

**Draft—SB335CS**  
**March 11, 2017**

The stated purpose of this bill is to preserve the municipal sales and use taxes, contingently reduce the rate of the severance taxes on natural gas production, prospectively balance the rate of the severance tax on coal production, prospectively repeal the consumer sales and service tax and the use tax, reduce, make uniform and phase down the rate of, and ultimately repeal, the personal income tax, enact the general consumption tax law and phase down the rate, and ultimately repeal the corporation net income tax.

According to our interpretation, the proposed bill would (1) repeal the Consumer Sales and Service Tax and Use Tax (sales and use tax); (2) replace the sales and use tax with the General Consumption Tax; (3) alter, phase-down, and ultimately repeal the Personal Income Tax; (4) alter, phase-down, and ultimately repeal the Corporation Net Income Tax; and (5) alter the current severance tax structure for natural gas, coal, and other minerals. Additional changes related to the Motor Vehicle Sales Tax are not included in this analysis. The West Virginia Division of Motor Vehicles would provide such an estimate.

Our understanding of the Committee Substitute suggests that the terms of the General Consumption Tax in the introduced version would remain largely intact. The Tax would still transfer legal incidence of the tax to the vendor with the expectation that the tax will be paid by the purchaser in the purchase transaction and remove certain exemptions currently in place. Items no longer exempted include (1) food for home consumption; (2) certain professional services, including legal, architectural, accounting, and engineering services purchases by individuals; (3) personal services including hair, nail, and skin care and non-medical personal home care; (4) public utility services such as electricity, natural gas, water, sewer, telecommunications, solid waste, and intra-state transportation; (5) contracting services with an added credit to final purchaser for material purchases used by contractors in fulfilling their contracts; and (6) various other smaller base enhancements, including but not limited to sales of farm products by the producer, health fitness services, newspaper sales by route carriers, and mobile homes at full rate.

The Committee Substitute contains a few notable differences to the introduced version with regard to the General Consumption Tax. Whereas the introduced version proposed a General Consumption Tax of 8 percent and base-broadening enhancements, all effective July 1, 2017, the Committee Substitute proposes that rate increase and base-broadening enhancements be effective October 1, 2017. The current proposal also reinstates the exemption for certain services (e.g., licensed professional services for accounting, architecture, engineering, or legal representation; advertising services; electronic data processing services; and employment recruiting and placement services) purchased by those who hold a business certificate; these services were taxable in the introduced version. This bill also keeps direct use purchase exemptions for communications, transportation, and transmission activities associated with movement of natural gas and electricity. It is proposed that the hotel rental tax be raised to 11 percent, a three percentage point increase over the proposed General Consumption Tax rate of 8 percent. The current version also preserves municipal sales tax provisions. Currently, 28 municipalities impose a local sales tax. An additional 11 municipalities are slated to begin imposing a local sales tax on July 1, 2017.

The consumption tax rate increase and inclusion of certain goods and services currently exempted from the sales and use tax would result in an estimated annualized gain in the General Revenue Fund of up to \$1.25 billion per year by FY2023. Due to the normal month lag in collection

of taxes relative to purchases, FY2018 General Revenue Fund tax receipts would rise by approximately \$750 million and FY2019 receipts would rise by roughly \$1.11 billion. It is important to note that these figures may not adequately account for potential leakages to surrounding states. These figures also exclude sales tax collections diverted to Sales Tax Increment Finance (STIF) Districts. Approximately \$15.5 million in sales tax collections are currently diverted to STIF Districts each year, and that amount may nearly double as a result of the provisions of this bill. The bill is also expected to increase municipal government sales tax collections by up to \$50 million per year due to the broadened tax base.

According to our interpretation, the Committee Substitute would also alter the structure of the Personal Income Tax by imposing a flat rate of 2.65 percent on West Virginia taxable income for taxable years beginning on and after January 1, 2018. The Personal Income Tax rate would subsequently decrease by 0.1 percentage points per each \$50 million of General Consumption Tax collections in excess of \$2.5 billion for the prior fiscal year, under the condition that the combined balances of the Revenue Fund Shortfall Reserve Fund and the Revenue Fund Shortfall Reserve Fund – Part B is at least 15 percent of the General Revenue Fund budget for that fiscal year. For taxable years beginning on and after January 1, 2023, the Personal Income Tax rate would be 2.38 percent and will be reduced annually as scheduled in the proposed bill until fully repealed effective January 1, 2032.

It is assumed that all current credits and modifications would remain in place for the determination of West Virginia taxable income. This reduction is expected to reduce FY2018 Personal Income Tax collections by approximately \$376 million to account for the reduction in estimated payments and withholdings, and would negatively impact FY2019 revenues by more than \$890 million. While it is difficult to determine whether the economic conditions in the State would result in a decline in the Personal Income Tax rate in any given year, we estimate that a 0.1 percentage point decline in the rate in TY2019 would equate to an estimated \$36.9 million loss in General Revenue Fund collections. This number would fluctuate year-to-year based on income inflation.

The Committee Substitute also authorizes the phase-out of the Corporation Net Income Tax rate by one percentage point per year beginning in the year that the Personal Income Tax rate falls to zero, so long as the combined Revenue Fund Shortfall Reserve Funds balance is at least 10 percent of the General Revenue Fund budget. The earliest date contemplated by the provisions of this bill for these phase-downs to begin would be 2032. No estimate is provided for these proposed changes due to concern that the triggering criteria would not be met absent the implementation of other financial changes not covered within this bill.

According to our interpretation, the Committee Substitute would reduce the Severance Tax rate on natural gas by one percentage point annually for two consecutive years, to a rate of 3 percent, beginning in the first year after the Corporation Net Income Tax rate is 0 percent. The proposed bill would also change the Severance Tax rate on coal effective July 1, 2017. Per our understanding, the rate on thin seam coal would increase to 2.5 percent and the rate on all other coal production would decrease to 3.75 percent on that date. Beginning July 1, 2018 the rate on all other coal production would decrease to 2.5 percent. We do not anticipate these changes to affect natural gas Severance Tax collections. The changes to coal Severance Tax rates would result in a net loss to the General Revenue Fund of \$30.0 million FY2018, \$68.1 million in FY2019, and \$75.4 million in FY2020. Coal-producing county governments also benefit from a 5 percent shared portion of State coal Severance Tax collections and would thus be impacted as well by this reduction. Losses at the local level resulting from these changes would be \$1.0 million in FY2018, \$2.9 million in FY2019, and \$3.8 million in FY2020.

The analysis contained in this writing accounts for sixteen years of revenue impacts beginning in FY2018. This note does not quantify any changes that may occur beyond FY2023. The fiscal consequences to the General Revenue Fund (i.e., Current Law absent any proposed enhancements proposed by the Governor or his budget) associated with the provisions of this bill are provided below.

**Table 1—Fiscal Impacts for General Consumption Tax Rate of 8 Percent**

<b><u>Fiscal Year</u></b>	<b><u>Consumption Tax</u></b>	<b><u>Income Tax</u></b>	<b><u>Coal Severance</u></b>	<b><u>Net Change</u></b>
2018	+\$750 million	-\$376 million	-\$30 million	+\$344 million
2019	+\$1.11 billion	-\$890 million	-\$68 million	+\$152 million
2020	+\$1.13 billion	-\$920 million	-\$75 million	+\$135 million
2021	+\$1.18 billion	-\$960 million	-\$78 million	+\$142 million
2022	+\$1.21 billion	-\$1.01 billion	-\$73 million	+\$127 million
2023	+\$1.25 billion	-\$1.11 billion	-\$71 million	+\$69 million
2024	+\$1.29 billion	-\$1.27 billion	-\$70 million	-\$50 million
2025	+\$1.34 billion	-\$1.46 billion	-\$70 million	-\$82 million
2026	+\$1.38 billion	-\$1.66 billion	-\$70 million	-\$350 million
2027	+\$1.43 billion	-\$1.88 billion	-\$70 million	-\$520 million
2028	+\$1.47 billion	-\$2.11 billion	-\$70 million	-\$710 million
2029	+\$1.52 billion	-\$2.36 billion	-\$70 million	-\$910 million
2030	+\$1.57 billion	-\$2.64 billion	-\$70 million	-\$1.14 billion
2031	+\$1.62 billion	-\$2.93 billion	-\$70 million	-\$1.38 billion
2032	+\$1.68 billion	-\$3.22 billion	-\$70 million	-\$1.61 billion
2033	+\$1.73 billion	-\$3.46 billion	-\$70 million	-\$1.80 billion

Under the assumption that the General Consumption Tax would increase to 8 percent effective October 1, 2017, our estimates indicate that total collections for this Tax would reach the \$2.5 billion benchmark by the end of FY2021. However, we do not anticipate the Rainy Day Fund requirement to have been met and therefore do not anticipate a 0.1 percentage point reduction from the Personal Income Tax rate. The rate reduction to 2.38 percent, proposed for taxable years on and after January 1, 2023, will have an impact in FY2023 via a reduction in estimated payments and withholdings. The income tax rate would subsequently decrease to 2.11 percent, 1.84 percent, 1.57 percent, 1.30 percent, 1.03 percent, 0.76 percent, 0.49 percent, 0.22 percent and 0 percent in 2024, 2025, 2026, 2027, 2028, 2029, 2030, 2031, and 2032, respectively. The more substantial impact of the income tax phase-out does not fully begin until FY2024. In total, this proposal is expected to result in a net positive revenue gain of roughly \$344 million in FY2018. While annual gains are anticipated through the first six years, we note that our estimates anticipate this gain will shrink year-to-year. The estimated revenue gain in FY2023 is approximately \$69 million. Thereafter revenues begin to decrease over time relative to the current baseline as the income tax is phased out.

We further note that the scheduled 10-year phase-out of the Personal Income Tax rate beginning in FY2023 would contribute to a significant reduction in state and local government services, absent other offsetting revenues. Beyond FY2023, the proposed bill would begin a phase-out of the Personal Income Tax over the next decade, resulting in the need for either additional revenue enhancements or a major restructuring of state and local government services to mitigate the inevitable budget gaps.

When comparing these revenue estimations to the current six-year financial plan, which covers the revenues and expenses expected for the remainder of FY2017 through projected FY2022, we note that the FY2018 budget year is expected to experience a surplus of nearly \$8 million. However, the budgetary position worsens in FY2019 (projected budget gap of nearly \$360 million) and continues through at least FY2022 (projected budget gap of nearly \$545 million), inclusive of the proposed revenue enhancements of the current Committee Substitute. These deficits are mainly driven by increased Medicaid costs and suggest the potential need for additional revenue enhancements or expenditure modifications in upcoming years.

**As described in the original fiscal note for Senate Bill 335, the bill proposes a massive tax reform effort, the full impact of which has not yet been appropriately assessed.** The net impact on General Revenue Fund collections is positive in the near term, partially due to the timing of sales tax base broadening changes beginning three months prior to the timing of the beginning of the income tax cuts. Current projections indicate a new budget gap will likely appear and widen over time. The additional burden placed on business inputs will still at least partially offset potential income tax savings for businesses. In addition, lower income households will experience an increase in overall tax liability, particularly related to the consumption of public utility services and groceries, along with the higher tax rates. Absent considerable economic activity to spur economic growth, expenditure adjustments or other revenue enhancements will be needed to address an emerging gap between revenue and expenditures. By comparison, over the last decade, the State has reduced its Corporation Net Income Tax by nearly 30 percent and eliminated the Business Franchise Tax with modest economic stimulus results to date.

The Tax Department maintains that the allotted time for analyzing these impacts is extraordinarily inadequate. Due to the restricted timeframe, the Department is unable to provide a thorough analysis and thus cautions that actual results could deviate significantly as the economy reacts to the proposed changes. The Department continues to anticipate some leakages in association with the increased consumption tax rate for goods and services and strongly recommends further independent analysis be completed before a reform of this magnitude is pursued.