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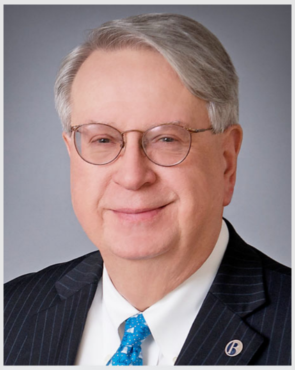

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In this installment of Inside West Virginia Taxes, Caryl looks at West Virginia's most recent legislative session and where the state tax reform debate may be headed.

One can look back at least half a century to see efforts by West Virginia's public leaders to review and dramatically reform the state's tax structure.[1] Unfortunately, despite those efforts, the changes actually made to the system over the years have clearly failed to effectively move the state from remaining a population-declining, low-income-earning, excessive-government-spending island of poverty in a sea of regional and national prosperity.

While the West Virginia Legislature's 60-day regular session concluded this year without enactment of the long-sought comprehensive reform of the state's tax system, there were important conversations and some actual legislative progress. Thus, while notable differences among policymakers and their advisers were exposed, some groundwork for meaningful reform has apparently been laid.

Perhaps the most relevant policy disparity that emerged was whether and how to reconcile two related — but fundamentally distinct — goals of substantive state and local tax reform. Thus, the primary focus of Republican Gov. Jim Justice's sweeping proposal was to immediately reduce and ultimately phase out the personal income tax for the sole purpose of attracting new residents to the state. The importance and urgency of that objective is vividly reflected in the most recent U.S. Census Bureau data, which show that in the last decade, West Virginia lost 60,000 residents, a higher percentage of its population than any concurrent population decline in any other state. Though the far more elderly profile of West Virginia's population has inherently led to a natural population decrease, that is simply another result of the real problem: the state's long-declining economy.[2]

On the other hand, the separate and traditional strategy of making tax law changes to attract new job-creating business investment remained the principal driver of several other proposals — some of which manifested in other approved legislation.

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[1] Earliest among those efforts was the 1970 enactment of the so-called Papke Plan, a version of a VAT to replace the long-standing business and occupation tax on most businesses' gross receipts. Robin C. Capehart, "Real Tax Reform for West Virginia," Public Policy Foundation of West Virginia (2009). However, then-Gov. Arch Moore, who was unconvinced of the plan's revenue-generating capacity, vetoed the bill after the time a legislative override of his veto could occur. Michael E. Caryl, "The Fair 55 Tax Reform Plan for West Virginia," Tuscarora Institute for Enterprise Studies & Advancement LLC, at 34-35 (2016).

In the only comprehensive change in the state's tax system in many decades, the Legislature in 1985 enacted a phased out repeal of the business and occupation tax, replacing it with a package of taxes on business capital and some industries' gross receipts. Since then, however, neither of the state's other two comprehensive tax reform projects resulted in enactment of significant legislation. Capehart, *id.* at 23.

[2] Interview of John Deskins, director of West Virginia University Bureau of Business and Economic Research, by Hoppy Kercheval, *Metro News* (Apr. 27, 2021).

Details of Process and Different Tax Relief Versions

First, to encourage individuals to relocate and become residents of the state, Justice in his State of the State address called for both immediate relief from some — but not all — aspects of the personal income tax, along with its ultimate repeal. But despite the scope and importance of such a proposal, it was not until nearly midway through the session that actual legislation was presented to implement such a plan.[3]

The governor's proposal called for an immediate 60 percent reduction of tax rates on individuals' income from wages, retirement plans, and unemployment income, while leaving the current rate system in place for their income from business profits and from investment income such as rents, royalties, capital gains, interest, and dividends.[4]

To recover just over three-fifths of the income tax cut's projected revenue losses,[5] Justice proposed both a major rate increase and a selective broadening of the consumers' sales and service tax base.[6] Other replacement revenue sources included a new excise tax on purchases of so-called luxury items; tiered severance tax rates (which are currently flat) on production of various types of natural gas, oil, and coal; and significant increases in excise taxes on tobacco products, alcoholic beverages, and soft drinks.

To somewhat mitigate the undeniably regressive effect of the consumption tax increases, the governor's plan called for the payment of tax rebates to lower-income taxpayers for some of their remaining — otherwise payable — personal income taxes.[7] But even after indulging presumptions by Justice's office that the plan would both stimulate taxable economic activity and somehow lead to public employment attrition, his proposal would still leave a deficit of more than $185 million — approximately 4 percent of the fiscal 2021 general fund budget.[8]

Moreover, that deficit would only decrease by half if specific spending reductions, the contemplated government employment attrition, and projected annual revenue growth also actually occurred. Anticipating other government spending cuts should, however, be entirely justified given the long-standing fact that — only partly because of its declining population — West Virginia has among the nation's highest levels of per capita state government expenditures ($9,343 vs. $6,573 nationally in 2018) and number of state and local government employees (including those in education) per 10,000 residents (565.9 vs. U.S. median of 526 in 2018).[9] Fortunately, recent manifestations of legislative fiscal discipline and restraint do signal a most encouraging prospect for lowering the cost of government in West Virginia.[10]

Unsurprisingly, reflecting little, if any, timely executive branch coordination with the Legislature to promote such a major proposal, neither chamber officially took up the governor's bill. Instead, in the House of Delegates, an entirely separate bill originated from the Finance Committee.[11] The House's legislation was far more limited in its scope and (depending on the operation of some acceleration contingencies) was primarily intended to more gradually phase out the personal income tax via rate reductions potentially spread over a dozen or more years.

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[3]S.B. 600 and H.B. 2027, identical 78-page bills containing Republican Gov. Jim Justice's proposals, were first introduced on March 9, which was 28 days into the 60-day session. This lag by the executive branch in initiating its tax relief legislation contrasts with legislative leadership's extensive efforts to organize and preplan much of the rest of the session's agenda.

[4]Under current law, on a joint return, graduated rates on all sources of taxable income range from 3 percent on taxable income below $10,000 up to a maximum of 6.5 percent on all taxable income over $60,000.

[5]Projected by the governor's office to represent more than $1 billion (or more than 22 percent of the current general fund budget).

[6]The 6 percent consumer sales tax rate would increase by nearly one-third to 7.9 percent, and the exemptions for sales of computer products and services (hardware, software, and processing), most nonmedical professional services, health/fitness memberships, and lottery tickets, would all be repealed.

[7]Gradually decreasing income tax rebates would be provided to taxpayers with otherwise taxable incomes up to $35,000.

[8]*See* Justice's "Personal Income Tax Repeal Plan," at 6-7 (published Mar. 4, 2021).

[9]*See Total State Expenditures Per Capita*, Kaiser Family Foundation (2018).

[10]For at least the last three years, the state's general fund budget has — unlike the pattern of preceding decades — remained flat in amount and timely in its approval within the 60-day annual session. Likewise, because of fairly consistent budget surpluses in recent years, the state's rainy day fund balance is now approaching $1 billion.

[11]H.B. 3300, originated on March 23, the 42nd day of the 60-day session.

Importantly, the House bill's relief would have applied to all personal income tax liabilities — regardless of income source — and it would not have implemented any other tax increases or new taxes. Rather, for fiscal balancing, it depended on recent and fairly consistent projected revenue growth, budget discipline, and use of expected surpluses from existing tax revenue sources.

Finally, the third version of income tax relief that lawmakers considered was the Senate's strike-and-insert amendment of the House bill. The Senate's version would reinstate many key concepts of the governor's original proposal, while also using — but refining — administrative aspects of the original House measure.[12]

Among the major changes to the governor's version that the Senate adopted were:

- an even larger sales and use tax increase to 8.5 percent;
- extension of the income tax relief to unincorporated business income (leaving only investment-source personal income to remain taxable at current rates);
- softening the impact of the governor's elimination of sales and use tax exemptions for most nonmedical professional services by reducing the tax on those charges to 3 percent; and
- reimposing the long since repealed tax on purchases of food for home consumption, but at an even lower rate of 2.5 percent.[13]

Most significantly, unlike the House version, the Senate would base the planned future annual phasedown/out of the personal income tax rates on the achievement of specific revenue collection goals from both existing and new revenue sources.[14] Among those new revenue sources under the Senate version would be sales of recreational cannabis that the bill would — subject to specific use limitations — legalize for the first time in the state.

Stated Policy Agenda

One rationale for each version of the personal income tax relief proposal was to take advantage of the recent trend toward jobs involving remote (virtual) work.[15] The argument was that assuming there are reciprocal agreements between West Virginia and the states where employers of those newly attracted, remotely working West Virginia residents are — agreements that would permit only West Virginia to impose taxes on its residents' wages — the lowered and ultimately repealed state income tax rates should be a major inducement for relocation. Of course, the same contention would apply to attracting more new residents to engage in the long-standing practice in which West Virginia residents commute daily to nearby employment in surrounding states.

Unfortunately, increasing both the rates and bases of West Virginia's consumption taxes would exacerbate the border competition concern about losing more revenue to the same neighboring states. As a practical matter, residents who commute out of state for work are, logic suggests, the prime prospects for out-of-state retail shopping during their daily commutes. Theoretically, comprehensive and effective use tax enforcement would preclude the adverse impact of that border competition, but the practical outcome under current law would continue to be largely otherwise.[16]

Fuller Context and More Effective Alternatives

Implicit in this state and local tax debate is the recognition that broad-based consumption taxes, along with their far easier taxpayer compliance and tax collector administration, are also far superior to income taxes in terms of many policy

[12]Both chambers would use special revenue fund structures to manage public revenue receipts from varying sources that — depending on the future annual levels of same — could result in an acceleration of the projected rate phasedown/out of the personal income tax. The House fund was designated the Income Tax Reduction Fund, and the similar Senate version was dubbed the Stabilization and Future Economic Reform Fund (SAFER Fund).

[13]Among the exceptions to those amended sales tax provisions the Senate made were to include contingent legal fees (made taxable for the first time) and currently taxable purchases of prepared food, which would both be taxed at the full 8.5 percent rate.

[14]New revenue sources in the Senate version included a hotel occupancy fee, modifications of the soft drink tax, and dedication of the revenues from lottery scratch-off games.

[15]The viability of such a trend occurring in West Virginia is highly dependent on effectively improving its inadequate broadband capacity, which was the focus of other legislation enacted this session (Comm. Sub. for H.B. 2002) — as well as strong efforts by U.S. Sens. Joe Manchin III, D-W.Va., and Shelley Moore Capito, R-W.Va., to direct major federal expenditures to that improvement.

[16]Caryl, "Fair 55 Tax Reform Plan," *supra* note 1, at 25-27.

goals.[17] Thus, one is led to reflect on how to replace state reliance on income taxes for revenue with higher or broader-based consumption taxes. Clearly, absent protective measures, interstate competition inherently undercuts simply raising existing consumption tax rates to replace revenue lost from reduction or removal of income taxes. Likewise, without thoughtful countermeasures, broadened consumption tax bases suffer from the same revenue loss threat.

Therefore, to achieve the benefits of shifting revenue reliance away from taxing income to taxing consumption, three inherent challenges of fair and effective consumption taxation must be addressed:

- the anti-competitive consequences of pyramiding tax burdens by causing multiple taxation of business inputs;
- the regressive effects of taxing purchases of necessities by low-income residents; and
- the border competition threat inherent in both relatively higher consumption tax rates and in a broader base of taxable items.

The basic design of value added taxes is recognized as enabling a broad-based consumption tax while avoiding the multiple taxation of business inputs.[18] Interestingly, despite the literal label of VATs, their designs can involve either the addition method (which taxes input values at the production stage where they are first introduced) or the subtraction method (which deducts previously taxed value inputs before taxing those just being added).

For reasons that are not entirely apparent, the VAT concept — while most common in tax systems throughout the rest of the free-market world — is seldom encountered in the United States. Exceptions include New Hampshire's current and Michigan's recently replaced single business taxes. In the Fair 55 Tax Reform Plan, this author proposed a similar VAT, the enterprise consumption tax (ECT), as a major aspect of a comprehensive reform of West Virginia's tax system. The ECT (unlike New Hampshire's single business tax) would also replace both the personal income tax and the corporation net income tax.[19]

Most importantly, by allowing the deduction from the taxable base of the cost of goods sold, the ECT's VAT-like design limits the direct taxation of all other business inputs to one time — which fully addresses the pyramiding concern.

The other major component of the Fair 55 Tax Reform Plan proposal, replacing all of West Virginia's taxes on income and tangible personal property along with its general sales and use taxes, is the general consumption tax (GCT) on individuals. In doing so, by issuing a fair tax credit card to low-income individuals, the plan would avoid a regressive impact on $500 of annual purchases of clothing by those residents — the only necessity not otherwise exempt.[20]

Finally, although the 5.5 percent GCT rate would be lower than West Virginia's current sales and use taxes, the Fair 55 Plan would further address the border competition concern inherent in its relatively broader base by imposing the progressive, creditable implied purchases tax.[21] Thus, based on a portion of the taxable consumption attributed to middle- and higher-income residents in the progressive income-graduated federal income tax tables allowing itemized deductions for state and local taxes, those residents would be subject to the equivalent of a use tax version of the GCT, but only to the extent that they do not demonstrate

[17] Jared Walczak, "Evaluating West Virginia Income Tax Repeal Plans," Tax Foundation, at 10, 16-17.

[18] Caryl, "Fair 55 Tax Reform Plan," *supra* note 1, at 34.

[19] Caryl, "Fair 55 Tax Reform Plan," *supra* note 1, at 28-35.

[20] Thus, under the Fair 55 Tax Reform Plan, each member of a household with annual federal adjusted gross income under $30,000 would receive the benefit of a fair tax credit card worth $500 in annual clothing purchases. That benefit would be ratably phased out in any year in which the household's annual federal adjusted gross income reaches $40,000. Moreover, because of the application of federal food stamps and the Supplemental Nutrition Assistance Program, regressive taxes on purchases of food for home consumption would remain exempt. At the same time, by retaining some long-standing excise and consumption tax exemptions, purchases of other necessities (housing, medical services, healthcare products, home utilities, and public transportation) would remain exempt for all residents, regardless of income levels. *Id.* at 22-26.

[21] 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).

their actual payment of either the GCT or of other, creditable consumption taxes in the other jurisdictions where they actually shopped.[22]

Steps in the Right Direction

Though omitting most provisions that comprehensive and truly effective state and local tax reform requires, the West Virginia legislation enacted this year did address two important aspects of reform. First and foremost was the adoption of a resolution to place on the state's next general election ballot (November 1, 2022) the question of amending its constitution to authorize the Legislature to exempt from property tax business tangible personal property and all vehicles (the only non-real-estate item on which individuals currently pay that tax).[23] Although the scope and curative effect of this year's resolution was not nearly as broad as the one considered but not adopted last year, it is a move in the direction of property tax reform.[24]

In another property tax system improvement, the Legislature enacted a measure that not only codified a more objective method of appraising some natural resource property but also enabled a fairer and more independent review.[25]

Finally, there was no reported consideration of accompanying the personal income tax relief with similar reductions of the corporation net income tax imposed on C corporations. However, legislation was enacted to replace with a single sales factor the multifactor apportionment method used to allocate among states the total net taxable income of multistate entities.[26] Thus, by eliminating consideration of in-state property and payroll, that legislation effectively removed one major and highly undesirable disincentive to locate those resources and personnel in West Virginia.[27]

Conclusion

This year's regular legislative session was yet another chapter in West Virginia's long history of considering comprehensive state and local tax reform. Beyond the necessity of an objective, collaborative approach, whether these efforts will ever achieve that goal depends on policymakers' recognition of fundamental substantive policy and procedural principles.

As noted, those are:

- A broad-based consumption tax is the ideal form of a broad-based tax system because of its far greater ease of compliance and administration, as well as the availability of effective solutions to each of its three major challenges of regressive effects on the purchases of life necessities by low-income residents, border competition, and tax pyramiding of business inputs.
- Any responsible process to achieve comprehensive tax reform should involve an inclusive planning process, sophisticated econometric projections, and implementation that relies on a gradual phase-in using fiscal milestones.
- Tax system improvements must attract new job-creating private investment and new residents of all ages — all of whom are powerfully discouraged by imposing heavy tax burdens on individual income,

[22] Though the progressive, creditable implied purchases tax was initially designed to provide another tool to improve collection of consumption taxes due on remote sales, it could be equally effective in addressing the border competition concern. Under the proposal, each resident of the state who is subject to the implied purchases use tax would be required to compute that tax based on the federal tables. Their liability would be less a credit for the cumulative amount of the sales or use taxes they actually paid during the same annual period to vendors in their home state or in any other U.S. jurisdiction. Admittedly, adoption of a progressive, creditable implied purchases tax arrangement requires a degree of policy trade-off between more effective anti-border competition enforcement and the maximum simplicity of both taxpayer compliance and tax collector administration that a broad-based consumption tax otherwise makes possible.

[23] Comm. Sub. for House Joint Resolution 3.

[24] *See* discussion of 2020 Senate Joint Resolution 9 and implementing legislation, S.B. 837, in: Robert S. Kiss, "Major Reform Continues to Elude West Virginia's Tax System," *Tax Notes State*, Apr. 20, 2020, p. 333.

[25] *See* Comm. Sub. for H.B. 2581, which established and mandated use of an income method to set the taxable values of producing oil, gas, and coal property — and most importantly provided taxpayers with the option of appealing disputes about those values to the State Tax Department's Office of Tax Appeals instead of to the inherently biased county commissions. Likewise, the appellate reform bill replaced the judicially established "clear and convincing evidence" burden of taxpayer proof with a more reasonable "preponderance of the evidence" standard.

[26] *See* Comm. Sub. for H.B. 2026.

[27] The policy merits of such an approach cannot be overstated. *E.g. see* Walczak, *supra* note 17, at 10.

business profits, and tangible personal property.

The coming months, which may include a special legislative session to consider comprehensive tax reform, will tell us whether the 2021 regular session was the penultimate chapter in West Virginia's long history of seeking that objective. ■