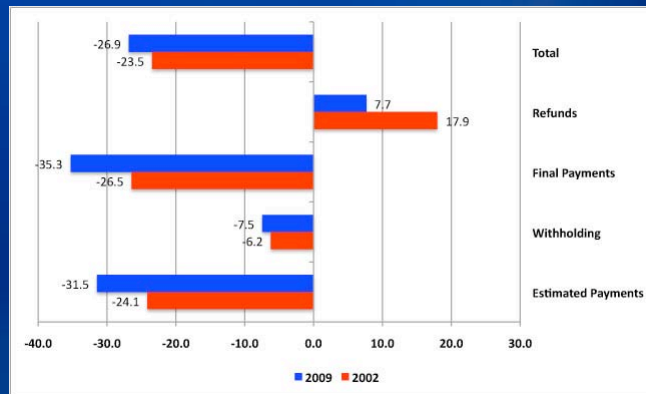
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April Income Tax Data



Source: Federation of Tax Administrators

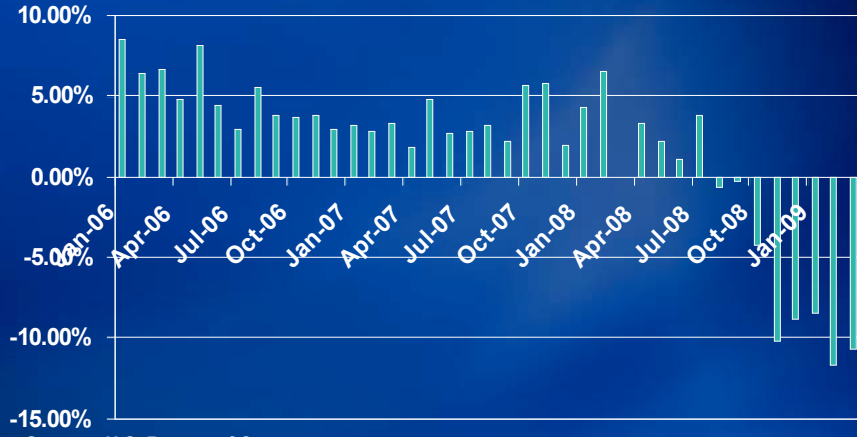


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Monthly Retail Sales Data

Percent change from year earlier



Source: U.S. Bureau of Census

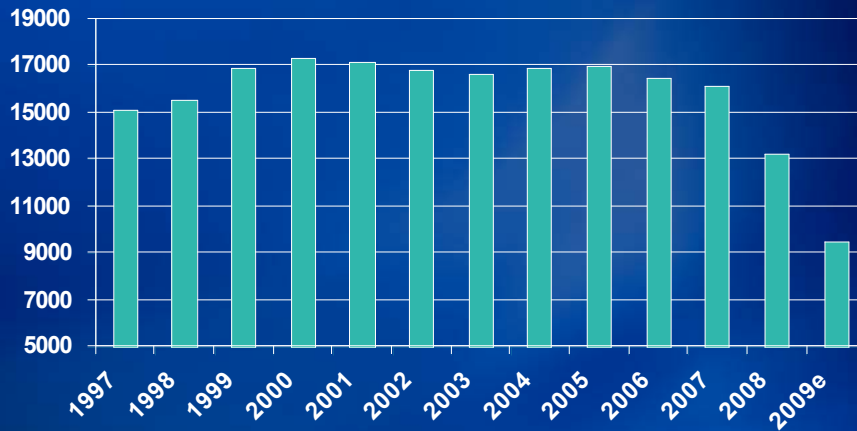


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New Car and Light Truck Sales

In Thousands – Annual Data



Source: National Association of Automobile Dealers 2009 is SAAR through March 2009.

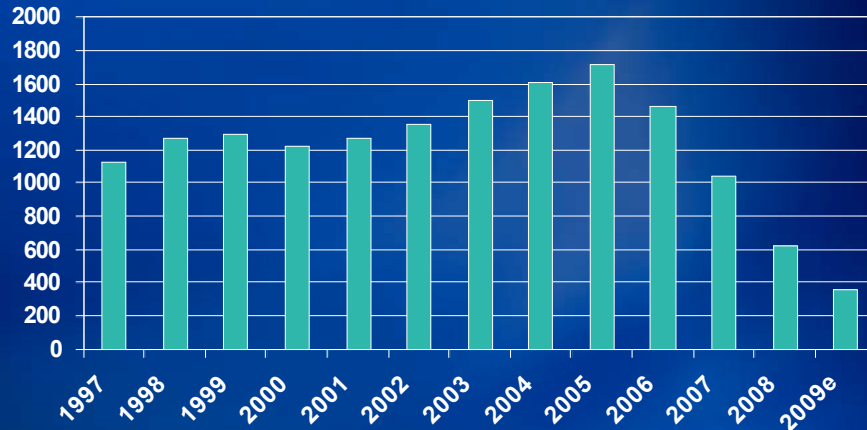


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Single Family Housing Starts

In Thousands – Annual Data



Source: National Association of Home Builders

2009 is SAAR through April 2009.



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Role of the Property Tax

Percent Change Year over Year on a Quarterly Basis



Source: Census Bureau

State Property



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What's It Mean for State Budgets?

● FY 2009

- \$40 billion gap closed in preparing budgets
- Since budgets enacted another \$60 billion gap has occurred
- Averages 8 percent of budget; over 10 percent in AL, AZ, CA, CT, GA, IL, NJ, RI, SC and UT

● FY 2010

- Deficit of \$130 billion in 44 states; trends indicate deficit likely to reach \$145 billion
- Over 20 percent shortfall in AZ, CA, CT, FL, LA, NV, NJ, NY and VT

● CBPP projects FY 2011 deficit could reach \$180 billion

Source: Center on Budget and Policy Priorities, My 2009



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What Is Ahead for States?

- Rockefeller Institute says budget gaps will persist well into 2012
- Historical pattern is for revenues to reach pre-recession peak (adjusted for inflation, tax changes and population) only after 5 years (Rockefeller)
- Federal stimulus (Medicaid and State Fiscal Stabilization Fund) provides about \$125 billion in flexible assistance through FY 2011. This is about 40 percent of total FY 2010-2011 shortfall
- Question is whether they use it for glide path or postponing decisions



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Tax Revenues and GDP

Percent Change Year over Year on a Quarterly Basis



Source: Census Bureau and Bureau of Economic Analysis



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What We Are Seeing on the Tax Side

- **Amnesties and other one-time revenue shots**
 - Accelerations, estimated payments, leasing assets
 - Stimulus funding
- **Sin/excise taxes**
 - Tobacco, alcohol, soda, snacks
- **Corporate income tax**
 - Economic nexus
 - Combined reporting
 - ‘Shoring up’ – add-backs and other related party transactions
 - Single sales factor, market sourcing on non-TPP sales
- **Sales and use tax**
 - Nexus – representative/affiliate
 - Taxation of digital goods
 - Taxation of services



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What We are Seeing

- **Other measures**
 - Decoupling
 - Penalties
 - NOL treatment
 - Shorten SoL
- **Broad-based tax increases**
 - Sales tax rate increases (temporary)
 - Increased rates on higher income individuals



Tax Amnesties

- **Alabama (2/1/09-5/15/09) – Not A/R; 3-year look back**
- **Massachusetts (3/1/09-4/30/09) – Individual only**
 - VDA for employer withholding and new hire reporting
- **Connecticut (5/1/09-6/25/09) – Not A/R; 25% interest reduction**
- **New Jersey (5/4/09-6/15/09) – 50% interest reduction; 5% additional post-amnesty penalty; 2002 forward**
- **Arizona (5/1/09-6/1/09) – Possible interest reduction; 2002 forward**
- **Virginia (TBD – FY 2010) – 20% post-amnesty penalty; 50% interest reduction**
- **Hawaii (Through 6/26/2009) – 50% interest reduction; not A/R**
- **Louisiana and Maine considering one for FY 2010**
- **Expanded settlement authority in Kansas**



Combined Reporting

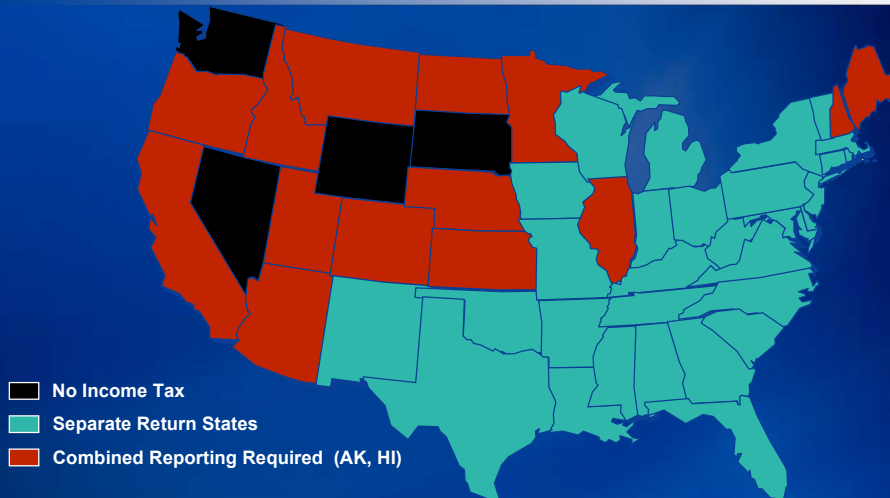
- Historically, 16 states
- For a 30-year period, enacted by only two states (Vermont in 2004 and Texas in 2006)
- Proposed by 11 states in 2007
 - Adopted in Michigan, New York, and West Virginia
- In 2008, proposed in Connecticut, Florida, Kentucky, Indiana, Iowa, Massachusetts, Missouri, New Mexico, Tennessee, and Wisconsin
 - Adopted in Massachusetts
- In 2009, proposed in Alabama, Connecticut, Florida, Iowa, Louisiana, Maryland, Missouri, New Mexico, North Carolina, Rhode Island, and Tennessee
 - Adopted in Wisconsin



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Combined Reporting – 2003



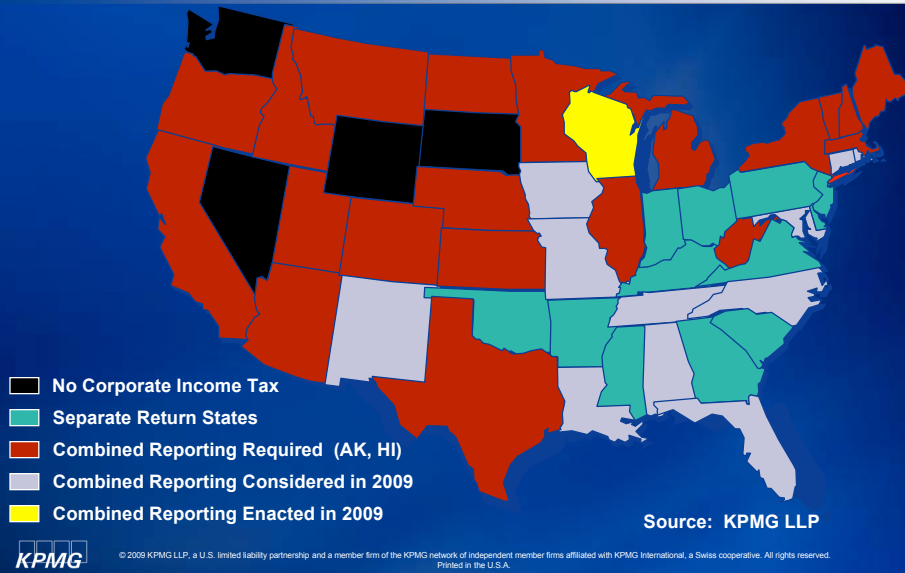
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Combined Reporting – 2009



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Combined Reporting

- **Concerns of the business community**
 - Significant administrative burdens
 - Increased complexity and uncertainty for taxpayers
 - Concept of “unitary” group requires in-depth look at operational relationships
- **Consistent application of principle**
 - Shared losses, shared credits?
- **Effect on state revenues uncertain**
 - “Winners” and “Losers”
 - Will expected revenue increase occur?
 - Expense disallowance statutes may reduce impact



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Combined Reporting – Recent Legislation Comparison

<i>Characteristics</i>	<i>MA</i>	<i>MI</i>	<i>NY</i>	<i>TX</i>	<i>WV</i>
50+% Ownership	X	X	80	X	X
Worldwide/Domestic/ Water's-edge	WE/ WW	D	D	D	WE/ WW
80/20 Exclusion	Y	Y+	N	Y	N
Unitary Test	I / I / I Flow of Value (MTC)	D/C/I Flow of Value	SIT/ Prior Test	MTC	I/I/I Flow of Value (MTC)
Joyce/Finnigan	F	F	F	J	J

Source: KPMG LLP



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Expense Disallowance – 2009

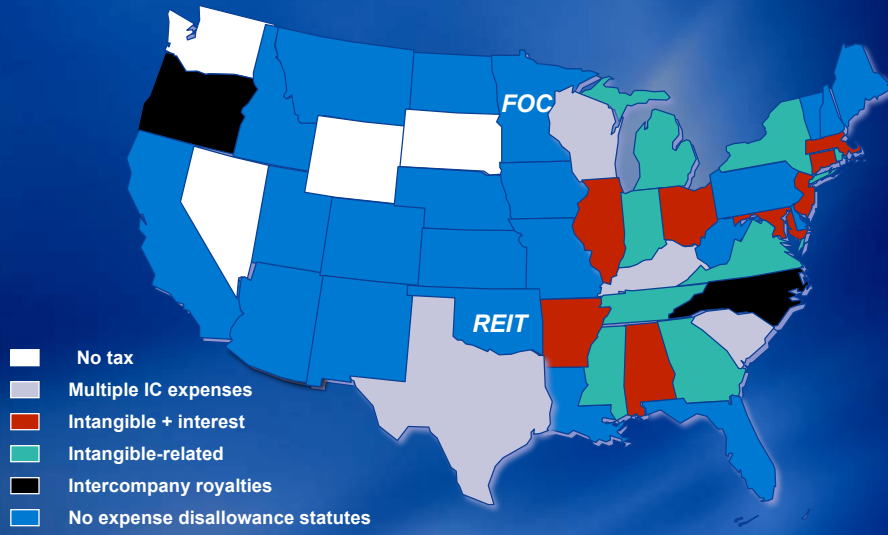
- **Legislation considered or enacted**
 - Wisconsin – Intangibles and management expenses (also CR)
 - Oklahoma – REIT correction
 - Colorado – REIT
 - Virginia – REIT
 - North Dakota -- REIT
 - Florida – New regime considered



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KPMG Expense Disallowance States - 2008



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Expense Disallowance – Chart Summary

Narrower		Broader	
Royalties	<i>and</i> intangible related interest	<i>and</i> all intercompany interest	<i>and</i> other expenses
North Carolina Oregon ¹	District of Columbia Georgia Indiana Mississippi Michigan New York Rhode Island Tennessee ² Virginia	Alabama Arkansas Connecticut Illinois ¹ Maryland Massachusetts New Jersey Ohio	Kentucky ³ South Carolina ⁴ Wisconsin ⁵

¹To recipient outside combined report
²For disclosure purposes only
³Management fees; but only intangible interest disallowed
⁴If accrued but not paid
⁵Expanded to include intangible expenses and management fees

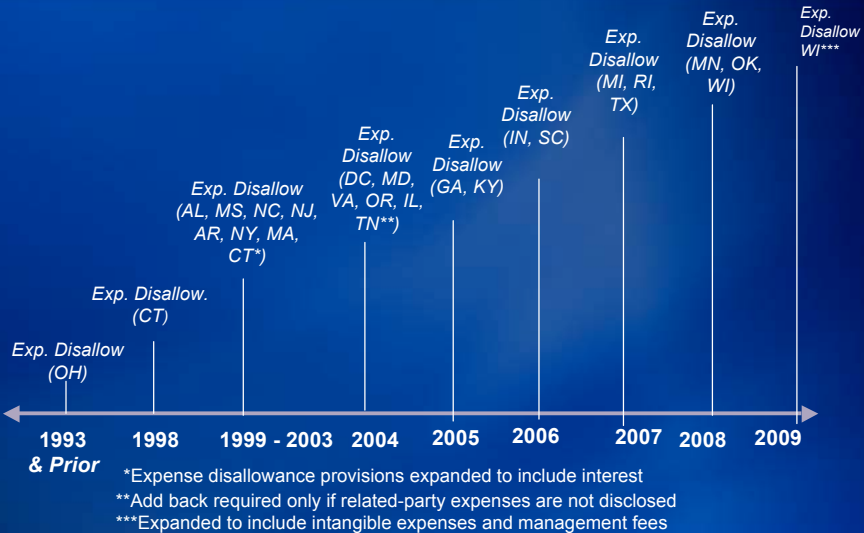
**Note that Minnesota has expense disallowance for FOCs, Oklahoma has expense disallowance for payments to captive REITs, and Texas has de facto expense disallowance



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Legislative Developments: Related Party Expense Disallowance—Who's Left?



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Separate Return States Without Expense Disallowance

- Delaware (unlikely)
- Florida (combined reporting legislation proposed in 2009)
- Iowa (combined reporting legislation proposed in 2009)
- Louisiana (enforces economic nexus / combined reporting legislation proposed in 2009)
- Missouri (combined reporting legislation proposed in 2009)
- New Mexico (enforces economic nexus / combined reporting legislation proposed in 2009)
- Oklahoma (enforces economic nexus)
- Pennsylvania (combined reporting legislation proposed in 2007)
- Tennessee (unless not disclosed; combined reporting legislation proposed in 2009)



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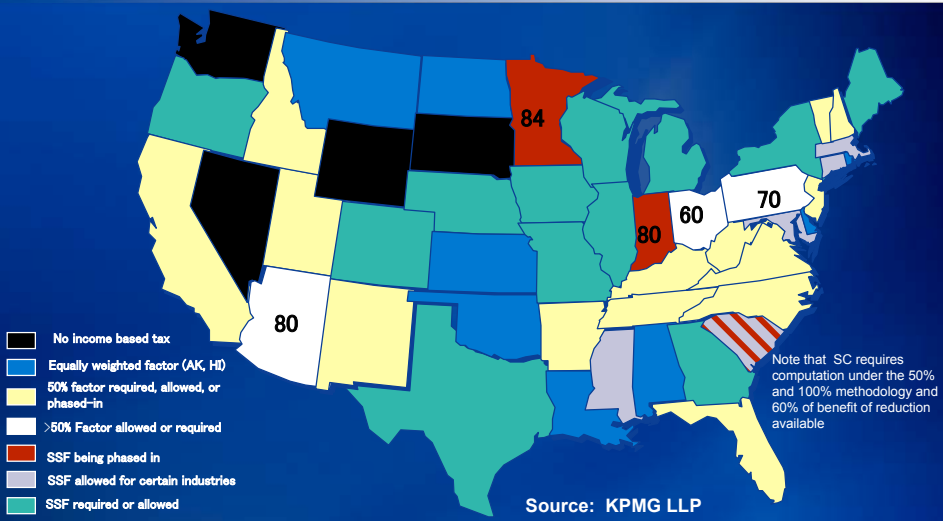
Sales Factor – Weight and Sourcing

- **Single Sales Factor – 2009 legislation**
 - California – Effective 2011
 - Wisconsin – Accelerated to 2009
 - Virginia – Adopted for manufacturers – Phased-in – Employment requirements
 - Colorado – Effective 2009; passed in 2008
- **For 2009, sales factor more than double-weighted (at least for some) in 23 states**
- **Sourcing sales of other than TPP**
 - California – effective 2011
 - Wisconsin – effective 2009
- **Numerous flavors of market-based sourcing**



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Sales Factor Weighting - 2009



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Sales Factor: Market Sourcing Rules

State	Sourced to state if
CA	To the extent the purchaser of the service received the benefit of the service in CA
GA	Customer has regular place of business in GA or if benefit of service received in GA
IA	Benefit of service received in IA
IL/MN	Services are received in IL/MN and taxpayer has a fixed place of business; otherwise if customer office from which services (1) ordered or (2) billed is in IL/MN
MD	Principal impetus for sale is in MD or, if no state with principal impetus, then if domicile is in MD
ME	Services received in ME or, if this is not determinable, then if customer office or home is in ME
MI	Benefit of service received in MI
OH	Services used or benefit of is received (location of use or receipt)
UT	Purchaser of the service receives a greater benefit of the service in UT than in any other state
WI	Purchaser receives the services in WI. Different sourcing rules for services related to RP, TPP, businesses, and individuals. Also partial throw-back.



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Conforming to COD Income Deferral

- Acted to specifically conform – Arkansas, Idaho and West Virginia
- Acted specifically not to conform – Florida, Maryland, Minnesota
- Fixed-date conformity that does not incorporate 2009 changes – Arizona, California*, Georgia, Hawaii, Indiana*, Iowa, Kentucky, Maine*, North Carolina*, New Hampshire, Oregon, South Carolina, Virginia, Wisconsin*
- Remainder are rolling conformity states

*= Legislature still in session

Source: KPMG LLP

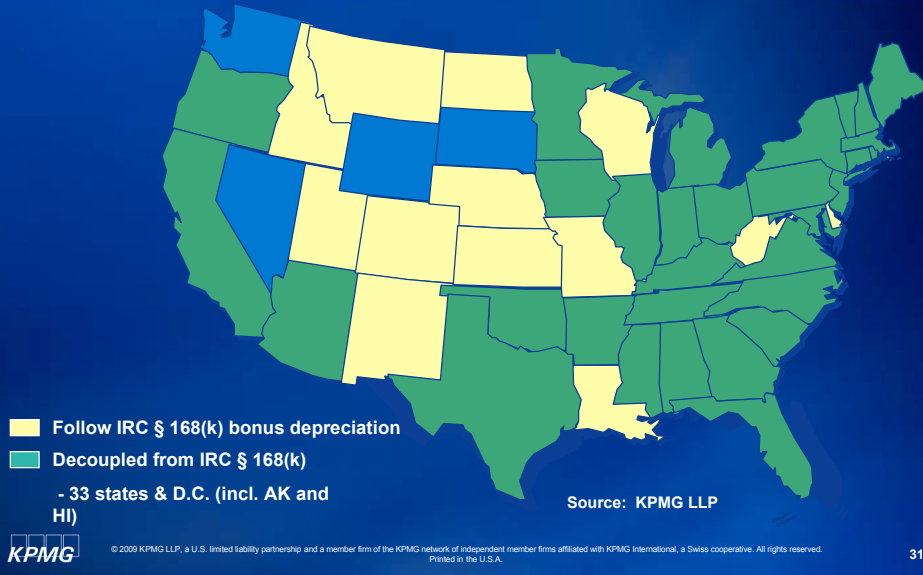


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State Reactions to Stimulus Legislation

American Recovery and Reinvestment Act of 2009 (P.L. 111-5)



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Other Issues

- **Net operating losses**
 - Iowa – Those incurred in TY 2009 and after may be only carried forward; carryback repealed
 - Maine – Proposed – Suspend utilization of carryforward for 2009-2011
- **Statute of Limitations**
 - Kansas – Sales Tax – Refund period reduced to one year effective for claims “filed after 6/15/2009”
- **Penalties**
 - Additional penalties in some amnesties



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Sales Tax Issues

- **Nexus Issues**
 - Affiliate nexus – New York, Wisconsin
 - Solicitation/Representatives in state a la NY 'Amazon' law
 - Proposed in CA, CT, HI, MN, NC, TN, MD – Illinois by rule
- **Taxation of Digital Goods -- Offshoot of Streamlined**
 - Passed in WA, WI, MS, KY
 - Considered in NY, CA, MA, NC, MN and VT
- **Taxation of Services**
 - Personal Services – CA, NY
 - "All services" – CA, CT, FL, GA, WA, MN
- **Vendor Compensation Reductions**
 - Passed in NV and CO; proposed by Gov. in IL and PA



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Broad-based Taxes

- **When gaps remain, reasonably limited alternatives**
- **Likely to be a preference for temporary increases**
- **Possible choices**
 - Sales tax rate increase – CA, MA
 - Income (personal and corporate) surcharges -- CT
 - Increased rates in higher-income taxpayers – CA, NY, HI



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Agency-Level Responses

- **Personnel and Staffing**
 - Furloughs
 - Reduce/eliminate temporary processing staff
 - Permanent staff reductions
- **Operating Expenses**
 - Travel reduction/elimination
 - Reduce/eliminate certain tax forms
 - Delay equipment acquisition and system upgrades; eliminate maintenance contracts
 - Eliminate unused telephone and data outlets
 - Close/consolidate offices
 - Eliminate in-person TP training sessions



Agency Responses – Cont.

- **Drive ‘em to the Web**
 - Forms
 - Filing and payment (mandated)
 - Correspondence – secured email
 - TP training
 - Staff training and communication
- **Compliance initiatives**
 - New auditors and collectors
 - Increased warehouse and mining investments
 - Collection analytics
 - Reducing protest backlog/accelerating settlements
 - Collection fees



Conclusion

- States facing most difficult budget situation since early 1980's
- Situation may last through FY 2012 or longer according to Rockefeller Institute
- Expenditure reductions and narrow tax increases likely to be insufficient in some cases
- Federal stimulus is not inconsequential
- Enacting broad-based reforms in a crisis is difficult
- May spawn preliminary reform work



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