Path to Prosperity

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The *"Welcome Back Tax"* Created by an Unconstitutional Tax Reform Law

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A key objective of the LD 1495 tax reforms was to "export" more Maine taxes to non-residents and visiting tourists. The law expands sales taxes, reduces state income tax rates, and replaces income tax deductions and exemptions with a new "household tax credit" - which applies to full-time residents only. This not only violates three protections in the U.S. Constitution, it also creates a new tax liability for new residents and Maine natives who want to move back to Maine, a *"Welcome Back Tax."* Middle class families, whether new residents or people returning home, can pay more than $2,200 in extra income taxes their first year in Maine. In total, the *"Welcome Back Tax"* affects 55,000 families a year.

There are many aspects of the newly enacted tax-shift legislation, LD 1495, that are being discussed and debated from a purely public policy perspective. A more fundamental consideration, however, that must be addressed even before a discussion of whether the changes are good policy or bad policy, is whether the changes are even constitutional. A legal analysis of the so-called "household credit" created by LD 1495 raises serious doubts about its constitutionality.

Essentially, the new tax law eliminates the deductions and personal exemptions that taxpayers typically use to reduce their taxable income. Instead, the law creates what it calls a "household credit". The law limits the availability of this new credit to established residents only. For example, commuters who travel from out-of-state to work in Maine are not eligible for the household credit. Similarly, new residents relocating to Maine and former residents returning to Maine cannot use the household credit for the first year they become Maine residents.[1]

The effect of replacing the deductions and personal exemptions with the household credit is that commuters and new or returning residents will pay higher taxes than established residents who have the same amount of income. For example, under the new law, a married couple with two children and an adjusted gross income of $45,000 would pay $725 as Maine residents, as shown in Table 1. If, on the other hand, the taxpayer was an out-of-state commuter, or a young person returning to live and work and raise a family in Maine, then that taxpayer would be ineligible for the household credit. His or her tax liability would be $2,925. By excluding out-of-state commuters and new or returning residents from the household credit, the new law creates a *"Welcome Back Tax"* for these taxpayers. In this example, the *"Welcome Back Tax"* equals $2,200.

Of course, creating a new tax of this magnitude for people coming to Maine to live and work certainly raises questions as to how these tax changes will strengthen the state economy or create jobs here. But when a law creates a higher level of taxation for people simply because they commute from out-of-state to work or because they moved to Maine during the tax year, the more fundamental question to be answered first is whether or not the law is constitutional.

As it turns out, if this new household credit were challenged in a court of law, there are three separate constitutional provisions that the court could rely on to strike down the law as unconstitutional.

Commerce Clause

The Commerce Clause of the United States Constitution gives Congress the exclusive power to regulate commerce among the different states. As a corollary to this grant of power, the states are prohibited from enacting laws that impose undue burdens on interstate commerce. State laws that discriminate against interstate commerce by giving local, in-state entities an explicit advantage are considered by the United States Supreme Court to be "virtually *per se* invalid."[2] This law certainly discriminates against interstate commerce by creating a tax penalty for income earners who cross the state line to earn income in Maine. Applying the Supreme Court's "*per se* invalid" test to the law, because the household credit is explicitly limited to established residents only, a court would strike down the law as unconstitutional.

Privileges and Immunities Clause

Another provision of the United States Constitution, the Privileges and Immunities Clause, generally prohibits a state from denying to non-residents the same benefits it provides to its residents who are similarly situated. This provision precludes a state from imposing higher tax rates or taxes on non-residents than it imposes on residents. For example, in the 1970s, the state of New Hampshire created an income tax on people who commuted from out-of-state to work in New Hampshire. The state imposed no income tax on its residents. The effect if this "commuter tax" was very similar to the effect of the new "household credit." That tax was challenged by a Maine resident who worked in New Hampshire, and found by the Supreme Court to deny non-residents the "substantial equality" required by the privileges and immunities clause.[3] Applying the same analysis that invalidated that "commuter tax" to the new "household credit", a court would strike down the law as unconstitutional.

Equal Protection Clause

This clause of the United States Constitution prohibits a state from denying a class of people "the equal protection of the law." Although the courts give states much leeway in creating tax classifications, the courts are less deferential when individual rights are infringed. For example, in 1982, the Supreme Court used equal protection analysis to review an Alaska statute that paid tax rebates to residents, based on their length of residency. The Court invalidated the residency requirement, recognizing that the right to travel, "when applied to residency requirements, protects new residents of a state from being disadvantaged because of their recent migration or from otherwise being treated differently from longer term residents."[4] By prohibiting taxpayers that move or return to Maine from using the "household credit" during the first tax year of their residency, the new law disadvantages them because of their recent migration to the state. A court recognizing this as an infringement on the fundamental right to travel would strike down the as unconstitutional.

Constitutional Conclusion

Whether or not the creation of a tax penalty for people coming to work in Maine might somehow strengthen the state economy is a moot point because the new law appears to violate several provisions of the United States Constitution. An unconstitutional taxation scheme cannot be allowed to stand and must be changed to comport with the constitution. The law of the land demands it.

Economic Impact

In addition to the constitutional issues, there are serious negative economic consequences for taxing non-resident and part-time residents more heavily than full-time residents. Table 1 shows how much more these taxpayers will owe under LD 1495. For example, a married couple with two children who moves into Maine on March 2010 (a part-time resident) and earns $55,000 per year will owe $2,200 more than a full-time resident - $3,575 versus $1,375. According to the Maine Revenue Service, there are approximately 55,000 non-resident and part-time returns filed every year.[5] The *"Welcome Back Tax"* created by LD 1495 will obviously mean higher costs for labor and capital for Maine's businesses.

Higher Labor Costs for Maine Businesses

In a perfect world, Maine's businesses would be able to find every type of skilled worker they would ever need right here in Maine. Unfortunately, they cannot. This means reaching outside Maine's border to find the skilled workers Maine's businesses need to thrive.

Almost all of these out-of-state hires will, for the first year, be a part-time resident. The denial of the household tax credit amounts to a *"Welcome Back Tax"* for relocating to Maine in order to take a new job. Since Maine businesses are competing nationwide, they will have to absorb some, if not all, of the tax in order to maintain nationally competitive pay-scales.

The *"Welcome Back Tax,"* therefore, will increase the cost of labor on Maine's businesses, damaging their ability to compete in the global marketplace. In the long run this will mean fewer businesses and fewer jobs for all Mainers.

Alternatively, in some cases, the new employee may continue to reside in another state—such as New Hampshire or Massachusetts—and commute to their new job in Maine. Even though they live in another state, these folks will still pay Maine's income tax because their job is physically located in Maine. This "Commuter tax," as with the *"Welcome Back Tax,"* will additionally burden Maine's workers and Maine's businesses.

Table 1
Resident versus Non-Resident and Part-Year Taxpayer under LD 1495
Calendar Year 2010

	Married Couple with Two Children				Single Mother with Two Children			
AGI	Resident LD 1495 Tax Liability	Non- and Part-Year-Resident LD 1495 Tax Liability	**Increase for Non- and Part-Year-Resident *"Welcome Back Tax"***	Percent Tax Increase for Non-Residents	Resident LD 1495 Tax Liability	Non- and Part-Year-Resident LD 1495 Tax Liability	**Increase for Non- and Part-Year-Resident *"Welcome Back Tax"***	Percent Tax Increase for Non-Residents
$0	($70)	$0	**$70**	n.a.	($50)	$0	**$70**	n.a.
$5,000	($70)	$325	**$395**	n.a.	($50)	$325	**$395**	n.a.
$10,000	($70)	$650	**$720**	n.a.	($50)	$650	**$720**	n.a.
$15,000	($70)	$975	**$1,045**	n.a.	($50)	$975	**$1,045**	n.a.
$20,000	($70)	$1,300	**$1,370**	n.a.	($50)	$1,300	**$1,370**	n.a.
$25,000	($70)	$1,625	**$1,695**	n.a.	($50)	$1,625	**$1,695**	n.a.
$30,000	($70)	$1,950	**$2,020**	n.a.	($50)	$1,950	**$2,020**	n.a.
$35,000	$75	$2,275	**$2,200**	2933%	$225	$2,275	**$2,050**	911%
$40,000	$400	$2,600	**$2,200**	550%	$550	$2,600	**$2,050**	373%
$45,000	$725	$2,925	**$2,200**	303%	$931	$2,925	**$1,994**	214%
$50,000	$1,050	$3,250	**$2,200**	210%	$1,331	$3,250	**$1,919**	144%
$55,000	$1,375	$3,575	**$2,200**	160%	$1,731	$3,575	**$1,844**	106%
$60,000	$1,775	$3,900	**$2,125**	120%	$2,131	$3,900	**$1,769**	83%
$65,000	$2,175	$4,225	**$2,050**	94%	$2,531	$4,225	**$1,694**	67%
$70,000	$2,575	$4,550	**$1,975**	77%	$2,931	$4,550	**$1,619**	55%
$75,000	$2,975	$4,875	**$1,900**	64%	$3,331	$4,875	**$1,544**	46%
$80,000	$3,375	$5,200	**$1,825**	54%	$3,731	$5,200	**$1,469**	39%
$85,000	$3,775	$5,525	**$1,750**	46%	$4,131	$5,525	**$1,394**	34%
$90,000	$4,175	$5,850	**$1,675**	40%	$4,531	$5,850	**$1,319**	29%
$95,000	$4,575	$6,175	**$1,600**	35%	$4,931	$6,175	**$1,244**	25%
$100,000	$4,975	$6,500	**$1,525**	31%	$5,331	$6,500	**$1,169**	22%
$105,000	$5,375	$6,825	**$1,450**	27%	$5,731	$6,825	**$1,094**	19%
$110,000	$5,775	$7,150	**$1,375**	24%	$6,131	$7,150	**$1,019**	17%
$115,000	$6,175	$7,475	**$1,300**	21%	$6,531	$7,475	**$944**	14%
$120,000	$6,575	$7,800	**$1,225**	19%	$6,931	$7,800	**$869**	13%
$125,000	$6,975	$8,125	**$1,150**	16%	$7,331	$8,125	**$794**	11%
$130,000	$7,375	$8,450	**$1,075**	15%	$7,731	$8,450	**$719**	9%
$135,000	$7,775	$8,775	**$1,000**	13%	$8,131	$8,775	**$644**	8%
$140,000	$8,175	$9,100	**$925**	11%	$8,531	$9,100	**$569**	7%
$145,000	$8,575	$9,425	**$850**	10%	$8,931	$9,425	**$494**	6%
$150,000	$8,975	$9,750	**$775**	9%	$9,331	$9,750	**$419**	4%
$155,000	$9,375	$10,075	**$700**	7%	$9,731	$10,075	**$344**	4%
$160,000	$9,775	$10,400	**$625**	6%	$10,131	$10,400	**$269**	3%
$165,000	$10,175	$10,725	**$550**	5%	$10,531	$10,725	**$194**	2%
$170,000	$10,575	$11,050	**$475**	4%	$10,931	$11,050	**$119**	1%
$175,000	$10,975	$11,375	**$400**	4%	$11,331	$11,375	**$44**	0%
$180,000	$11,375	$11,700	**$325**	3%	$11,700	$11,700	**$0**	0%
$185,000	$11,775	$12,025	**$250**	2%	$12,025	$12,025	**$0**	0%
$190,000	$12,175	$12,350	**$175**	1%	$12,350	$12,350	**$0**	0%
$195,000	$12,575	$12,675	**$100**	1%	$12,675	$12,675	**$0**	0%
$200,000	$12,975	$13,000	**$25**	0%	$13,000	$13,000	**$0**	0%

Note: Excludes the Earned Income Tax Credit.
Source: Maine Legislature and The Maine Heritage Policy Center.

Higher Capital Costs for Maine Businesses

Even more so than with labor, Maine businesses must have access to out-of-state capital in order to fund their operations. Such funds can range from equity holders (stock) to long-term borrowing (mortgages). Access to capital is the life-blood of business - especially to the small businesses which dominate Maine's economy.

According to Maine Revenue Services, 20 percent of the approximately 55,000 non-resident and part-time resident taxpayers report partnership, S-corporation, royalty and rent income.[6] The elimination of the household credit for these taxpayers will result in a dramatic decrease in their after-tax rate of return. Over time, these out-of-state investors will reduce their investments in Maine as they seek higher returns elsewhere.

Economic Conclusion

In today's global economy, Maine simply cannot afford to erect a virtual toll-booth at the state border on the labor and capital that are working to help sustain Maine's economy. Both labor and capital are highly mobile, which means Maine businesses must absorb much of the new tax burden on non-residents and part-time residents in order to remain competitive. Unfortunately, higher costs will mean fewer businesses and jobs for all Mainers in the long run. This is short-sighted tax policy that must be reversed.

Conclusion

This analysis of the constitutional and economic issues presented by the new household credit clearly illustrates that there are major problems with this clumsy attempt by the legislature to "export" Maine's tax burden. A far more preferable way to deal with Maine's high taxes is to simply lower them by cutting taxes for everyone, rather than attempt, though processes of questionable legality, to get other people to pay them for us. Maine's businesses, and those who would come to Maine to work and live, deserve better.

Notes and Sources

[1] Public Law 2009, ch. 382.
[2] *Oregon Waste Systems, Inc. v. Dep't of Envtl. Quality*, 511 U.S. 93, 99 (1994).
[3] *Austin v. New Hampshire*, 420 U.S. 656 (1975).
[4] *Zobel v. Williams*, 457 U.S. 55 (1982).
[5] Email correspondence with Mike Allen, Director of the Research/Econometrics Division, Maine Revenue Service.
[6] Ibid.

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