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In this edition of Don't Miss This, the author discusses the history of the West Virginia tax system, recent failed attempts to reform that system, and what lawmakers and the governor must do if successful reform is to occur.

After an unusually divisive regular session and special session, the West Virginia Legislature made almost no changes to the state's tax structure and passed a budget that Gov. Jim Justice (R) allowed to become law without his signature. That inaction occurred despite the presence of major tax and spending proposals advanced by the governor and a major restructuring of the entire tax system proposed by a Senate select committee. In the foreground of the debate was an estimated $500 million revenue shortfall. This article explores how and why little transpired despite the pending financial crisis.

I. Background

A. Early History

West Virginia's tax controversies predate its 1863 split from Virginia.[1] While opposition to slavery is often given as the reason for creation of a new state, taxation was also a prime mover. Virginia's 1851 Constitution provided for property taxation at true value except that enslaved persons over the age of 12 were assessed at $300 and those 12 and under were not taxed at all.[2] That provision, plus allowing enslaved persons to be counted for voting enumeration while not allowing them to vote, particularly rankled the mountainous western Virginia counties where there were a limited number of slaves yet significant real property for the state to tax.

Because West Virginia had been part of Virginia, its 1863 and 1872 constitutions relied heavily on the mother state's. Provisions of the early constitutions required taxes to be "equal and uniform throughout the State" and required that "all property both real and personal, shall be taxed in proportion to its value."[3] Those first constitutions emphasized property taxation, as this was the most readily available source of revenue for a predominantly agrarian state.[4]

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[1] Robert M. Bastress, *The West Virginia State Constitution: A Reference Guide* (1995); West Virginia Tax Modernization Project, "2006 Report to Governor Joe Manchin III by the West Virginia Tax Modernization Project," West Virginia Department of Revenue, 31-85 (Oct. 2006); and Natalie Belville, "Tax Tales: State Tax Reform Remains a Hot Topic That Predates West Virginia's Statehood," *The State Journal*, Jan. 9, 2015.

[2] Otis K. Rice, *West Virginia: A History* (1985).

[3] Constitution of West Virginia, Art. VII and Art X , section 2 (1872).

[4] Tax Modernization Project, *supra* note 1, at 37.

B. 1884-1930

West Virginia's tax system remained largely unchanged for half a century. But major tax studies completed in 1884[5] and 1902[6] led to the creation of a state tax commissioner position to improve statewide uniformity in property assessment and grant local governments limited ability to raise revenue.

Until 1914 the state government relied almost exclusively on direct levy on real and personal property and a charter tax on corporations. In 1915 the state imposed a special net income tax on corporations. When alcohol tax revenue disappeared during prohibition, the state imposed a gross receipts tax in 1921. Between 1923 and 1925, the Legislature expanded the gross receipts tax, expanded the business and occupation (B&O) tax,[7] and imposed a gasoline tax. In 1937 a temporary sales tax on goods and services was made permanent.[8]

C. The Great Depression

The economic collapse of the 1930s left many unable to pay property taxes on homes and farms, and the state experienced a deterioration in its receipts. In 1932 a tax limitation amendment to the state constitution was passed, which dramatically changed property taxation. Property was placed into four classifications: Class I — intangible personal property and personal property used in agriculture; Class II — owner occupied residential property and all agricultural property; Class III — all other property outside municipalities; and Class IV — all other property inside municipalities.

The assessment level for all property was dramatically lowered from 100 percent of market value to 60 percent. Maximum levy rates for local governments were set at 5 cents per $100 of assessed value for Class I, $1 per $100 for Class II, $1.50 per $100 for Class III, and $2 per $100 of assessed value for Class IV. By a 60 percent majority vote, local governments could pass excess levies.[9] The 1932 amendment resulted in state use of the property tax being significantly curtailed, a dramatic reduction in the ability of local governments to provide services, and a shift in tax burden from homeowners and agriculture interests to business and commercial interests.[10]

D. 1959-1960 Tax Commission

In response to widespread discontent with the state's tax structure, the Legislature established the State Tax Study Commission, which issued three reports, including the final report with recommendations.[11] While noting that the overall state tax burden was below average, the report called for improvement of highways and educational opportunities. Although concluding that the B&O tax was inequitable and not based on a taxpayer's ability to pay, the commission recommended keeping it because of its administrative simplicity. Using either a corporate net income tax or a personal income tax was considered infeasible. The major concern documented in the report was with the lack of uniformity of the property tax. The commission advanced several programs that later became law, including:

- a personal income tax based primarily on Internal Revenue Code adjusted gross income (1961);[12]
- a permanent 3 percent consumer sales and services tax (1965);[13]
- a corporation net income tax with the B&O tax allowed as a full credit (1967);

[5] West Virginia Tax Study Commission, "Final Report of the 1884 West Virginia Tax Study Commission" (1884).

[6] West Virginia Commission on Taxation and Municipal Charters, "Final Report," West Virginia Legislature (1902).

[7] The B&O tax was levied on gross receipts and was collected on each $100 of gross receipts, with a $10,000 deduction for each taxpayer. Rates of taxation varied based on the type of product or service being taxed. All natural resources (oil, coal, natural gas, limestone, and timber) were included.

[8] Governor's Commission on Fair Taxation, "Recommendations to the Governor" (Dec. 1999).

[9] The requirement for school bonds was a simple majority.

[10] Bastress, *supra* note 1, at 240.

[11] State Tax Study Commission, "Final Report of the State Tax Study Commission," West Virginia State Legislature (1960).

[12] The Depression-era personal income tax had been repealed in 1940. Although modified as to rates, exemptions, and deductions, the personal income tax has basically remained unchanged.

[13] When the term "consumer sales tax" is used in this article it refers to both the consumer sales and services tax and the use tax.

- an exemption of household goods and personal effects from the property tax by constitutional amendment (1972);[14]
- the creation of a homestead exemption from the property tax (1973); and
- a phaseout of the sales tax on food (1979).

E. The School Finance Question

As was the case in many states during the 1970s, West Virginia's system of education finance was found unconstitutional.[15] The court concluded that substantial inequalities in the property tax base for county school districts had led to wide disparities in per-pupil spending, thereby violating the state constitution's requirement for a "thorough and efficient" system of education.[16] In response, the Legislature passed a complex seven-step formula, under which the state would pick up the difference between what a uniform property tax levy and an established level of per capita expenditure would provide.[17] The case remained open until 2002.

F. The 1982 Property Tax Limitation and Homestead Amendment

Fueled by a West Virginia Supreme Court decision requiring that all property be assessed at full market value,[18] the Property Tax Limitation and Homestead Amendment of 1982 was enacted, which lowered the assessed value of property from 100 percent to 60 percent of market value. County and municipal governments saw significant decreases in their ability to tax and suffered declines in revenue with no replacement revenue source being made available. Because of the new school aid formula, county school districts were not as adversely impacted, but demands on the state general fund increased.

G. 1984 Tax Study

By 1983 the state was in a deep recession that dramatically impinged on its capacity to finance its budget. Major changes were made to almost all revenue sources, including reducing from 100 percent to 50 percent the B&O tax credit against the corporate income tax and increasing the top personal income tax rate to 7 percent. But those changes proved insufficient, resulting in the creation of another tax study by the Legislature, which reported its findings in 1984.[19]

A major goal of the study was to provide municipal governments with more revenue options, including income taxes, sales taxes, and fees. The B&O tax at the state level was to be phased out and the lost revenue replaced by an expanded corporate income tax and graduated personal income tax rates. Taxes relating to state road funding were increased. Over the next few years a series of constitutional changes resulted. Among those was the enactment in 1984 of an exemption for most intangible personal property and a freeport exemption for inventory in transit, which was adopted in 1986.[20]

Legislative changes included:

- removing the state B&O tax except on public utilities and electric power plants (1985);
- enacting a franchise tax on corporate net equity (1987);
- subjecting natural resource producers to severance taxes (1987);
- increasing the consumer sales and service tax (temporarily) to 6 percent (1989); and
- increasing the rates for almost all other taxes.

Although there were other minor changes in tax policy, "these reforms were the last major changes" to West Virginia's system of taxation until the next century.[21]

H. Commission on Fair Taxation

In July 1997 then-Gov. Cecil H. Underwood created the Commission on Fair Taxation, which

[14] Money, stocks, and bonds had been exempted earlier. West Virginia Constitution, Art. X, section 1a.

[15] *Pauley v. Kelly*, 255 S.E.2nd 859, 878 (W.Va. 1979).

[16] West Virginia Constitution, Art. XII, section 1.

[17] Henry Marockie, *Handbook for School Finance in West Virginia*, West Virginia Department of Education (1990).

[18] *Killen v. Logan County Commission*, 295 S.E.2nd 689 (W.Va. 1982).

[19] West Virginia Tax Study Commission, "A Tax Study for West Virginia in the 1980s: Final Report," West Virginia Legislature (1984).

[20] West Virginia Constitution, Art. X sections 1a and 1c.

[21] Tax Modernization Project, *supra* note 1.

"conducted what, at the time, was the most comprehensive review of the state's tax structure in West Virginia's history."[22] Over nearly three years, the commission prepared legal studies and an econometric model measuring the impacts on employment, income, and taxes for all state and local taxes covering the entire state, local subdivisions, each industry, and each income group. A more than 1,000-page report[23] and a 500-page supplement[24] detailed the commission's findings and recommendations.

After finding that the West Virginia tax structure (income, sales, and property) did not conform to the principles of a good tax system and thus was "unfair,"[25] the commission recommended implementing:

- A general excise tax, which would have replaced the consumer sales tax with a much broader base and fewer exemptions.
- A single business tax, which would have been a privilege tax measured by the amount of compensation, rents, interest depreciation payments, and profits in each year. Capital expenditures would have been subtracted from the base, and small business would have been excluded.[26] The tax would have applied to both profit and nonprofit entities, and it would have replaced all other business taxes. Because of its broad base, it was estimated that a 2 percent rate would have been sufficient.
- Special revenue taxes that would have been placed on activities that placed burdens on government, "beyond the usual or customary responsibilities." These taxes included the usual sin taxes on alcohol and tobacco, plus gaming, lottery, racing, and bingo. Severance and estate taxes were also placed in this category.
- A progressive income tax that would have been levied at a flat 6 percent rate with generous exemptions for taxpayers at or below the poverty level as defined by the federal government.

The commission also recommended an almost complete overhaul of education funding. The goal was to eliminate the significant differences in assessed valuations among the counties and litigation over the meaning of "thorough and efficient." Among their recommendations:

- eliminate the use of local property taxes for school finance and replace the revenue with amounts from the new state taxes;
- amend the state constitution to allow the Legislature to define what was a "thorough and efficient" education system; and
- allow local voters to pass excess levies to fund activities above what the state funded.

Local governments were found not to have viable property tax bases, and the commission recommended allowing local governments more flexibility to establish property tax rates and to piggyback on state taxes including the consumer sales tax. As could be expected, the recommendations were controversial and no bills were introduced to implement them; however, interest continued.

I. West Virginia Tax Modernization Project

In 2005 Gov. Joe Manchin III established the West Virginia Tax Modernization Project. The members of the project were divided into subgroups that included individuals who were not members of the project team from business, agriculture, and interest groups. Each subgroup prepared short- and long-term recommendations from its study area. Below are descriptions of the subgroups and their recommendations.

Personal Income Tax. The subgroup generally favored the personal income tax "first because the tax is based on the federal income tax system it is easy to enforce," and "the structure produces relative competitive tax liabilities when compared to surrounding states."[27] The subgroup recommended:

- A family tax credit eliminating tax liability for those with incomes below the poverty

[22] Belville, *supra* note 1.

[23] Governor's Commission on Fair Taxation, *supra* note 8.

[24] Governor's Commission on Fair Taxation, "Recomendations to the Governor: Supplement," West Virginia Department of Revenue (Sept. 1999).

[25] Governor's Commission on Fair Taxation, *supra* note 8, at 2:27-2:81.

[26] A similar tax was passed in 1970 by the House and Senate but was vetoed by the governor.

[27] Tax Modernization Project, *supra* note 1.

line. The tax would be indexed by family size and the federal poverty definition.

- A credit for local property taxes against the personal income tax. This would be an alternative to the personal income tax alternative minimum tax.
- Improved withholding for out-of-state passthrough entities by raising the withholding rate from 4 to 6.5 percent to match the highest personal tax rate.
- Elimination of the rehabilitated residential credit, which the subgroup concluded had been ineffective.

Business Taxes. The business tax subgroup found that the "current West Virginia tax structure on business . . . creates artificial barriers that prevent the flow of capital into West Virginia." This, according to the report, "places a much heavier burden on business capital and on business in general, than other states' structures impose on their respective enterprises."[28] The subgroup recommended:

- a reduction if not elimination of the business franchise tax, as it was a major impediment to capital formation;
- a reduction of the corporate net income tax rate from 9 percent, which was found to be among the highest in the nation, to 6.5 percent;
- a rejection of a return to a gross receipts tax or the adoption of a single business tax as proposed by the Commission on Fair Taxation;
- streamlining the business registration tax, corporate license tax, and attorney-in-fact fees;
- a continuation of the severance taxes on coal, natural gas, and timber; and
- elimination of most tax credits that do not achieve their original purposes.

Consumer Sales and Excise Taxes. This subgroup recommended:

- Continued taxation of food for home consumption. This tax had been repealed and readopted several times since it was first adopted in 1934.[29]
- An extended prescription drug exemption for drugs sold to hospitals.
- An increased tax on tobacco products.

Property Taxes and Local Government Finances. The project determined that property taxes on owner-occupied homes were among the nation's lowest, while property taxes on business were well above surrounding states and national averages. The project also concluded that "West Virginia provides fewer fiscal options to its local governing bodies (counties, municipalities, and school boards) than any other state in the nation."[30] The subgroup provided an extensive list of recommendations to improve the administration of the property tax, including:

- state production of the property tax sales ratio study;
- revision of the definition of charitable institutions and farm for property tax exemptions; and
- reduction of the majority voting requirement for passage of municipal bond levies from 60 percent to 50 percent.

The subgroup also recommended giving municipalities more flexibility in using local sales taxes and the ability to impose income taxes, as allowed in surrounding states. Despite finding that personal property taxes on business inventories deter economic development, the subgroup could not recommend repealing them without an adequate replacement revenue source for local governments.

State Road Fund. Since the 1984 Tax Study Commission report[31] there has been recognition the state road fund is inadequate because of rising costs and stagnant revenue. Under West Virginia Constitution Article VI, section 52, all motor fuel, license fees, vehicle registration fees, and license taxes are dedicated solely to the road fund. The subgroup recommended:

[28] Tax Modernization Project, *supra* note 1.

[29] The food for home consumption tax was enacted in 1934, was partially exempted in 1941, had its partial exemption repealed in 1951, was phased out in 1979, had its exemption removed in 1989, had its rate reduced in 2006, and was repealed in 2013.

[30] *Id.*

[31] Tax Study Commission, *supra* note 19.

- raising the floor of the average wholesale price on the variable component of the motor fuel tax;
- removing the "welcome to West Virginia tax," in which no credit is given for sales taxes paid in other states when vehicles are registered in West Virginia;
- increasing all fees associated with motor vehicles;
- placing the vehicle privilege tax under the consumer sales and service tax and raising the rate from 5 percent to 6 percent; and
- transferring money from the state general fund to supplement the road fund.

J. Past Decade

Many, though not all, of the tax modernization project's recommendations were accepted. The following were the more important changes adopted during this period.

- **Home Rule.** Granting municipal governments more taxing authority had long been advocated, but it was a hard sell to rural lawmakers. Cities had been allowed to levy the B&O tax and to place charges on designated municipal services, but most major cities found themselves in financial difficulty because of pension and medical costs. As an alternative to requesting bailouts from the state, eight cities were allowed to levy no more than a 1 percent consumer sales tax, which was piggybacked on the state's tax.[32] Use of income taxes was specifically denied.
- **Reduction in Corporate Net Income Tax.** The corporate net income tax rate in 1987 was 9.75 percent. Beginning in 2008, the rate was gradually reduced to the current 6.5 percent.[33] Proponents of the reduction believed that West Virginia's corporate income tax, which was one of the highest in the nation and the highest in the region, was a major deterrent to new business formation.
- **Elimination of the Business Franchise Tax.** For 27 years West Virginia taxed business capital investment. That tax, which had been as high as 0.34 percent and was seen as a deterrent to business investment, was phased out and finally eliminated in 2015.[34]
- **Phaseout of the sales tax on food for home consumption.** The exemption, which was implemented in 2013, has proven to be politically popular. Its supporters cite the regressivity of the food tax and the creation of food insecurity as reasons for its elimination.[35] This position was firmly endorsed by former Gov. Earl Ray Tomblin.[36]
- **Sales and property taxation.** Changes included salvage value for some types of tangible personal property, special treatment of ethane cracker facilities costing more than $2 billion, special valuation for some aircraft property, and revision of the tax appeal process. Also, with legislative approval county commissioners and municipalities can create economic opportunity districts and impose a 6 percent sales tax for a 30-year period, which would apply in lieu of the state tax on any incremental sales after establishment of the district.[37]

II. 2017 Regular and Special Session Action

During 2015-2016, a Joint Select Committee on Tax Reform consisting of eight Republicans and eight Democrats was appointed. It held several meetings and heard testimony from tax researchers, interest groups, and the public. While it presented no specific tax legislation, its work became the basis for 2017 legislation.[38]

[32] W. Va. Code Ann. section 8-1-5a. Thirty-six cities as of July 1, 2017, levy 1 percent local taxes.

[33] Alan Mierke and David L. Phillips, "Corporation Net Income Tax" in *Guidebook to West Virginia Taxes*, West Virginia Society of Certified Public Accountants (2017).

[34] Lyman Stone, "West Virginia Reduces Franchise Tax, Corporate Income Tax," Tax Foundation (Jan. 22, 2014).

[35] Nicholas Johnson and Iris J. Lav, "Should States Tax Food?" Center on Budget and Policy Priorities (Apr. 1998); and Norbert L.W. Wilson et al., "Do Grocery Food Sales Taxes Cause Food Insecurity?" (2016).

[36] Gail Cole, "West Virginia Eliminates Sales Tax on Food," retrieved from Avalara TaxRates (July 3, 2013).

[37] Three counties have established these districts. *See* W. Va. Code section 7-22-1 et seq. and 8-38-1 et seq. and Calvin Kent, Interview of West Virginia State Tax Commissioner Dale W. Steager (Sept. 17 and 19, 2017).

[38] Videos of its hearings and copies of all materials and reports received by the Joint Select Committee can be downloaded from its website.

Governor's Proposal

On February 8, 2017, Justice gave his first State of the State address, which focused almost exclusively on taxes. Calling the state's financial situation "beyond dire" and facing a $500 million revenue shortfall, he proposed the following:

- implementing a 0.0002 percent commercial activities tax (CAT) on all business in the state, which would raise $214 million;
- raising the consumer sales tax rate from 6 percent to 6.5 percent, which would raise an estimated additional $93 million;
- eliminating the sales tax exemptions for advertising and undisclosed professional services, which would raise $88 million; and
- increasing the beer tax and wholesale markup on liquor to raise $5.6 million.

Justice also proposed an ambitious plan for financing the state's roads, which included:

- issuing $400 million in general obligation bonds if voters approve an amendment to the state constitution;
- raising $500 million in turnpike bonds to be paid by increasing and extending tolls on the West Virginia Turnpike;
- issuing $500 million in GARVEE (grant anticipation revenue vehicles) bonds;[39]
- increasing the gasoline tax by 10 cents per gallon; and
- increasing the Department of Motor Vehicles fee from $30 to $50.

Omitted from the governor's plan were several items that had been suggested, including:

- a "Better Health Initiative," which comprised a 1-cent-per-ounce tax on sugary drinks and a 50-cent-per-pack increase on cigarette taxes;
- a surtax on high earners at a rate of $500 for those with income above $200,000, $750 for those with income above $250,000, and $1,000 for those with income above $300,000;
- reducing the CAT rate to $0.00075;[40]
- increasing the consumer sales tax to 6.25 percent;
- placing the consumer sales tax on professional services except advertising;
- retaining the beer tax and wholesale liquor markup.

That program, with $50 million in budget cuts (primarily to higher education), plus transfers from other budget lines would have balanced the budget and eliminated the $497 million estimated budget gap.

The governor's proposals were met with little enthusiasm from portions of the public who called it the "largest tax hike in West Virginia history."[41] Faced with negative reaction, the governor indicated he would cut $450 million from the state budget, including cutting in half the budgets of West Virginia University and Marshall University, closing all other state universities, and eliminating the Bureau of Senior Services and Department of Veterans Services.[42]

B. Senate Select Committee on Tax Reform

Early in the 2017 legislative session, the Senate established the Senate Select Committee on Tax Reform. The committee held extensive hearings and received reports before presenting S.B. 335 — "the most massive tax reform effort of any state in recent memory."[43] The bill would have repealed the consumer sales and service tax, the use tax, and the personal income tax; enacted the general consumption tax and a temporary single-rate income tax; and phased out the corporate net income tax.[44] Specifically, the bill would have

[39] GARVEE bonds are issued by pledging future federal highway grants to pay the principal, interest, and other costs. This allows a government to accelerate its spending on road-related projects. U.S. Department of Transportation, Federal Highway Administration, "Tools and Programs: Federal Debt Fianacing Tools."

[40] The final recommendation for the CAT rate was $0.00045, which was supported by the West Virginia Chamber of Commerce. Release, "West Virginia Chamber of Commerce Backs Key Part of Justice Budget Plan" (Mar. 31, 2017).

[41] Paul Blair, "Democrat Governor Jim Justice Proposes Largest Tax Hike in West Virginia History," Americans for Tax Reform (Feb. 9, 2017).

[42] Andrew Brown, "GOP Criticizes Justice's Plan to Raise Taxes for Half Billion Budget Gap," *Charleston Gazette-Mail*, Feb. 8, 2017; and Phil Kabler, P. "WV Governor's Officials Reinforce Stark Choices: Taxes or Cuts," *Charleston Gazette-Mail*, Feb. 9, 2017.

[43] West Virginia State Tax and Revenue Department, "Fiscal Note S.B. 335" (Feb. 16, 2017), at 1.

[44] *Id.* at 4.

repealed the 6 percent consumer sales tax and replaced it with an 8 percent general consumption tax.[45] In addition to expanding the tax on mobile home sales from 5 percent to 8 percent, the tax base would have been expanded to include:

- food for home consumption;
- direct use purchases by business engaged in transportation, communications, gas storage, public utility services, transmission, and research and development;
- nonmedical professional services (legal, accounting, engineering, architecture, real estate, brokerage, advertising, and funeral services);
- personal services (hair, nail, and skin care, and nonmedical home care);
- public utilities;
- contracting services excluding materials used in construction; and
- other services such as sales of farm products, health fitness clubs, and newspapers for home delivery.

The bill also would have repealed the personal income tax in stages by replacing the current personal income tax with a temporary single-rate income tax of 0.6 percent in 2018, 0.4 percent in 2019, and 0.2 percent in 2020. The tax base would have been the federal adjusted gross income minus $2,000 for each personal exemption allowed under the Internal Revenue Code.

The corporate income tax would have been phased out by being reduced by 1 percentage point per year until it was eliminated, and the severance tax would have been phased out over a two-year period beginning in the year the personal income tax was eliminated. These reductions were contingent on the state rainy day fund being at least 10 percent of the general fund budget and the personal income tax being reduced to zero.

While increasing the consumer sales tax would have raised state revenue, when combined with the elimination of the corporate and personal income taxes, the tax department's estimate of the net general fund revenue loss was $870 million over the first four years.[46]

In addition to the loss of state revenue, debate on the proposal considered the following issues.

1. Increased Sales Tax: The Border Issue

The fiscal note raised, but did not investigate, the probability that the increase in the general consumption tax would affect retail sales in border cities. Almost 60 percent of West Virginia's population lives in cities near another state, and most cities levy a 1 percent sales tax. Assuming they would continue to be allowed that 1 percent levy, the total tax rate in those cities would be 9 percent. The State Tax Department announced that it anticipated "significant leakages because of compliance issues" caused by individuals going to lower-tax jurisdictions to shop.[47]

All states surrounding West Virginia would have had lower combined state and local sales tax rates than the combined 9 percent rate under S.B. 335.[48] The Tax Foundation has written that states "should be cautious about raising rates too high relative to their neighbors because doing so will yield less revenue than expected or, in extreme cases, revenue losses despite the higher tax rate."[49]

That conclusion was affirmed in a report[50] received by the committee that investigated border sales tax issues generally and this proposal specifically. It found that:

- consumers respond to sales tax differentials by moving their purchases to lower-tax jurisdictions;
- higher-cost items are the items most likely to be purchased in lower-tax jurisdictions;
- the greater the tax differential between the jurisdictions, the greater the movement;

[45] While unintended, this change would have repealed the local sales and services taxes imposed by 36 municipalities.

[46] The first year there would have been a gain in the state general fund because the sales tax would have gone into effect in July 2017 and the income tax cut would not have been effective until 2018. State Tax and Revenue Department, *supra* note 43.

[47] *Id.*

[48] Scott Drenkard and Nicole Kaeding, "State and Local Sales Tax Rates in 2016," Tax Foundation (Mar. 9, 2016). Combined state and local sales tax rates in border states in 2016: Kentucky 6 percent, Maryland 6 percent, Ohio 7.14 percent, Pennsylvania 6.34 percent, and Virginia 5.63 percent.

[49] *Id.*

[50] Kent, "Scoring the Proposed General Consumption Tax: S.B. 335 Committee Substitute," Center for Business and Economic Research, Marshall University (Mar. 10, 2017).

- higher-income consumers are more likely to cross jurisdictional boundaries;
- availability of alternative vendors in low-tax states will increase the border effect; and
- major shopping areas within 15 miles would see the greatest effect, with the impact diminishing 50 miles from the border.

The current boom in internet sales,[51] which are largely untaxed, may be accelerated when state sales taxes are increased, as residents in any location seek to avoid the tax.

2. Sales Taxation of Services

The taxation of personal and business services under a general excise tax was hotly contested. There has been a trend for states to add more services to the sales tax base. Academic literature does not support the taxation of business services because of the problem of tax pyramiding.[52] Pyramiding occurs when the "tax is applied both to inputs (potentially at several stages) and to outputs."[53]

Exclusion of personal services primarily consumed at final purchase is generally seen as an economically unjustified reduction in the sales tax base.[54] States that include some services generally confine the tax to consumer purchases. The department found that "one of the components of a model sales tax is that the tax should apply to consumption expenditures."[55] West Virginia extends its sales tax to more services than is typical elsewhere.[56] The Commission on Fair Taxation[57] recommended expanding the sales tax base to include more services, but the Tax Modernization Project made no recommendation.

West Virginia presumes all sales of goods and services are taxable unless specifically exempted.[58] All but three states use the presumed nontaxable standard, which provides that the good or service is not taxable unless specifically listed in legislation. Services already taxed in West Virginia include those performed directly on real property (car repairs, HVAC installation, home repairs, equipment repairs and installation). The state also taxes bundled services when a service contract is included as part of the product price.[59]

Professional service providers united against the proposal to tax services, citing articles from professional organizations in other states. In addition to pyramiding, objections included that the taxes were unfair to:

- small firms, because larger firms can provide those services inside and avoid the tax;[60]
- in-state firms because business entities move work to out-of-state vendors;[61]
- consumers because "a tax on the basic, constitutional right of citizens to have access to justice and the courts";[62] and
- the state because it adds to an unfavorable business tax climate, retarding economic development by reducing investment.[63]

Further, their argument noted that only three states (South Dakota, Hawaii, and New Mexico) tax professional services under their gross receipts taxes, and West Virginia would be an outlier, making enforcement difficult.[64] Those arguments prevailed and consideration of

[51] U.S. Census Bureau, "Quarterly Retail E-Commerce Sales" (May 16, 2017).

[52] Walter Hellerstein, "Sales Taxation of Services: An Overview of Critical Issues," in William F. Fox, *Sales Taxation: Critical Issues in Policy and Administration* 41-50 (1992); and Kent, *supra* note 50.

[53] Fox, "Sales Taxation of Services: Has Its Time Come?" in Fox, *Sales Taxation: Critical Issues in Policy and Administration* 51-61 (1992).

[54] David Brunori, "Don't Be Fooled — Services Should Be Subject to Sales Tax," *Forbes*, Sept. 24, 2015.

[55] West Virginia Department of Tax and Revenue, "West Virginia Tax Expenditure Study: Consumers Sales and Service Tax and Use Tax Expenditures" (Jan. 2016).

[56] Mark B. Muchow and Mark S. Morton, "Consumer Sales and Use Taxes: Prepared for the Joint Select Committee on Tax Reform," West Virginia Department of Tax and Revenue (Aug. 31, 2015). The four states broadly taxing most services are South Dakota, Hawaii, New Mexico, and West Virginia.

[57] Commission on Fair Taxation, *supra* note 8, at 3, 127-128.

[58] W. Va. Code section 11-15.

[59] W. Va. Code R. section 110-15-8.

[60] Arizona Society of CPAs, "Taxation of Professional Services" (Dec. 2010).

[61] This argument can be questioned on grounds the tax is levied based on where the service is received and not on where it is produced. South Dakota Department of Revenue, "Tax Facts: Accountants, Attorneys, Advertizing Agencies" (June 2016).

[62] Pennsylvania Bar Association, "Sales Tax on Legal Professional Services" (2016).

[63] Robert Cline et al., "Sales Taxation of Business Inputs," Council On State Taxation (Jan. 25, 2005).

[64] Washington has a 1.8 percent gross receipts tax on professional services and Delaware has a minimal tax of 0.004 percent.

professional services inclusion was dropped from later proposals.

3. Taxation of Food for Home Consumption

Return of the on-again, off-again sales tax on food for home consumption was originally proposed by the Senate Select Committee as one of the major sources of new revenue to offset the loss of personal income tax yields. Removal of the food exemption was recommended by the Tax Modernization Project.[65] That view was reinforced by a recent study.[66]

In 1997 the Commission on Fair Taxation recommended maintaining the food tax, finding that "reductions in the sales tax on food for home consumption may not benefit low-income individuals as much as some have alleged. Repeal of the sales tax on groceries has a strong emotional appeal, it does not represent a significant improvement in tax equity."[67] Low-income individuals did not benefit as much as others because more than 70 percent of their food purchases were covered by nontaxable government vouchers. Any regressivity in the food tax, it was noted, could be offset by a more progressive personal income tax or some form of refundable credits.[68]

4. Decreased Personal Income Taxes

Throughout both the regular and the special sessions, debate flowed about the desirability of lowering and then eliminating the personal income tax. Advocates presented comparisons that showed that states with no tax experience greater economic growth than those with the tax.[69] Support for repeal was based on the increased number of passthrough businesses in recent decades. Passthrough entities are financed by higher-income individuals who pay the business's taxes as part of their personal income tax. Raising taxes on these individuals "could curtail their hiring and other investment plans, further delaying economic recovery."[70]

The majority opinion is contrary. A report to the Legislature looked at both the research and the results of cutting income taxes in various states.[71] Reviewing seven recent studies[72] and the results in Kansas and Oklahoma, which cut personal income taxes, the authors wrote: "It is difficult to draw any conclusion based on the studies reviewed and the two states which have radically decreased their personal income taxes, other than, these cuts lead to budget deficits, reductions in essential services and increased taxes on other bases."[73]

C. The Senate Alternative

When it was determined that the state's general fund would be faced with an $870 million, four-year deficit, the select committee proposed a new bill, S.B. 409. The bill contained some of the features of S.B. 335, which itself had already been amended 35 times in committee, plus some of the governor's ideas, but with alterations. The new bill would have:

- Increased the consumer sales tax from 6 percent to 7 percent and expanded the base as in S.B. 335.
- Included food for home consumption in the sales tax base at a 3.5 percent rate.
- Established "trigger points" for repeal of the personal income tax. When the yield of the

[65] Tax Modernization Project, *supra* note 1, at 170-173.

[66] Mehmet S. Tosun and Pavel A. Yakovlev, "West Virginia Sales Tax on Food for Home Consumption," *W.Va. Bus. & Econ. Rev.* 8-15 (Mar. 2006).

[67] Tax Modernization Project, *supra* note 1, at 172-173; Governor's Commission on Fair Taxation, *supra* note 8.

[68] Alan D. Viard, "Should Groceries Be Exempted From Sales Tax?" *State Tax Notes*, July 25, 2011, p. 241.

[69] Arthur B. Laffer and Stephen Moore, "Taxes Really Do Matter: Look at the States," The Laffer Center for Supply Side Economics (Sept. 2012).

[70] Scott A. Hodge and Alex Raut, "Individual Tax Rates Also Impact Business Activity Due to Higher Number of Pass-Throughs," Tax Foundation (June 6, 2012).

[71] Kent, "Impact of State Personal Income Taxes on Economic Growth: What Does the Research Say?" Center for Business and Economic Research, Marshall University (June 12, 2017).

[72] Barry Paulson and Jules Kaplan, "State Income Taxes and Economic Growth," *Cato Journal* 53-71 (Winter 2008); Michael Leachman and Michael Mazerov, "State Personal Income Tax Cuts: Still a Poor Strategy for Economic Growth," CBPP (May 2015); Mazerov, "State Taxes and State Economic Performance," National Conference of State Legislatures Task Force on State and Local Taxation (Jan. 14, 2017); Dan Rickman, "Do Cuts in State Income Taxes Boost Economic Growth?" Scholars Strategy Network (Sept. 2013); Thomas Dye and Richard Feiock, "A State Income Tax Adoption and Economic Growth," 76 *Soc. Sci. Q.* 3 (Sept. 1995); William Gale, Arnold Krupkin, and Kim Rueben, "The Relationship Between Taxes and Growth at the State Level: New Evidence," *Nat'l Tax J.* 919-942 (Dec. 2015); and Institute on Taxation and Economic Policy "'High Rate' Income Tax States Are Outperforming No-Tax States" (Feb. 2012).

[73] Kent, *supra* note 71.

consumer sales tax reached $1.8 billion, for each $50 million above that amount, the tax rate would have been reduced by 1 percentage point.

- Cut the 5 percent severance tax on coal to 2.5 percent. Because the severance tax is shared with local governments, their financial capacity would have been adversely affected.
- Capped local property tax increases.
- Included an additional property tax credit, up to $200, for owner occupied homes. The credit would have been phased out as income rose with elimination for those with incomes more than 125 percent of the federal poverty line.

The bill assumed that the increase in the sales tax and economic growth would offset the loss of personal income tax revenue. The tax department did not agree and found that by 2019, revenue losses would total $190.2 million.[74] The bill passed the Senate, but was almost entirely rewritten in the House — gone were the proposed sales tax increases and the personal income tax reductions.

D. Action in the House

The Republican-held House of Delegates was bypassed in the negotiations between the governor and the Senate. It developed tax legislation on its own (H.B. 107) that bore no resemblance to the Senate's version, with no tax increases except for broadening the sales tax base to include some personal services and a budget balanced by spending cuts. Its proposal would have cut income taxes on military pensions and Social Security benefits, and increased personal exemptions for income below $100,000.[75]

E. Final Action

The regular session ended with no action on taxes. As a result, it was impossible to pass a balanced budget as required by the state constitution.[76] If a balanced budget is not passed at least three days before the end of the 60-day session, the governor must extend the session. Faced with a constitutional deadline of July 1 to enact a budget, the governor called a special session.

That session was characterized by repeated passage of one chamber's bill only to have the proposal rejected by the other chamber. The Senate held firm on personal income tax cuts and sales tax rate increases with base broadening. The House remained unmoved in its insistence of not raising taxes but cutting expenditures to erase the anticipated budget deficit.

Late on the day before the budget deadline, and after daily conference committee meetings, both a tax bill and the budget bill (S.B. 1013) finally passed. The $4.255 billion budget was balanced primarily by cutting expenditures. The budget was $85 million less than the current budget and $125 million less than the governor's request. While the budget did backfill Medicare, it cut higher education and eliminated economic development funding requested by the governor. There were no budget enhancements.

After debating whether to sign the bill, the governor let it go into effect without his signature, saying, "I'm not going to put my name on this mess."[77] He cited not only the cuts in higher education, but the absence of raises for public school teachers, tax breaks for the coal industry, and tax rebate checks for low-income individuals.

The budget is $125 million short of being balanced by tax revenue, but additional funding is coming from transfers from other state agencies and the rainy day fund, as well as the expected growth in taxes because of the revival of the coal industry and road construction.

F. Roads Plan

Although his tax and spending ideas were not enacted into law, the governor saw his funding for road projects pass. During the special session, S.B. 1006 was passed, which raised the wholesale fuel tax, the sales tax on vehicles — from 5 percent to 6 percent — and document fees. Also, the

[74] West Virginia Department of Tax and Revenue, "Fiscal Note S.B. 409" (Mar. 29, 2017).

[75] Associated Press, "West Virginia House Backs Alternative Tax Overhaul," May 19, 2017.

[76] West Virginia Constitution, Art. 6-51 B(5).

[77] Associated Press, "West Virginia Governor Won't Sign Budget Amid Tax Impass," June 21, 2017.

Legislature passed S.B. 1003, which authorized the State Turnpike Authority to increase tolls on the West Virginia Turnpike and other roads. Further, the Legislature placed on the October 7, 2017, special election ballot a constitutional amendment to issue general obligation bonds.

The breakdown of the $2.8 billion in road funding is $500 million in federal GARVEE bonds, $500 million in increased turnpike tolls, and $1.8 million in state bonds, to be paid from the fees and other taxes in S.B. 1006. There was little opposition to the plan, but the governor's claim that "my roads plan is the pathway to prosperity for West Virginia"[78] due to the creation of 48,000 good jobs has been criticized because of doubt about the number of new jobs, the speed of the plan's implementation, and the availability of a labor force.[79]

III. Conclusion

The lack of action does not mitigate West Virginia's budget crisis. If the coal industry continues its revival and enough road projects are started, the state may make it to the next fiscal year. Unfortunately, during past years, the failure of revenue receipts to live up to projections has forced midyear budget cuts and spending freezes. This coming fiscal year may repeat the pattern.

The continuing attempts and failures to enact substantive tax reform demonstrate the difficulties of getting major changes passed. The governor's bill and the committee's bill were complicated, even for those who took the time to read them. The effect of the proposals on state income and employment was not calculated, nor was the interaction among the various tax alterations analyzed despite the department's suggestion this be completed.[80]

Major changes in tax policy require consultation and collaboration of all parties. Until late in the process the House had not been fully in the loop, and Democrats in both houses were never fully involved.[81] Most of the interaction took place between the Republican governor[82] and the Senate's Republican leadership. However, the battle was not primarily partisan, but between Republican leadership in the House and Senate. The House held firm on no tax increases except for some sales tax base expansion with expenditure cuts, while the Senate wanted an almost total rewrite of the tax code, including major revenue enhancement to prevent budget reductions.

For major tax reform in West Virginia to happen, a proposal must be carefully crafted and thoroughly evaluated. Consensus must be reached with all affected parties. Lawmakers must be given ample time to digest the bill and raise questions, and the public must be educated on how they will individually be affected. None of this happened. While there is widespread agreement the West Virginia tax system is broken, reform is unlikely until those steps are taken. ■

[78] Release, "Governor Justice Tells Contractors They Play a Key Role in Building a Brighter Future for West Virginia" (Mar. 23, 2017).

[79] Rusty Marks, "Details Remain Short on Impact of W.Va. Roads Plan," *The State Journal*, July 17, 2017.

[80] West Virginia State Tax and Revenue Department, *supra* note 43.

[81] The Senate Select Committee included two Democrats.

[82] Justice returned to the Republican Party on August 2, 2017. He had been a Republican until he decided to run for governor in 2013.