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Michael E. Caryl is of counsel with Bowles Rice LLP. He served as West Virginia tax commissioner from 1985-1988, and was special adviser to the West Virginia Senate's Select Committee on Tax Reform during the 2017 legislative session.

In this edition of Inside West Virginia Taxes, Caryl examines the prospects for comprehensive tax reform in the 2019 legislative session based on efforts in the prior two sessions.

Since the mid-1980s, the issue of reforming West Virginia's 1930s-inspired tax structure has been the subject of extensive study and debate.[1] Although a few major changes have been made, there remains a general consensus that much more needs to be done to make the state's tax structure competitive.[2] In fact, virtually all the major new private capital investment made in West Virginia in the last 30 years has required the investing company to be granted multiyear relief from major aspects of the state's general business tax structure.

Against that background, despite having devoted significant time debating comprehensive state and local tax reform during its extended 2017 session, the West Virginia State Legislature failed to reach a consensus on reform. Although in 2018 there remained no appetite to revisit comprehensive reform of the major general fund taxes, there were more limited proposals to enhance West Virginia's economic competitiveness by phasing in exemptions for tax on business tangible personal property such as machinery, equipment, and inventory. But the entire agenda of the 2018 session was soon overwhelmed by a statewide teachers' strike and the ensuing process of enacting historically significant pay raises for most public school and state government employees.[3]

By reviewing the primary issues involved in the 2017 debate, some light can be shed on the prospects for tax reform in later sessions. The major elements of the 2017 reform proposals initiated in the Senate would have:

- phased out and repealed personal and corporate income taxes while greatly expanding the base and raising the rate of the sales and use taxes;[4] and
- phased out and repealed the ad valorem taxes on most tangible personal property while authorizing local governments to raise property taxes on many categories of real estate.[5]

[1]The studies include: "A Tax Study for West Virginia in the 1980's," West Virginia Tax Study Commission (Mar. 1984); "Recommendations to the Governor," The Governor's Commission on Fair Taxation (Dec. 1999); "2006 Report to Governor Joe Manchin III," West Virginia Tax Modernization Project (Oct. 2006); and the Joint Select Committee on Tax Reform, which met throughout the 2015 and 2016 interim sessions of the Legislature, but has not issued a substantive written report.

[2]Those changes consist of the 1987 repeal of the former business and occupation (gross receipts) tax for most businesses; the multiyear (2009-2014) phaseout of the business franchise tax (on equity capital) and the multiyear (2008-2014) phase-down (to 6.5 percent) of the nationally high rate of the corporation net income tax. The latter two were enacted to replace the first-referenced business and occupation tax. Finally, there also has been an "on again/off again" imposition of sales tax on groceries, the sales of which were last completely exempted starting in 2013.

[3]*See* Robert S. Kiss, "More Delays on the Road to Tax Reform," *State Tax Notes*, Apr. 30, 2018, p. 397; and Comm. Sub. for H.B. 4145 (Mar. 6, 2018). Funding for the broad-based pay increase was enacted without any statutory increase in taxes and occurred — for the first time in decades — during the regular 60-day session.

[4]*See* H.B. 335, which, within hours of its introduction on February 16, 2017, was significantly amended.

[5]S.J.R. No. 8, the FASTR — "Fair and Simple Tax Reform Amendment."

The amended versions of the Senate income and sales tax reform proposals called for lowering and compressing the personal income tax rate brackets so that every taxpayer would experience some relief.[6] An important part of the proposal was a phase-in approach to the rate reduction and ultimate repeal of the income taxes based on meeting multiyear fiscal milestones (triggers), the forms of which evolved dramatically over the course of the legislative debate and negotiation.

The fiscal milestone measures ranged from the specific revenue yield of the reformed consumption taxes to targets stated either as minimum percentages of the state's relatively healthy rainy day funds or as minimum amounts of surplus collections over most recent total general fund budget appropriations. With the failure to enact the overall reform proposal, it became moot which of those approaches was more prudent, but they are not substantively interchangeable in terms of effective fiscal policy.

Thus, because the policy goal was to condition future levels of phased-in tax relief and reform on the performance of that same tax reform scheme during its earlier phases, the most principled version of such milestones would be one that measures achievement of that performance. It would not be one which is also significantly influenced by the separate measures of varying fiscal budget surplus or reserve fund levels or, even more problematically, of changing authorized spending amounts.

Of course, in keeping with the fundamental economic principles justifying a progressive income tax scheme (that is, the diminishing marginal utility of each additional dollar of income), the resulting dollar amount of relief for those in the upper-income brackets would have been larger than the relief for those in the lower brackets.[7] Naturally, that outcome triggered strong opposition from those who favor wealth redistribution as a — if not the — major objective of income taxation. Typically, there is a correlation between those holding that view and support for increased government spending. However, because the underlying goal and design of the Senate proposal was structural reform and not merely general tax relief, the policy debate about the overall scale of government spending was not immediately implicated.

Nevertheless, the Senate's initial proposal and its subsequent iterations contained significant interim individual income tax relief in the form of exemptions for income from some sources and tax credits for some socially favored constituencies. Specifically, the exemptions applied to retired military pensions and Social Security benefits for retirement and disability. In an effort to improve progressivity, the credits were based on the earned and retirement income of low-income individuals.

The Senate proposal would also have eliminated a wide array of sales and use tax exemptions, including many for business-to-business purchases. That represented a radical departure from West Virginia's relatively broad approach to exempting such purchases, and, predictably, it generated strong resistance from the trade associations representing the affected industries. The nearly complete retreat of the proposal's sponsors in the face of that opposition, and the resulting reinstatement of most current exemptions, naturally reinforced the fiscal pressure to raise the sales and use tax rate.

Although one may question the legitimacy of the economic policy rationales often advanced in opposition to tax pyramiding, that discussion exceeds the immediate scope of this article.[8] Suffice it to say, the virtually universal acceptance of a policy of avoiding imposing sales and use tax on the purchase of most business inputs — regardless of differences in the overall tax structure context — easily carried the day in the 2017 tax reform debate in West Virginia.

In its tax reform plan the House of Delegates proposed a flat income tax rate scheme.[9] In selecting the proposed single rate, the House used the overall effective personal income tax rate — namely, the typical annual revenue from income taxes divided by the annual amount of

[6] Comm. Sub. for S.B. 409.

[7] *See* Alfred Marshall, *Principles of Economics* (1890).

[8] *See* Michael E. Caryl, "The Fair 55 Tax Reform Plan for West Virginia," Public Policy Institute of West Virginia and Tuscarora Institute for Enterprise Studies & Advancement LLC (2016), at 11 (note 10) and at 28-35.

[9] H.B. 2934.

reported taxable income. Thus, House sponsors proposed a flat income tax rate of 5.1 percent — well below the current maximum rate of 6.5 percent for taxable incomes over $60,000 (joint and single) and $30,000 (married filing separately), and, absent altered economic behavior, revenue neutral in the aggregate. Unfortunately, such a change in the rate structure would have effectively imposed an income tax increase on more than 85 percent of individual taxpayers.[10]

To offset the adverse impact of that increase, other House members concurrently called for reducing the sales and use tax rate while retaining far more of the exemptions that the initial Senate version would have eliminated.[11] The House's approach, by favoring simple consumption tax relief over income tax phaseout and repeal, appeared to be primarily motivated by a desire to avoid perceived competitive disadvantages given the relatively lower sales tax rates in West Virginia's five neighboring states.

As with the conventional wisdom disfavoring the pyramiding of consumption taxes, lawmakers should have undertaken an independent and objective study before uncritically embracing their concerns about border tax competition. If they had, factors might have yielded a different outcome. These include:

- the mitigating factor (in terms of market competitiveness) of the growing significance of convenience over small price savings;
- the effectiveness of use tax compliance enforcement for business purchases;
- the implications of the wider application of market-based sourcing of sales for consumption tax administration; and
- regardless of the U.S. Supreme Court's 5-4 decision in *South Dakota v. Wayfair Inc.*[12] and any subsequent congressional intervention in the remote seller debate, the potential of at least one self-help solution.[13]

Also, although the members of the then relatively new Republican majorities in both houses[14] had been among the leaders of the earlier successful effort to exempt grocery sales from the consumption tax, they appeared to be the more adamant in defending that provision on policy grounds. Here too, there is extensive professional and academic literature calling into question the policy advantage of eschewing large amounts of easily generated consumption tax revenue simply to avoid the dubiously regressive implications of the tax on groceries, which low-income Supplemental Nutrition Assistance Program beneficiaries do not even pay.[15] Ultimately a compromise was reached which, while providing for elimination of the full exemption, would have used a 50 percent rate discount on all purchases of food for home consumption.

When it came to repealing the tax on tangible personal property, the Senate alone offered such a proposal. The ad valorem property tax is expressly imposed in the state's constitution, so a popularly ratified constitutional amendment would be necessary to repeal it.[16] Senate leaders proposed an amendment which would have, in the next fiscal year immediately following ratification by a popular vote, repealed the tax on motor vehicles and would have phased out the tax on most other tangible personal property over several years.[17] Thus, based on a desire to greatly improve the state's economic competitiveness, the tangible personal property of businesses (including inventory, which is taxed by few other states) would have become exempt from the tax,

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[10] To experience a personal income tax reduction under H.B. 2934, a taxpayer would have to report more than $85,000 in taxable income after exemptions and allowable deductions. Extrapolated from "Personal Income Tax Summary for Tax Year 2015," in "Fifty-Second Biennial Report, West Virginia Tax Laws," Tax Commissioner of West Virginia (Oct. 2017), at 55.

[11] H.B. 2933.

[12] 585 U.S. _ (2018).

[13] *See* Caryl, "The Progressive, Creditable, Implied Purchases Tax: A Modest Self-Help Proposal Enabling Individual States to Address the Remote Seller Tax Problem and Much More," Tuscarora Institute for Enterprise Studies & Advancement LLC (2018).

[14] After more than 80 years of control of both houses of the West Virginia State Legislature by members of the Democratic Party, Republicans took control of both houses following the 2014 election.

[15] *E.g.*, Anna L. Johnson and Steven M. Sheffrin, "Rethinking the Sales Tax Food Exclusion With SNAP Benefits," *State Tax Notes*, Jan. 11, 2016, p. 149.

[16] W.Va. Const. Art. X, section 1.

[17] *Supra* note 5.

just as are individuals' property, which has been fully exempt for decades.[18]

Proponents of the Senate plan argued that the repeal of the tax on motor vehicles was designed to remove a major regressive aspect of the state's structure because West Virginia's low-income, largely rural population depends more on their cars and pickups for access to employment, education, and healthcare, than those in urban areas with mass transit. At the same time, and essentially for the same reason, the provision calling for immediate repeal of the tax on vehicles was considered politically critical to the popular ratification of the amendment containing the property tax reform question.

One exception from the tax phaseout would have been made for so-called working interests of in-place natural resource mineral reserves, which, despite their status as chattels real under the law of property, are statutorily classified as tangible personal property for West Virginia ad valorem property tax administration purposes.

Another important exception to the phaseout would have been made for regulated public service businesses (for example, electric power generators and railroads), the operating assets of which are centrally assessed by the state based on an integrated, in-place, in-use unit method that makes no distinction between tangible personal and real property. Although the Senate proposal contained a mandate for the Legislature to provide local government bodies, which rely heavily on property tax revenue, with expanded taxing authority and access to replacement revenue sufficient to offset those losses, local officials remained among its most adamant opponents. Such opposition is the result of long-standing factors such as the uniquely high degree of central, state-level control of government operations in West Virginia. Based on that long-standing circumstance, the reflexive tendency of local elected officials is to "blame Charleston" instead of seeking greater autonomy (and the correlative accountability) that more local control of decisions about taxation and expenditures would entail.

Thus in searching for other rationales to oppose what would have changed the status quo, local officials raised concerns whether the forgoing exception — retaining the tax on public service company machinery and equipment — would violate the anti-discrimination principles of federal laws such as the Railroad Revitalization and Regulatory Reform Act of 1976.[19] On even a cursory examination, one sees that concern is not well-founded, not only because of the long-standing federal judicial deference to state legislatures in establishing tax classifications, but, more specifically, because that question was resolved in favor of the state of Oregon in an 8-1 U.S. Supreme Court ruling.[20]

The other fundamental changes to the overall constitutional property tax structure in the Senate proposal involved lowering the maximum rate structure for taxes on real property based, in turn, on changes in the state's rather unusual rate classifications. Since the Great Depression, the state constitution has mandated that maximum rates for farms and owner-occupied residences be only one-half of the (still relatively low) rates imposed on all other property.[21] However, the primary vehicle proposed to offset the significant revenue reduction resulting from the phased-out repeal of the tax on most tangible personal property was the elimination of the 40 percent constitutional discount of taxable value from appraised value.[22]

Against that background, in various public policy forums one still hears both vague references to a continuing commitment to tax reform and calls for doubling the severance tax rate on natural gas production, despite the comparatively heavy tax burden already borne by that industry. True tax system reform should not

[18] W.Va. Const. Art. X, section 1a.

[19] 49 U.S.C. section 11001, et. seq.; and Pub. L. 94-210, 90 Stat. 31.

[20] *Department of Revenue of Oregon v. ACF Industries Inc.*, 510 U.S. 332 (1994).

[21] This has a highly regressive effect on those who cannot afford to own their homes and, thus, through their rent pay their landlords' commercial tax, which has rates twice as much as those paid on owner-occupied residences. This consequence would have been terminated in S.J.R. 8 (the FASTR amendment), which would have eliminated the rate classification distinction between owned and leased residential property.

[22] W.Va. Const. Art. X, section 1b.

be focused on expanding government spending, wealth redistribution, or, from the opposite perspective, on simple tax cuts and downsized government.

Instead, structural state and local tax reform requires policy makers to proceed in a constructive, creative, well informed, and objective manner through a series of steps. Those steps are:

- to design a reformed structure based on consensus policy objectives and a multiyear, performance-based phase-in;
- to engage independent experts to apply today's most sophisticated econometric modeling tools to project the economic impact, revenue yield, and burden shifts expected from the new structure; and
- before formal legislative action is taken, to educate and engage with all stakeholders both about the policy rationales of the restructured system and the results of those studies.

Although there are well-developed substantive concepts already on the public policy table and awaiting refinement and adoption, until political leaders take that first step, the longer timelines for the second and third steps cannot even begin. Fortunately, the second stage, while critically important, should not consume anywhere near the time needed for the multiple public meetings, presentations, and extended proceedings of the 2015-2016 Joint Select Committee on Tax Reform. Indeed, because the third step would be far less open-ended, even public airing of a fully designed and objectively tested proposal should not require more than a fraction of the time consumed by earlier proceedings. Thus, whether we can expect in the 2019 legislative session broader tax reform or a repeat of the limited effort involving some business tangible personal property tax relief, will become more apparent as each week goes by without serious progress toward reform.

Absent timely action toward broader reform, the issue will become whether, even if the limited reform of property taxes is achieved, it would be a small, but welcome first step in the right direction. Alternatively, policymakers may conclude that they have fully and conclusively checked the far larger tax reform box on the list of actions needed to make West Virginia competitive.

The recent Republican primary defeat of West Virginia Sen. Robert Karnes — the most active and involved leader of the Senate's 2017 tax reform effort — cannot be a good sign for the prospects of reform. Likewise, the widely rumored movement to enact legislation increasing (even doubling) the severance tax rate on natural gas production, or the rate of any tax, for that matter, would be completely antithetical to the spirit of tax reform that enhances competitiveness. On the bright side, given the remarkable overall fiscal achievements of the 2018 Legislature, little, including comprehensive tax reform, should be beyond its now-demonstrated capacity for making extraordinary progress. ■