

**2006 Report to  
Governor  
Joe Manchin III  
by the  
West Virginia Tax  
Modernization  
Project**



**West Virginia  
Department of Revenue**

**THE 2006 REPORT  
OF THE WEST VIRGINIA  
TAX MODERNIZATION PROJECT**

**Presented to  
Governor Joe Manchin III**

**October 2006**





JOE MANCHIN III  
GOVERNOR

DEPARTMENT OF REVENUE  
OFFICE OF THE SECRETARY

JOHN C. MUSGRAVE  
ACTING SECRETARY

STATE CAPITOL  
CHARLESTON, WEST VIRGINIA

October 23, 2006

The Honorable Joe Manchin III  
Governor  
State of West Virginia  
1900 Kanawha Boulevard, East  
Charleston, West Virginia 25305

Governor Manchin:

At your direction earlier this year, I formed the West Virginia Tax Modernization Project (the "Project"). The Project is composed of a host of executives from the Department of Revenue, including myself and State Tax Commissioner Virgil Helton, as well as experts from the Center for Business and Economic Research at Marshall University and the Bureau of Business and Economic Research at West Virginia University.

Since the formation of the Tax Modernization Project, we have diligently focused on fulfilling your charge to the Project: **A comprehensive overview and analysis of West Virginia's system of state and local taxation.**

Based on your challenge to the Project, we developed the following mission statement, aimed at modernizing our system of State and local taxation:

*The systematic research and analysis of State and local taxation resulting in the creation of a more equitable and improved tax structure which encourages economic growth.*

We have ambitiously proceeded on this task and each member of the Project has contributed an extensive amount of time and energy toward improving and modernizing our tax system. Additionally, pursuant to your charge, we have sought a great amount of public input through questionnaires, several public meetings, and the internet. We are pleased to note that numerous Legislators took part in this process. In fact, our group, in keeping the Legislature informed of our actions, made a presentation to the entire Legislature in July 2006.



**DEPARTMENT OF REVENUE  
OFFICE OF THE SECRETARY**

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By using the collective knowledge and experience of the Project members and by seeking and genuinely reviewing input from the public, the members have identified many areas in which our tax system – at both the State and local levels – is in great need of modernization. The conclusion of this work has resulted in the 2006 Report of the West Virginia Tax Modernization Project (the “Report”), which I am pleased to present for your review and consideration. The Report is the first significant step toward analyzing and improving West Virginia’s system of State and local taxation. Importantly, the Report includes specific proposals for modernization and identifies additional areas of concern that necessitate further study and input from the citizens and elected officials of this State.

Specifically, given the complexity of our tax system, the need for further study and analysis, and the need for stability of both State and local governments, the West Virginia Tax Modernization Project recommends that the changes be undertaken in phases rather than attempted at one time. Indeed, just as our economy is constantly changing, so is the need to continually review and update our tax system. As such, this Report is in many respects a starting point not only for beginning action, but also to inspire continued and informed discourse concerning our system of taxation. Based on this approach, the Project has identified:

- (1) Changes that may be implemented immediately during the initial phase of tax modernization or during future upcoming sessions of the Legislature after debate and further analysis; and
- (2) Areas of concern that require in-depth analysis and study before implementation.

It is our hope that the work we have undertaken and its culmination in this Report will continue the process of developing our tax system in a manner that will benefit all West Virginians now and for generations to come. I sincerely appreciate the opportunity to participate in the tremendous challenge of the Tax Modernization Project. I hope that this Report will meet with your approval and that it will continue to build on the recent successes of your Administration and this State.

Sincerely,

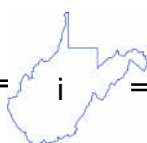
  
John C. Musgrave  
Acting Cabinet Secretary

JCM/cn



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# **Chapter I**

## ***Project Membership and Acknowledgment***



**I. Project Membership and Acknowledgment**

**MEMBERS**

**Department of Revenue:**

*Office of the Secretary:*

John C. Musgrave – Acting Cabinet Secretary  
James Robert Alsop – General Counsel  
Michele Duncan Bishop – Deputy General Counsel  
Audrey Pennington – Executive Assistant

*State Budget Office:*

Roger Smith, Director

*State Tax Department:*

Virgil T. Helton – State Tax Commissioner  
Christopher G. Morris – Deputy Tax Commissioner  
Mark Muchow – Director, Office of Fiscal Policy  
Mark Morton – General Counsel and Director, Legal Division  
Roger Cox – Director, Research and Development Division  
Wade Thompson – Director, Property Tax Division

*Marshall University*

Calvin Kent, Ph.D. – Vice President of Business and Economic Research,  
Center for Business and Economic Research  
Jennifer Price – Research Associate, Center for Business and Economic  
Research  
Kent Sowards – Director, Data and Survey Services, Center for Business and  
Economic Research

*West Virginia University*

Tom Witt, Ph.D. – Director, Bureau of Business and Economic Research  
Amy Higginbotham – Economist, Bureau of Business and Economic  
Research  
Pavel Yakovlev, Ph.D. – Research Assistant and Professor, Bureau of  
Business and Economic Research

*Technical Support Staff:*

A special thanks to Carol Nichols and Susan Fox, Office of the Secretary; and  
Dana Miller, Tonja Oakes and the Research and Development Division, State  
Tax Department, for their invaluable assistance.

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**John C. Musgrave** was appointed as Acting Cabinet Secretary for the Department of Revenue in November 2003. He oversees ten State agencies, and in June 2004, assumed the additional duty of State Budget Director. In addition, he has served as Director of the State Lottery Commission since 1997.

Secretary Musgrave brings to State government a strong finance background with more than two decades of public service at the federal, State, and local levels, including United States Department of Agriculture; Rural Development Administration; West Virginia Farmers Home Administration; Deputy Secretary of State; Mason County Development Director; and Mayor of Point Pleasant.

Under Director Musgrave's tenure with the State Lottery Commission, lottery profit has risen from \$72 million in 1997 to \$605 million in 2005. A Mason County native, Secretary Musgrave received his B.S. degree in Business in 1968 from Morris Harvey College (now the University of Charleston).

**Virgil T. Helton** has served as State Tax Commissioner since the beginning of the Manchin Administration in January 2005. He originally served in an Acting role and his full appointment was effective July 1, 2006. Previously, he served the last two administrations as Deputy Director and Chief Financial Officer of the West Virginia Lottery. Early in his professional career, Mr. Helton was employed by two different international accounting firms, both of which are now among the industry's "Big Four." The Commissioner has 20 years of experience in the commercial banking industry, including serving in the capacity of Chief Operating Officer of a Baltimore based bank. The Commissioner serves on the Board of Directors of the Economic Development Authority.

Mr. Helton is a 1967 graduate of Concord University, Athens, West Virginia, and is licensed by the West Virginia Board of Accountancy to practice as a Certified Public Accountant.

**James Robert Alsop** was appointed General Counsel for the Department of Revenue in October 2005. Mr. Alsop previously served as Deputy General Counsel

to Governor Joe Manchin III. He received his bachelor's degree in political science from West Virginia University and is also a graduate of the West Virginia University College of Law. Mr. Alsop also served as a law clerk for the United States Circuit Court of Appeals, Fourth Circuit, for the Honorable Robert Bruce King.

**Christopher G. Morris** was appointed Deputy Tax Commissioner/Chief of Staff for the State Tax Department on March 1, 2005. Mr. Morris previously served as the Acting Assistant Tax Commissioner and Assistant Cabinet Secretary for the Department of Revenue, a position he was appointed to on September 17, 2003. Mr. Morris attended public school in Mineral County, West Virginia. He earned his Bachelor's degree in 1999 and a Master's of Public Administration in 2001, from West Virginia University.

**Michele Duncan Bishop**, a Boone County native, serves as Deputy General Counsel for the Department of Revenue. Mrs. Bishop received a B.A. in economics from Marshall University and a J.D. from the West Virginia University College of Law. She has nearly ten years of experience as an attorney, having worked in both the private and public sectors, and having served as a law clerk for the Honorable John T. Copenhaver, Jr., in the United States District Court for the Southern District of West Virginia.

**Roger Cox** was named Director of the Research and Development Division in March 2001. Prior to assuming the position of Director, he had been employed in the Division since October 1980. Mr. Cox is a graduate of West Virginia University Institute of Technology and the Marshall University Graduate College.

**Mark S. Morton** is General Counsel and Director, Legal Division, of the State Tax Department. Mr. Morton is a graduate of West Virginia University with a B. S. degree in Business Administration, majoring in accounting, and is a graduate of the



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West Virginia University College of Law. He has been an attorney with the State Tax Department since 1983.

**Mark Muchow** is Director of Fiscal Policy for the State Tax Department, where he works with the State Budget Director on matters of fiscal and budget policies for the State. Prior to this current appointment, Mr. Muchow was the Chief Administrator for Revenue Operations and assisted the Research Division with the preparation of economic forecasts, revenue estimates, fiscal notes, and tax policy studies. Mr. Muchow has over 22 years of experience with the State Tax Department, including more than 18 years of revenue forecasting; assisting the State Tax Commissioner in the role of liaison with the State Legislature; and providing technical assistance to the State's Development Office and others with regard to tax incentive programs. Among other achievements, he was a consultant to the 1999 Commission on Fair Taxation, and he co-authored a study of tax incentive programs in West Virginia that contributed to the enactment of significant reforms in 2002. He has a B.A. degree in History/Secondary Education from Edinboro University and a M.S. in Public Management and Policy from Carnegie-Mellon University.

**Audrey Pennington**, Executive Assistant to the Cabinet Secretary, Department of Revenue, has over 21 years of professional management experience in State government working in the Office of the Governor and the Department of Revenue. She served as a member of the support staff of the 1999 Commission on Fair Taxation.

**Roger Smith** has served with the State Budget Office since 1974 and was named Director in 1988. In that capacity, he and his staff are responsible for preparing the Governor's Executive Budget Document, which has received the Distinguished Budget Presentation Award from the Government Finance Officers Association for 11 consecutive years. Mr. Smith is a member of the National

Association of State Budget Officers and has served on several State committees, including the Governor's Cabinet Council on Government and was Chair of the Governor's Salary/Benefit Study Group. He received a B.S. degree in Business Administration from the University of Charleston in 1973 and was named a Distinguished West Virginian in 2005.

**Wade Thompson**, a Charleston native, graduated from the University of Charleston in 1972 with a B. S. degree in Management. He accepted a position as a Tax Appraiser with the Property Tax Division, State Tax Department upon graduation. Since that time he has also served as a Tax Examiner, Tax Administrator, Chief of Appraisal Services, Assistant Director, and his current position as Director of the Property Tax Division.

Mr. Thompson has in excess of 34 years experience in the administration of property taxes in West Virginia. He has also been a speaker and instructor of numerous property tax seminars and workshops in West Virginia. He is a member of the International Association of Assessing Officers (IAAO) and past State representative.

### ***Marshall University<sup>1</sup>***

**Calvin Kent, Ph.D.**, is the Vice-President of Business and Economic Research for the Center for Business and Economic Research at Marshall University. Dr. Kent received a B.A. in economics from Baylor University in Waco, Texas, and a Master of Arts and Ph.D. in philosophy and economics from the University of Missouri. Dr. Kent also has engaged in post-doctorate study in law and economics at the University of Virginia, Chicago University, Wichita State University, and Rice University. He has served as a former staff economist for

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<sup>1</sup> The opinions expressed by the Marshall University and West Virginia University researchers on the West Virginia Tax Modernization Project are their own, and do not reflect the positions of their respective institutional boards of governors nor the West Virginia Higher Education Policy Commission.

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the United States Senate Finance Committee; Chief Economist for the South Dakota Legislative Research Council, where during his tenure, the entire South Dakota State Tax Code was rewritten; served as a consulting economist for the Texas Research League, where he rewrote the Texas property taxes and school aid formula; and was the Co-Vice Chair for 1999 Commission on Fair Taxation.

**Kent Sowards** serves as the Director of Data and Survey Services for Marshall University's Center for Business and Economic Research. Mr. Sowards received a B.A. degree in Management from Marietta College in 1998. He completed his Master's in Business Administration at Marshall University in 1999.

**Jennifer Price** is a Research Associate for Marshall University's Center for Business and Economic Research. Ms. Price received a B.B.A. degree in Finance from Marshall University in 1995. Ms. Price completed her Master's of Business Administration at Marshall University in 1997. Past professional experience includes three years as a full-time instructor in Marshall University's Elizabeth McDowell Lewis College of Business Division of Finance and Economics, and five years of auditing and financial analysis in the banking industry.

**West Virginia University<sup>2</sup>**

**Tom S. Witt, Ph.D.**, is the Director of the Bureau of Business and Economic Research in the West Virginia University College of Business and Economics, a position he has held since 1985. Dr. Witt also serves as a professor of economics at West Virginia University. He received his B.A. degree from Oklahoma State University and his M.A. and Ph.D. degrees from Washington University (St. Louis).

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<sup>2</sup> The opinions expressed by the Marshall University and West Virginia University researchers on the West Virginia Tax Modernization Project are their own, and do not reflect the positions of their respective institutional boards of governors nor the West Virginia Higher Education Policy Commission.

Dr. Witt joined the Department of Economics at West Virginia University in 1970 as an assistant professor, rising to the rank of professor in 1980.

Dr. Witt's research spans the areas of regional economics, public finance, economic development, and energy economics. In recognition of his economic research expertise, Dr. Witt was selected for Who's Who in West Virginia 2000 by The State Journal, West Virginia's leading weekly business newspaper. Dr. Witt is a member of many professional associations, including the American Economics Association, Regional Science Association and the National Association for Business Economics.

**Amy Higginbotham** has been an economist at the West Virginia University Bureau of Business and Economic Research since June 2005. She specializes in economic impact analysis, cost of living analysis, and public finance. Ms. Higginbotham graduated with her Masters in Economics in May 2005 from West Virginia University, and is currently working on a Ph.D. in economics, with an emphasis in Public Finance and Financial Economics.

**Pavel Yakovlev, Ph.D.**, is a Research Assistant Professor of Economics at the Bureau of Business and Economic Research at West Virginia University. His research interests include state and local public finance, public choice, defense economics, and economic growth. Dr. Yakovlev graduated with a B.S. degree in economics from Shepherd University in 2002 with *summa cum laude* and *Phi Kappa Phi* honors. He was awarded the West Virginia University Foundation Distinguished Doctoral Fellowship in Social Sciences while working on his Ph.D. in economics, which he earned from West Virginia University in May 2006.



## **Chapter II**

### ***Background and Development of the Report***



## II. Background and Development of the Report

Governor Manchin, in urging the review and analysis of our present tax system, stressed that input from the citizens of West Virginia is essential to the success of the Tax Modernization Project. Ultimately, it is the citizens of this State who not only will carry the taxation burden, but also will receive the benefit of the revenues derived therefrom. The system of revenue collection, therefore, must be consistent with the desires and values of West Virginians. Accordingly, members of the Project have engaged in extensive inquiry, offering constituents myriad opportunities for idea-sharing. The information extracted from this process has been invaluable.

The emphasis on public collaboration is not new to this Report or to West Virginia tax modernization in general. The 1999 Commission on Fair Taxation sought a significant amount of public input, and attempts at tax development have – throughout the State’s history – placed special focus on community discourse and involvement. In fact, in 1922, State Tax Commissioner Walter S. Hallanan said,

The future growth and development of this great State depends in large measure upon **the ability of its citizens to recognize the necessity for a modernizing of our present tax system and upon their willingness to approve intelligent remedial legislation.** It is evident to all students that many far-reaching changes must yet be made before the State can be said to have a consistent, well-balanced, modern, adequate and equitable system of taxation.

Cognizant of this philosophy and of the Governor’s directive, the Tax Modernization Project obtained public input through a variety of methods.

First, to generate enthusiasm and invite continued public interaction, the Project conducted a kickoff meeting on May 12, 2006, in Charleston, West Virginia. Governor Manchin began the meeting by stressing the importance of tax modernization to the State. He challenged everyone in attendance to “roll up their sleeves” and provide sincere suggestions to improve our tax system. Economists from Marshall University and West Virginia University, in conjunction with key staff



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members of the Department of Revenue, including the Office of the Secretary, State Budget Office and the State Tax Department, made presentations concerning our State's economy, tax structure, and budget. Attending this meeting were representatives from the Governor's Office, the Department of Revenue, various Constitutional Officers, Cabinet Secretaries and Commissioners from other State Departments, former Department of Revenue Secretaries and former State Tax Commissioners, and representatives from the Legislature. This meeting also was the first opportunity for the Project members to collaborate with a number of key private sector leaders representing labor, business and industry, energy and environment, natural resources, construction, health care, retail, and various other constituencies.

At the kickoff meeting, these leaders of our State were given a task: meet with their respective peers to study the tax system in West Virginia and work to recommend changes for modernization. A questionnaire<sup>3</sup> was provided and also was made available to the public via the Project website at <http://www.wvtax.gov/tmp.htm>.<sup>4</sup>

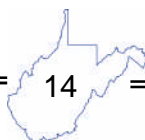
A second public meeting was conducted on July 6, 2006, at the Charleston Civic Center. This event, called the Tax Summit, gave West Virginia citizens another opportunity to discuss alternatives for changing the State tax system. More than 300 people attended the Summit, including State legislators; representatives from business, labor, and other interest groups; local government officials; economists; and experienced tax professionals from both the public and private sectors.

After Secretary Musgrave opened the Summit, State Tax Commissioner, Virgil Helton, served as moderator for the day. The first person to address the group was the Honorable Robert S. Kiss, Speaker of the House of Delegates, who delivered his thoughts on tax modernization, focusing on the lessons learned from

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<sup>3</sup> The Informal Questionnaire is attached as Appendix A.

<sup>4</sup> Additionally, the Project invited questions or other feedback by electronic mail to [tmp@tax.state.wv.us](mailto:tmp@tax.state.wv.us).



the 1985 tax reform and the resultant 1989 tax increases. Speaker Kiss also discussed the actions of the Legislature over the past 18 years, noting the Legislature's high degree of fiscal responsibility during that time. He pointed to the Legislature's diligence ascertaining the depth of, and then having begun managing and paying down, the State's significant unfunded liabilities. The Speaker particularly imparted the importance of continued vigilance in seeking to solve the State's long-term debt problems.

Governor Manchin then addressed the group on his vision for a better, brighter future for all West Virginians. The Governor discussed the importance of conducting State government activities in a business-like manner, specifically identifying two important concerns. First, he noted that we must ensure that the State provides superior services to its customers, the citizens of West Virginia. Second, the Governor echoed the sentiments of Speaker Kiss, stressing the importance of the State achieving financial order and operating in a fiscally prudent manner, making certain that the government has the ability to pay for the services it is obligated to provide. The Governor also reminded those present that the State must make changes to its tax system so that we can continue to work together to make the State of West Virginia "Open for Business."

Following Governor Manchin's comments, Dr. Tom Witt and Dr. Calvin Kent teamed with the State Budget Director, Roger Smith, and the State Director of Fiscal Policy, Mark Muchow, to make presentations about West Virginia's existing tax structure, the current budget outlook, and the policies that should serve as the fundamental building blocks of any system of taxation.

The Tax Summit participants then were divided into topic-oriented workgroups. Each Summit participant was assigned to a room that dealt with one of four subjects: **Business Taxes, Personal Income Taxes, Property Taxes and Local Government Finance**, and the **State Road Fund**. Each group was comprised of approximately 20 individuals. During the morning session, every group member was given the opportunity to articulate issues that he or she regarded as

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problematic to our system of taxation. Moderators facilitated the group discussions, and subject matter experts were available to answer technical questions.

During a networking lunch, Summit participants were treated to a presentation by Harley Duncan, Executive Director of the Federation of Tax Administrators. Mr. Duncan provided a lot of experience and insight to the Summit. He has served as Executive Director of the Federation of Tax Administrators since August 1988, and he has previously served as Secretary of the Kansas Department of Revenue, as well as positions with state government in South Dakota. During his presentation, Mr. Duncan highlighted some tax reform successes and failures of other states, emphasizing the need for diligence and collective agreement in making changes to any system of taxation.

After lunch, participants returned to the workgroups to develop at least four solutions that would combat the problems the group identified in the morning session, and that also would further the modernization of State and local taxation.

At the end of the Summit, the groups reconvened in one area, so that each group could share its report with all attendees. By the conclusion of the Summit, dozens of problems had been identified, with solutions proposed for each issue.<sup>5</sup>

The Tax Modernization Project provided the public with further opportunity to participate in the tax modernization process by teaming with the Chancellor of the Higher Education Policy Commission and eight colleges and universities around the State to conduct public hearings. At each hearing, citizens were given the opportunity to provide feedback, thoughts, and criticisms concerning our tax system. In an effort to reach as many people as possible, and to accommodate concerned individuals in every geographic region, the hearings were scheduled throughout the State during the months of August and September 2006 at the following institutions of higher learning:

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<sup>5</sup> The Tax Modernization Project had the recommendations recorded and transcribed. The transcription is included as Appendix B.

- Marshall University;
- West Virginia University at Parkersburg;
- Shepherd University;
- West Liberty State College;
- West Virginia State University;
- Concord University;
- West Virginia University; and
- Pierpont Community and Technology College.

Project members have engaged in an ongoing effort to disseminate information and solicit input for the tax modernization process by securing speaking engagements with various groups and organizations, including:

- West Virginia Association of Counties;
- West Virginia Association of Engineers;
- West Virginia Association of Retired School Employees;
- West Virginia Bankers' Association;
- West Virginia Business Summit;
- West Virginia Chamber of Commerce;
- West Virginia Farm Bureau;
- West Virginia Forestry Association;
- West Virginia Hospitality and Tourism Association;
- West Virginia Manufacturers' Association;
- West Virginia Municipal League;
- West Virginia Oil and Natural Gas Association;
- Putnam County Chamber of Commerce;
- West Virginia Retailers' Association;
- West Virginia School Superintendents
  - Annual Meeting, and
  - Meeting of eight County Superintendents from small school districts;

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- West Virginia Sheriff's Association;
- West Virginia Society of Certified Public Accountants:
  - Annual Meeting,
  - State and Local Taxation Committee,
  - Industry and Government Professionals,
  - Charleston Chapter Meeting, and
  - Huntington Chapter Meeting;
- West Virginia State Bar's Taxation Committee;
- West Virginia State Finance Officers' Association;
- West Virginia Tax Institute; and
- West Virginia Woodland Owners' Association.

The Tax Modernization Project team also addressed the Legislature. On July 23, 2006, during Legislative Interim Committee meetings, the Project members made a presentation to the entire Legislature in the Chamber of the House of Delegates.

Much like the West Virginia Tax Study Commission of 1984, the Tax Modernization Project undertook review of our current system of taxation by breaking into four study groups: the Business Tax Subgroup; the Personal Income Tax Subgroup; the Property Taxes and Local Government Finance Subgroup; and the State Road Fund Subgroup. Over the summer and into the fall, various members of the Project began meeting in these subgroups to contribute a wide range of expertise, to apply those skills to analyze the input received over the course of the year, and to endeavor to develop proposals for modernization. Each subgroup identified goals for its particular area of taxation, detailed the current taxation scheme for that area, identified problems and issues for study, and eventually developed, to the extent possible, ideas for modernizing our system of taxation. The culmination of the Subgroups' efforts is described in Chapters VII through XI of this Report.

Finally, it is important to note that the individuals involved with the Tax Modernization Project also reviewed tabulations of the responses of the Informational Questionnaire referred to above and set forth in Appendix A. A total of 182 on-line and mailed questionnaire responses were received. Each was reviewed and included for consideration.<sup>6</sup> A full analysis of the input provided from the public is attached as Appendix B.

The overwhelming majority of informational questionnaires were completed by individuals or representatives of businesses. Respondents reported affiliation with a wide variety of industries through the selection of a broad industry code (based upon the North American Industrial Classification System). However, many failed to provide an industry affiliation. Roughly two-thirds of respondents indicated that they considered themselves either “familiar” or “quite familiar” with West Virginia’s tax structure.

Respondents most often cited the Property Tax as the top tax issue in the State. Specifically, the tax on personal property concerned many respondents, including the tax on vehicles and the tax on inventories. Other broad taxes that elicited a significant amount of responses included the Consumers Sales and Service Tax (including the sales tax on food), the Corporation Net Income Tax, the Business Franchise Tax, the Personal Income Tax (specifically, the tax rates), and the Municipal Business and Occupation Tax.

These concerns and recommendations received by the Tax Modernization Project have helped to focus and guide the members of the Project as we have moved forward on this task. The Tax Modernization Project members are proud of the fact that a significant number of West Virginians were willing to provide meaningful input into West Virginia’s tax system. Moreover, we hope that this Report will help further the dialogue necessary to make positive changes to the current tax system. We do note, however, that although many respondents made

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<sup>6</sup> The survey database also contained some records without responses to the questions. The tabulations are based only on those surveys with a response to at least one of the major questions.

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suggestions for tax reductions or eliminations, respondents had great difficulty in coming up with alternative ways to pay for the reductions. An effort at tax changes comes not only with the responsibility to make sound changes to the system of taxation, but also to ensure that the State has sufficient resources to meet the expected expenditures mandated by the citizens.

## **Chapter III**

# ***Principles of the Tax Modernization Project***





### III. Principles of the Tax Modernization Project – the Standards of a Good Tax System

The Tax Modernization Project members recognized that it would not be prudent to offer suggestions about the tax structure without first identifying the components of a successful tax system. Over the years, a great deal of time has been devoted to such study, and many groups have provided elements that should form the basis of any tax system. For example, the National Center for State Legislatures has concluded that a high-quality state revenue system:

1. Comprises elements that are complementary, including the finances of both state and local governments;
2. Produces revenue in a reliable manner, with an emphasis on stability, certainty, and sufficiency;
3. Relies on a balanced variety of revenue sources;
4. Treats individuals equitably by, at a minimum, imposing similar tax burdens on people in similar circumstances, limiting regressive activity, and curtailing taxes on low-income individuals;
5. Facilitates taxpayer compliance based on ease of understanding and minimization of compliance costs;
6. Promotes fair, efficient, and effective administration, emphasizing simple and professional administration, efficiency in the raising of revenue, and uniform application;
7. Is responsive to interstate and international economic competition;
8. Minimizes its involvement in spending decisions and makes any such involvement explicit; and
9. Is accountable to taxpayers.<sup>7</sup>

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<sup>7</sup> National Center for State Legislatures, “Principles of a High Quality Revenue System,” available online at <http://www.ncsl.org/programs/fiscal/fpphqrs.htm#principles>.

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Similar principles were recurrent in the conclusions of various studies. The members of the Project condensed the range of considerations into four fundamental categories: (1) efficiency; (2) equality/fairness; (3) revenue adequacy; and (4) simplicity/accountability. These components are essential to a successful system of taxation for West Virginia. Each is described in greater detail below.

### **A. Efficiency**

An efficient tax system encourages economic growth and job creation, and does not impede or reduce the productive capacity of the economy. It allows West Virginia taxpayers to remain competitive with those in other states. This concept is related to some degree to that of equality, and specifically to the role that neutrality plays in encouraging an equitable system, as mentioned below. As others have noted: “economic growth and efficiency is impeded by tax rules that favor a particular industry or investment thereby causing capital and labor to flow to such areas for reasons not supported by economic factors which can potentially harm other industries and investments, as well as the economy as a whole.”<sup>8</sup> For example, the State of West Virginia in 2002 successfully eliminated several ineffective credits that had improperly affected market decisions. The State should attempt to develop a tax system that is consistent with the existing economic principles and objectives of West Virginia.

### **B. Equality and Fairness**

This principle is simply stated: “Similarly situated taxpayers should be taxed similarly.”<sup>9</sup> It also has been observed that an equitable tax system has minimal impact on low-income taxpayers. The concept of equity is more complicated than it seems, however, inasmuch as the term “fair” is somewhat subjective. In any event,

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<sup>8</sup> American Institute of Certified Public Accountants, “Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals,” at 13, available online at <http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf>.

<sup>9</sup> *Id.* at 9.

to determine whether a system is equitable, lawmakers should consider the range of taxes levied on each taxpayer, rather than evaluating any single tax in isolation.

One of the predecessors to the Tax Modernization Project, the 1999 Commission on Fair Taxation, suggested a number of factors that would contribute to a fair system. For one, it determined that a tax system should be based on the taxpayers' ability to pay. Though current income often is regarded as the measure of ability to pay, other measures of ability to pay like wealth, which cannot be manipulated between tax years, and consumption, should not be disregarded. Various taxes draw strength from different indicators. For example, personal income tax is based on current income, estate and gift taxes draw on wealth, and sales taxes are coextensive with consumption.

Another related concept adopted by the 1999 Commission on Fair Taxation to develop a fair system was the belief that each taxpayers' burden should reflect the benefit that he or she receives from government. In order to be a fair tax system, the taxes collected should match the benefits that taxpayers receive. Thus, general benefits from the government are best supported by all taxes, while benefits used by a limited number of individuals are paid for through the receipt of specific taxes.

### **C. Revenue Adequacy**

The tax system should produce a stable yield in excess of collection costs, and the yield should be sufficient to balance the State budget in the short run and should change at approximately the same rate as government spending as the economy grows. It should be capable of financing government services that citizens and lawmakers have labeled important, at levels that have been deemed appropriate. The need for stability is especially important to a state like West Virginia that operates under a balanced budget requirement, where the State must predict the amount of revenue it expects to receive.

This also means that the administrative cost should be as low as possible, so that minimal intake is expended on collection. With this principle in mind, it is noted that narrow, inefficient taxes often are a greater burden on the tax system than

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broad-based efficient taxes because the return from a narrow tax must be stretched to cover administration. West Virginia has taken several recent steps to help reduce the administrative costs of its tax system. First, the State entered into the Streamlined Sales Tax Agreement, which will greatly decrease the burden of sales tax collection on businesses. Second, the State Tax Department is currently installing an integrated tax system, as explained below in Chapter IV.

Adequacy can be achieved by diversifying the tax base. When taxes are collected from a variety of sources, the entire tax structure is less likely to feel the effects of economic changes. Furthermore, broad-based taxes make lower rates possible. For these reasons, broad-based taxes are preferable. It also is important, however, that tax burdens remain low, consuming as little income as possible, so not to interfere with economic growth or diminish capital investments.

Revenue adequacy is a special concern for West Virginia. Due to below-average economic capacity and a tax structure that places significant limits upon residential property taxes, West Virginia's per capita total State and local tax collections are less than 80 percent of the average state. West Virginia is, therefore, a low-tax capacity state. Below-average tax revenues result in less-than-adequate government services. However, demand for State and local government services in West Virginia tend to be similar to demand in neighboring states. Members of the Project note that over the past several months many groups proposed increasing governmental services, ranging from increased spending on health care and transportation to salary increases. In light of these demands and other demands for government spending, members of the Tax Modernization Project feel that revenue adequacy is important. As such, any proposals to significantly lower tax collections will have to be monitored closely to ensure that the State of West Virginia retains the ability to meet its required expenditures.

**D. Simplicity and Accountability**

When the tax structure is easy to understand, or “transparent,” and when payment is as convenient as possible to the taxpayer, voluntary compliance increases. There are at least two reasons for the improved compliance: first, taxpayers are not asked to navigate complex requirements; and, second, taxpayers are able to confirm that the system is equitable. The increased compliance leads to lower costs associated with enforcement.

A tax system should also be accountable in providing sufficient knowledge to evaluate the system. To that end, any legislative action should be open with full opportunity provided for public commentary.

These goals are served by maintaining stable laws. The Tax Foundation suggests that changes to tax laws should not occur frequently. Such instability impedes long-term planning and increases economic uncertainty. Taxpayers must be afforded some degree of confidence in the system under which they operate. For this reason, retroactive changes also are discouraged. The Project members believe, nevertheless, that the system should be subject to ongoing review to ensure that the State taxation system continues to meet these four goals described above.



## **Chapter IV**

# ***West Virginia's System of Taxation: A Historical Perspective***





#### IV. West Virginia's System of Taxation: A Historical Perspective

When Governor Manchin charged the Tax Modernization Project with its mission, he directed the group to provide a history and overview of our system of taxation. The reason is simple. Prior to proposing any significant changes to West Virginia's system of taxation, it is necessary not only to examine the current state of affairs, but also to attempt to understand the development of the fundamental underpinnings of our tax system. Only with a proper understanding of the specifics of the system – including its history and development – can we begin to intelligently determine whether any changes are needed and the extent of modification required. As has been said time and time again, “Those who cannot learn from history are doomed to repeat it.”<sup>10</sup> As explained below, this history can be broken into several broad categories or eras, each showing the continued evolution of our system of State and local taxation.

First, it is important to understand the constitutional structure that was adopted at the formation of the State by engaging in a brief analysis of taxation in the Commonwealth of Virginia and continuing through West Virginia's Constitutions of 1863 and 1872. The next era, which lasts from the adoption of the 1872 Constitution until the 1930s, includes an analysis of issues of the day concerning local taxation and the growth of State level taxation. The third portion of this Chapter of the Report focuses on the Tax Limitation Amendment of 1932 and the landmark changes that resulted from its adoption. This Report also examines the permanent establishment of the personal and corporate income taxes in the 1960s

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<sup>10</sup> George Santayana. It is important to note that this history is neither exhaustive nor cumulative, but is instead intended to provide a basic overview of the development of our tax system so that the citizens and elected officials of this State can properly evaluate and consider the recommendations and issues contained in this Report. Two sources have been heavily relied upon in developing this history. First, beginning in 1905 and continuing through today, the Biennial Report of the State Tax Commissioner has been published regularly. Second, in the 120-year span between 1884 and 2003, the State of West Virginia has commissioned several reports to examine all or significant parts of our system of State and local taxation. Those sources, when combined with available literature, provide great insight into the development of and the rationale behind our current system of taxation.

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and the development of the tax structure prior to the 1980s. Then, this section of the Report turns to the State's most recent comprehensive tax reform, which occurred in the 1980s. This included the repeal of the State Business and Occupation Tax (on most businesses) in 1987 and the significant tax increases that were enacted in 1988 and 1989. Finally, although not necessarily categorized as tax reform, the last portion of this Chapter details the significant tax changes that have occurred to our system of State and local taxation since 1989, including the 2002 review and overhaul of the State's tax credits, our recent entry into the Streamlined Sales Tax Project, and the current process of installing the State Tax Department's new integrated tax system.

### **A. Taxation in the Commonwealth of Virginia in the 1800s and West Virginia's 1863 and 1872 Constitutions**

To understand our system of taxation, we logically begin with a survey of the provisions relating to taxation in our State's first Constitution in 1863, including an analysis of the reasoning behind the adoption of those provisions and how our Constitution has changed with respect to taxation since the State was founded. Indeed, one must look prior to West Virginia's formation to an analysis of the Virginia Constitution of 1851 governing those areas of West Virginia that were part of the Commonwealth of Virginia prior to our Statehood. An examination of Virginia's Constitution is important for two reasons. To begin with, West Virginia's first and second Constitutions (adopted in 1863 and 1872) relied heavily on Virginia's Constitution.<sup>11</sup> Moreover, many of the differences between Virginia's Constitution and West Virginia's Constitution "were direct responses to disputes between the east and west about particular provisions of the Virginia Constitutions."<sup>12</sup>

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<sup>11</sup> Robert M. Bastress, "The West Virginia Constitution: A Reference Guide" (1995), at 1 (hereinafter "Bastress"). Professor Bastress's commentary and analysis is an excellent source of information concerning West Virginia's constitutional structure.

<sup>12</sup> *Id.* at 1.

During the 1800s, significant disputes arose between the eastern and western portions of Virginia. The disputes between the east and west became so contentious that a constitutional convention was called for in 1850. With respect to taxation, the key facts relate to the development of the Virginia Constitution of 1851. In this 1851 Constitution, assessments for all property were to be at true value. In fact, taxation was to be “equal and uniform.” There were, however, exemptions embedded in the Constitution that benefited property predominantly located in the Tidewater Basin of Eastern Virginia. Accordingly, “citizens in the west were to pay on the full value of their real estate and livestock, while easterners would be assessed on only a fraction of the ever-increasing value of their [property].”<sup>13</sup> This conflict, embedded in the Virginia Constitution, led to great turmoil and unhappiness in the west, and “ultimately became one of the reasons why the western counties failed to follow the commonwealth into secession.”<sup>14</sup>

There are a few pertinent facts in West Virginia’s move toward statehood and the development of its own Constitution in 1863.<sup>15</sup> In January 1861, the General Assembly of Virginia called for a convention to determine whether to secede. In April 1861, the Convention voted in favor of secession (with the western part of Virginia overwhelmingly opposed), subject to a statewide referendum scheduled for May. At the same time, on April 22, 1861, a large meeting was held in Clarksburg to discuss these matters, at which a proclamation was issued calling for an additional assembly in Wheeling. On May 13, 1861, that second meeting was held in Wheeling, denouncing the secession and calling for yet another assembly in Wheeling that June in the event that the referendum was affirmed. On May 23, 1861, the secession ordinance was affirmed, and, true to their word, more than four hundred delegates convened in Wheeling on June 11, 1861. During this

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<sup>13</sup> Bastress at 8-9. The property in question was “slave property.”

<sup>14</sup> Bastress at 240.

<sup>15</sup> See generally West Virginia Archives and History, available online at [www.wvculture.org/history/statehood](http://www.wvculture.org/history/statehood).

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meeting, the delegates created the “Re-Organized Government of Virginia,” calling for a General Assembly and a constitutional convention for later in 1861.

The First Constitutional Convention of West Virginia began in November 1861, and continued until February 1862. The delegates at this First Constitutional Convention spent a significant amount of time discussing taxation. Delegate J.W. Paxson stated, for example:

I apprehend that there can be little doubt in the mind of anyone that the fundamental cause of this division and desire for a new state may be found in the injustice and oppression which our people have suffered from unequal taxation, from oppressive taxation and unequal representation.<sup>16</sup>

On the second day of the Convention, the delegates appointed the Committee on Taxation and Finance. The result of the dialogue was Article VIII of the Constitution of 1863, the “Taxation and Finance” article, which provided as follows:

Taxation shall be equal and uniform throughout the State, and all property, both real and personal, shall be taxed in proportion to its value, to be ascertained as directed by law. No one species of property from which a tax may be collected, shall be taxed higher than any other species of property of equal value; but property used for educational, literary, scientific, religious or charitable purposes, and public property, may, by law, be exempted from taxation.<sup>17</sup>

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<sup>16</sup> Debates and Proceedings of the First Constitutional Convention of West Virginia, Volume III, at 54-55.

<sup>17</sup> Constitution of West Virginia, Article VIII, § 1, available online at [www.wvculture.org/history/statehood/constitution.html](http://www.wvculture.org/history/statehood/constitution.html). Article VIII also provided, “A capitation tax of one dollar, shall be levied upon each white male inhabitant who has attained the age of twenty-one years.” Additionally, it is important to note that the Constitution of 1863 required the Legislature to “provide for an annual tax, sufficient to defray the estimated expenses of the State for each year; and whenever the ordinary expenses of any year shall exceed the income, shall levy a tax for the ensuing year, sufficient, with other sources of income, to pay the deficiency, as well as the estimated expenses of such year.” W. Va. Const., Article VII, § 3.

These changes are illustrative of the discord between the east and west with respect to taxation. As one commentator has stated, “Having grown to thoroughly resent the tax break given the wealthy eastern slave owners in the 1851 Constitution, the delegates ensured their new state would not enact similar inequities.”<sup>18</sup> Thus, although the West Virginia Constitution of 1863 used language borrowed from the Virginia Constitution of 1851 (i.e., taxation was to be “equal and uniform”), it did not include exemptions similar to those in place in Virginia. More importantly, **all property** was to be taxed in proportion to its value, except for the narrow categories of public property and property being used for educational, literary, scientific, religious, or charitable purposes.

West Virginia became a State on June 20, 1863, under the Constitution of 1863. Eight years later, the voters of West Virginia called for a Second Constitutional Convention to be held in Charleston. The Second Convention had its first meeting on January 18, 1872, and finished its business on April 9, 1872, by proposing a new Constitution. The voters of the State of West Virginia approved the new Constitution in the summer of 1872. Although amended more than 60 times since its adoption, the Constitution of 1872 remains in effect today.

The “Taxation and Finance” provisions contained in the 1863 West Virginia Constitution were left largely intact, with few changes made. Changes between the Constitutions of 1863 and 1872 are set forth below. Section 1 of the Taxation and Finance provisions of the 1872 Constitution reads as follows:

Taxation shall be equal and uniform throughout the State, and all property, both real and personal, shall be taxed in proportion to its value, to be ascertained as directed by law. No one species of property, from which a tax may be collected, shall be taxed higher than any other species of property of equal value; but property used for educational, literary, scientific, religious or charitable purposes; **all cemeteries** and public property, may, by law, be exempted from taxation. **The Legislature shall have power to tax, by uniform and**

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<sup>18</sup> Bastress at 12.

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**equal laws, all privileges and franchises of persons  
and corporations.**<sup>19</sup>

Clearly, delegates to the 1872 Convention remained concerned with equal and uniform taxation, and especially the equal treatment of property for tax purposes.

This section differed from the 1863 Constitution in only two respects, as is indicated in bold. First, the Legislature was given the authority to exempt all cemeteries from taxation. Second, and importantly, the Legislature was given the authority to tax – **by uniform and equal laws** – all privileges and franchises of persons and corporations.<sup>20</sup>

In apparent concern about the over-taxation of property in the State, the 1872 Constitutional Convention placed additional restraints on such taxation. Section 7 of the Taxation and Finance provisions of the 1872 Constitution read as follows:

County authorities shall never assess taxes, in any one year, the aggregate of which shall exceed ninety-five cents per one hundred dollars valuation, except for the support of Free Schools; payment of indebtedness existing at the time of the adoption of this Constitution; and for the payment of any indebtedness with the interest thereon, created under the succeeding section, unless such assessment, with all questions involving the increase of such aggregate, shall have been submitted to the vote of the people of the county, and have

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<sup>19</sup> W. Va. Const. art. X, § 1 (emphasis added), available online at [www.wvculture.org/history/government/1872constitution.html](http://www.wvculture.org/history/government/1872constitution.html).

<sup>20</sup> As in the 1863 Constitution, the 1872 Constitution's Section 2 of the Taxation and Finance provisions related to a capitation tax. The provisions in the 1872 Constitution read as follows: "The Legislature shall levy an annual capitation tax of one dollar upon each male inhabitant of the State, who has attained the age of twenty-one years, which shall be annually appropriated to the support of free schools. Persons afflicted with bodily infirmity may be exempted from this tax." Three changes were made to this section. First, all males were made subject to the tax. Second, the moneys from the capitation tax were dedicated to support education. Finally, the last sentence of this section was added. As noted below, the capitation tax was repealed by an amendment to the West Virginia Constitution in 1970.

received three-fifths of all the votes cast for and against it.<sup>21</sup>

Two remaining provisions are worth mentioning. First, the Legislature was empowered to “authorize the corporate authorities of cities, towns, and villages, for corporate purposes, to assess and collect taxes.” Again, concerned about consistency, this authority was limited by the requirement that “such taxes shall be uniform, with respect to persons and property within the jurisdiction of the authority imposing” the tax. Finally, the 1872 Constitution confirmed that the authority of the Legislature with respect to taxation extended to “provisions for the payment of the State debt, and interest thereon, the support of Free Schools, and the payment of the annual estimated expenses of the State.”

**B. Continued Development: 1872 through 1932**

The discussions concerning the 1863 and 1872 Constitutions in West Virginia indicate that the greatest concern with respect to taxation for West Virginia’s founding fathers at our Constitutional Conventions was the taxation of property. This focus was well founded. Virginia’s system of taxation at the time of secession relied heavily upon the taxation of property. Moreover, at the time of West Virginia’s formation in 1863, real and personal property were the most readily available source for taxation. Indeed, West Virginia’s undeveloped economy in its formative years was based heavily on agriculture, and such property was in reality the only available source for taxation. As the 1999 Commission on Fair Taxation stated:

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<sup>21</sup> Additionally, counties, cities, school districts, and municipal corporations were limited in their ability to authorize bonds in that bonds were not allowed to be issued in an amount “including existing indebtedness, in the aggregate, exceeding five per centum on the value of the taxable property therein to be ascertained by the last assessment for State and county taxes.” W. Va. Const., art. X, § 7. The local governmental entities also had, at the time of issuing debt, to provide for a “direct annual tax, sufficient to pay, annually, the interest on such debt, and the principal thereof, within, and not exceeding thirty-four years.” *Id.* Finally, no debt could be issued “unless all questions connected with the same shall have been first submitted to a vote of the people, and have received three-fifths of all the votes cast for and against the same.” *Id.*



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In 1863, West Virginia became the 35<sup>th</sup> State in the Union. At that time, West Virginia was still primarily an agricultural state with pockets of industrial development. Much of the economic activity in the State involved either making your own clothes, growing your own food or the barter system. Thus, the property tax was the primary source of generating public revenues since property was the only thing that could be taxed to any appreciable degree.<sup>22</sup>

As such, during the first fifty years of West Virginia's existence, revenues were derived primarily from *ad valorem* real and personal property taxes, and those taxes were administered, collected, and used almost exclusively at the local level. Indeed, until 1904, the State of West Virginia did not have a state tax commissioner to oversee the State's system of state and local taxation, and local officials were solely charged with taxing authority.

Thus, it is fair to conclude that during its initial few decades of existence, the State did not have an elaborate scheme of taxation. Indeed, when compared to the current tax structure, which involves a high degree of centralization, resources at the State level were very limited prior to the 1930s.

Given these facts, the first fifty years of development of the State's system of taxation can be divided into three categories. First, the State was very concerned about equal treatment and attempted to ensure that taxes were uniform, as embodied (a) in the law, (b) in administration, and (c) in collection. Second, the State struggled with providing sufficient resources necessary to pay for the expenses and policies of the State. Finally, as time passed, a belief surfaced that the Constitution of 1872, with respect to property taxation, was too limited and restrictive upon the Legislature. As explained below, the struggle with these issues caused West Virginia to examine its system of tax administration in the early 1880s, only twenty years after the formation of the State.

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<sup>22</sup> The Governor's Commission on Fair Taxation, Recommendations to the Governor (1999), at 2-71 ("1999 Commission on Fair Taxation").

For example, in the early 1880s, the State of West Virginia became concerned with its system of revenue collection, and the first recorded study of our system of taxation was ordered. Specifically, the West Virginia Tax Commission was created to study and report on the problems associated with West Virginia's tax structure.<sup>23</sup> The Commission was directed to "ascertain and report such facts and suggestions as would enable the Legislature to give effect to Section 1, Article X of the Constitution."<sup>24</sup> Moreover, the Commission was to collect and report such information as will enable the "Legislature to legislate intelligently and with safety upon subjects calculated to promote the development of the resources of this State."<sup>25</sup> The Commission concluded that three problems existed in taxing property:

1. How to get all the property on the assessor's books;
2. How to procure the fair valuation of listed property; and
3. How to compel each person to pay the assessed tax amount.

With respect to getting all of the property on the assessor's books, the Commission made a distinction between visible property (e.g., land and horses) versus invisible property (e.g., stocks, bonds, and money). Generally speaking, the Commission was of the opinion that much invisible property escaped taxation in West Virginia, and it made several suggestions with respect to subjecting invisible property to taxation.<sup>26</sup>

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<sup>23</sup> Preliminary Report of the 1884 West Virginia Tax Commission at 3-5.

<sup>24</sup> *Id.* at 5.

<sup>25</sup> *Id.* at 5. See also Final Report of the 1884 West Virginia Tax Study Commission at 4 ("This Commission was appointed to collect and bring within the reach of the members of a Legislature the character of information which will enable them to act with intelligence and safety.").

<sup>26</sup> Final Report of the 1884 West Virginia Tax Study Commission at 8-10 ("In view of what has been published we presume that the Legislature will be disposed to adopt measures which will be more effective than the present statute, to reach and place on the tax books such invisible property as has heretofore escaped the assessor.").

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With respect to fair valuation, the Commission concluded that “in some counties property is assessed at its full market value, yet in others it is rated at one-half and others again at less than half.” The Commission indicated that the lack of uniform standards, due in part to the State’s failure to create a statewide office to deal exclusively with the administration of tax laws, contributed to this problem.<sup>27</sup> As with the Constitutional Conventions of 1863 and 1872, the Commission Report, delivered in 1884, was enamored with the fair and equal taxation of property. Despite the Commission’s recommendations, the Legislature, in the wake of the 1884 Report, did not make any landmark changes to the system of revenue collection before it decided to obtain another study in 1901.<sup>28</sup>

On February 20, 1901, the West Virginia Legislature authorized the appointment by the Governor of a new State Tax Commission to perform a study and report to the Legislature:

What changes are required in the tax assessment of revenue laws of this State, to equalize taxation, to reach property, firms, persons, and corporations not now bearing their just proportion to the burdens of taxation, and to raise the necessary amount of revenue, with the least possible burden upon the people and property of the State, and to secure a proper disbursement of the same.<sup>29</sup>

In this Report, issued in late 1902, the Commission was concerned that the property values of the State were low and not uniform, and that the State lacked

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<sup>27</sup> Preliminary Report of the 1884 West Virginia Tax Commission at 7-8, 12-19. The 1884 Commission concluded that only a small amount of individuals failed to pay taxes.

<sup>28</sup> As the Legislature found in 1901: “The system of tax assessment and revenue laws and laws in relation to disbursement of revenue, now in force, in this State, is substantially the same as that adopted at the organization of the State.” Preliminary Report of the West Virginia Commission on Taxation and Municipal Charters at 1 (1902) (citing Joint Resolution No. 15 from the 1901 Legislature). It is important to note, however, that the State of West Virginia enacted an inheritance tax in 1887.

<sup>29</sup> *Id.*

sufficient revenues to cover its expenses. The Commission believed that these problems could be solved with one action: The Commission proposed providing sources of “State revenues entirely separate and distinct from those which county and local revenues can be derived.”<sup>30</sup> Reliance on State collection would also, in turn, create statewide uniformity in administration and collection of those taxes.

The 1901 Commission also looked for ways to increase uniformity at the local level, specifically focusing on inequalities between districts and individuals; the expediency of ensuring full valuations of property; and the need to ensure that intangible personal property was properly valued. As the 1884 Commission had focused on the problem with “invisible property,” the 1902 Report concluded that much intangible personal property was not properly reported. Finally, like the 1884 Report, the 1902 Report also recommended the appointment of a state tax commissioner.

Although the Legislature did not immediately act upon the 1902 Report, Governor A. B. White called it into Extraordinary Session during the summer of 1904. In that session, several changes were enacted with respect to our system of taxation,<sup>31</sup> including the creation of the Office of the State Tax Commissioner,<sup>32</sup>

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<sup>30</sup> *Id.* (“Early in its deliberations, the Commission was impressed with the importance of raising revenues sufficient for general State purposes, and for the State’s share of the support of free schools, without levying any tax upon property real or personal in the State.”)

<sup>31</sup> First Biennial Report of the State Tax Commissioner at 6.

<sup>32</sup> As part of the creation of the Office of the State Tax Commissioner, the Legislature mandated that this newly-created official was responsible for preparing “a report in writing to the governor biennially, on or before the first day of October next preceding the regular session of the Legislature, in which he shall show his official transactions during the period not covered by any preceding report; shall give information respecting the operation of the tax laws throughout the State; and shall recommend such changes in the laws concerning the assessment and collection of taxes, and kindred subjects, as he may think ought to be made, and shall report upon any special matter which may be referred to him by the governor, auditor or board of public works; his report shall be printed, communicated to the Legislature and distributed as in the case of other like reports.” W. Va. Code § 11-1-4. In the First Biennial Report, the State Tax Commissioner confirmed that the creation of the new statewide office had been long in demand to ensure that the revenue laws of the State were faithfully executed and based on calls for changes to the system of taxation: “The

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which was intended by the Legislature to “see that the laws concerning the assessment and collection of all taxes and levies, whether of the State or any county, district, or municipal corporation thereof, are faithfully enforced.”<sup>33</sup>

As the State moved forward, beliefs began to surface that it needed to review Section 1 of Article X of the West Virginia Constitution. In 1908, State Tax Commissioner White concluded:

Under [Section 1, Article X], of the Constitution the State is wedded to the *ad valorem* or general property tax system. The command of West Virginia’s Constitution is that all property shall be taxed and taxed at a uniform rate. **It should be borne in mind that this Constitution was adopted in 1872, before the State began to develop and at a time when there was little to tax except real estate and tangible personal property. The presently developed industrial conditions call for a change in the Constitution.**<sup>34</sup>

The State Tax Commissioner further explained his reasons for such a claim. First, he believed that there should be a separation of sources upon which State

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necessity for such a department had long been felt in this State, and is the result of a growing demand and agitation for a more modern tax system for the past decade.” First Biennial Report of the State Tax Commissioner at 5.

<sup>33</sup> First Biennial Report of the State Tax Commissioner at 5, 11-12. Other changes included shifting the basis of property valuation from “fair cash value” to “true and actual value,” making each county a single unit for assessment purposes; charging assessors with valuing both real and personal property and including such values in land books; moving toward the reassessment of all real property in the State; and providing that the Board of Public Works was to assess the property of all public service corporations.

<sup>34</sup> Second Biennial Report of the State Tax Commissioner at 14 (emphasis added). The Commissioner also relied upon studies by a then recent International Tax Conference, which resolved in 1908 that, “The greatest inequalities have arisen from laws designed to tax all the widely differing classes of property in the same way, and such laws have been ineffective in the production of revenue . . . . The appropriate taxation of various forms of property is rendered impossible by the restrictions upon the taxing power contained in the constitution in many states.” *Id.* at 14-15. On this basis, the International Tax Conference resolved that “all state constitutions requiring the same taxation of all property, or otherwise imposing restraints upon the reasonable classification of property, should be amended by the repeal of such restrictive provisions.” *Id.* at 15.

and local revenues are derived. Second, he believed that the Legislature ought to be given more flexibility in terms of taxation.<sup>35</sup> Indeed, as explained below, subsequent State Tax Commissioners made the same calls for reform to our Constitutional structure during the 1910s and 1920s.<sup>36</sup>

As individuals in West Virginia contemplated changes to the West Virginia Constitution during the 1910s and 1920s, leaders also were focused on ensuring that the State had sufficient resources to meet its expenses. Until 1914, the State of West Virginia derived its income from three sources:

1. A direct levy on real and personal property;
2. A charter or license tax on corporations;<sup>37</sup> and

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<sup>35</sup> Second Biennial Report of the State Tax Commissioner at 15-16.

<sup>36</sup> Two years later in 1910, State Tax Commissioner Townsend stated the following concerning Section 1 of Article X:

Here is the weight that pulls us down. Under this constitutional provision we are linked to the general property tax system – that is, taxation at the same rate upon all classes of property. The Legislature does not have the power to classify property for taxation, or to select distinct subjects of taxation for State and local purposes. We have been tied to this body of death since the State was created, and will continue to march under the yoke of an inequitable system of taxation until a couraged and long-suffering public raises the embargo and lets our people go.

The present constitution was framed in 1872. It contains substantially the same provisions on the tax question as was found in the Constitution of 1863. And the framers of the 1863 Constitution borrowed this constitutional provision from the Commonwealth of Virginia.

Third Biennial Report of the State Tax Commissioner at 6-7. Commissioner Townsend went on to speak at length about the need for classifications for property taxes. *Id.* at 20-22.

<sup>37</sup> In 1909, the Legislature gave the State Tax Commissioner the authority to collect license taxes. Third Biennial Report of the State Tax Commissioner at 30 (citing Chapter 68, Acts of the Legislature of 1909).

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### 3. Liquor and other licenses.<sup>38</sup>

In 1914, however, the State went “dry” and lost liquor taxation revenues.<sup>39</sup> Combined with an already present need for additional resources at the State level, the loss of liquor taxation revenues required the State to adopt additional methods of taxation. Importantly, around the turn of the century, the shift from an agrarian-based economy to one built upon the “extraction of mineral resources and the production of goods” provided a new basis for taxation in West Virginia.<sup>40</sup>

Thus, the Legislature, in Extraordinary Session in 1915, enacted a measure that placed an excise tax on the privilege of doing business in a corporate capacity in West Virginia.<sup>41</sup> This tax was based on the net income derived from business transacted or capital invested in the State of West Virginia and used the same classifications and amounts as required for federal income tax purposes.<sup>42</sup> The tax rate for 1915 and 1916 was one-half of one percent. After only two years, the rate was increased to three-quarters of one percent in 1917.<sup>43</sup>

This new excise tax apparently met with some degree of popularity. Three years after its institution, in 1918, the State Tax Commissioner made the following comment:

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<sup>38</sup> Ninth Biennial Report of the State Tax Commissioner at xviii.

<sup>39</sup> In fact, the State Tax Commissioner was named the ex-officio State Commissioner of Prohibition. Sixth Biennial Report of the State Tax Commissioner at 16.

<sup>40</sup> 1999 Commission on Fair Taxation at 2-71, 2-72.

<sup>41</sup> Chapter 3, Acts of the Second Extraordinary Session of the Legislature of 1915. Specifically, this legislation required “every corporation, joint stock company, or association organized for profit under the laws of the State of West Virginia, or under the laws of any other state or government and engaged in business in West Virginia, to pay a special excise tax equivalent to one-half of one per centum upon the entire net income received by it from all sources during the year from business transacted and capital invested in the State of West Virginia.” Sixth Biennial Report of the State Tax Commissioner at xiv.

<sup>42</sup> Sixth Biennial Report of the State Tax Commissioner at 14 – 14b.

<sup>43</sup> *Id.* at 14.



The principle of the excise tax based upon net income of corporations is growing in public favor. There is a widespread sentiment that an indirect tax of this character which is borne by those corporations receiving privileges at the hands of the State, and which are able to bear this burden of taxation is a just measure of taxation.<sup>44</sup>

In 1921, the Legislature continued on its two-pronged track of (1) ensuring that property taxes were collected in an equal and uniform manner and (2) broadening its indirect tax base for State revenues. With respect to the first prong, in 1921, three changes were made to “secure a literal enforcement of our tax laws and to bring into effect an equalized and uniform assessment of property throughout the [State].”<sup>45</sup>

These changes were as follows: First, the assessment date was changed from April 1 to January 1 of each year to allow assessors adequate time to make valuations and assessments. Second, the assessor’s office was made a full-time position and given fixed responsibility. Finally, the State Tax Commissioner was granted additional powers to resolve inequities.<sup>46</sup>

In 1919, the Legislature imposed a privilege tax on pipelines equivalent to two cents per barrel of oil and one-third of a cent per thousand cubic feet of gas transported into or through the State. The act was held unconstitutional by the United States Supreme Court and the ruling was one of the reasons why, in 1921, the State moved to the Gross Sales Tax on businesses.<sup>47</sup>

As to “[r]esponding to the need for additional revenue and the general feeling that the burden of taxation should be spread more widely,” the Legislature, in 1921, repealed the excise tax and passed the “Business-Profession” Tax Law, putting into

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<sup>44</sup> *Id.* at 14b.

<sup>45</sup> Ninth Biennial Report of the State Tax Commissioner at vi.

<sup>46</sup> Ninth Biennial Report of the State Tax Commissioner at vi-vii.

<sup>47</sup> Tenth Biennial Report of the State Tax Commissioner at x.



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operation in the State of West Virginia a gross receipts tax.<sup>48</sup> The computation of the tax was broken down into the following classes: mining and production of coal, oil, gas, and other minerals; manufacturing; selling tangible property other than at wholesale; selling tangible personal property at wholesale; banking and public utilities; and an “all other” category.<sup>49</sup>

In 1920, the voters of the State ratified the Good Roads Amendment of 1920. It specifically provides that the:

Legislature shall make provision by law for a system of state roads and highways connecting at least the various county seats of the state, and to be under the control and supervision of such state officers and agencies as may be prescribed by law. The Legislature shall also provide a state revenue to build, construct, and maintain, or assist in building, constructing and maintaining the same.

Thus, with this amendment the State of West Virginia, as opposed to local governments, became responsible for a State road system to connect the State’s 55 counties. The following year, in 1921, the Legislature established a fund specifically dedicated to maintaining a system of roads.

Four years later, the Legislature decided to reform the Gross Sales Tax. During an Extraordinary Session of the Legislature in 1925, the Gross Sales Tax law was repealed and in its place the State Business and Occupation Tax was enacted. Similar to the Gross Sales Tax, the State Business and Occupation Tax was based on gross receipts, as it was a law “providing a tax for the privilege of engaging in any business and the value being determined by the application of specified rates against gross receipts.”<sup>50</sup> The tax was collected at a rate per \$100 of gross receipts, with each class of taxpayer given the ability to deduct \$10,000

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<sup>48</sup> Tenth Biennial Report of the State Tax Commissioner at xix.

<sup>49</sup> Tenth Biennial Report of the State Tax Commissioner at x-xi.

<sup>50</sup> Eleventh Biennial Report of the State Tax Commissioner at ix. See also Chapter 1, Extraordinary Session of the Legislature of 1925.

from sales proceeds or gross income. In 1925, the rate for each class per \$100 of receipts was as follows:

1.	Mining and production of coal, oil, gas, and other minerals:	
	A. Coal	\$0.42
	B. Oil	\$1.00
	C. Natural gas	\$1.85
	D. Limestone, sand and other minerals	\$0.45
	E. Timber	\$0.45
2.	Manufacturing	\$0.21
3.	Selling tangible property – other than wholesale	\$0.20
4.	Selling tangible property at wholesale	\$0.05
5.	Banks and public utilities	
	A. Banks	\$0.30
	B. Steam railroads	\$1.00
	C. Street railroads	\$0.40
	D. Operation of pipelines for oil and gas	\$1.00
	E. Telephone, telegraph, express, power	\$0.60
	F. Other public service or utilities	\$0.49
6.	Contracting	\$0.30
7.	Operating places of amusement to the public	\$1.00
8.	All other businesses	\$0.30

Following their adoption in 1925, the Business and Occupation Tax statutes remained unchanged for nearly eight years, until an Extraordinary Session of the 1933 Legislature revised the rates, exemptions, and business activities subject to tax. As explained below, this eight-year period from 1925 to 1933 represented the longest time interval that the law for the Business and Occupation Tax remained unchanged until its complete overhaul in 1985.

The 1920s also saw continued calls for a reform or “modernization” of our system of taxation. State Tax Commissioner Hallanan in 1922 stated:

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The power of taxation is a sovereign right essential to the existence of government. However, although a necessary burden, public contribution has never been popular. [Indeed], taxation is a branch of economics and in some measure affects every citizen either directly or indirectly.... Taxation should, therefore, be the subject of careful study on the part of every element of our citizenship.... The future growth and development of this great State depends in large measure upon the ability of its citizens to recognize the necessity for a modernizing of our present system and upon their willingness to approve intelligent remedial legislation. It is evident to all students of the subject that many far-reaching changes must yet be made before the State can be said to have a consistent, well-balanced, modern, adequate and equitable system of taxation. We have veritably outgrown the limitations prescribed by our present and constitutional tax provisions.<sup>51</sup>

Moving into 1930, the State saw the State Tax Commissioner again call for reform, as he stated: “My study of the tax problems of West Virginia convinces me that the Constitution should be changed. The hands of the Legislature should be untied. It should be free to deal with existing conditions.”<sup>52</sup> At the same time, however, he believed that “the Constitution should contain a limitation upon all tax rates.” He continued:

Real estate, since the creation of the State, has been the basis of all taxation for local purposes. If a Constitutional amendment should be submitted to the people of the State and adopted, it will be necessary, following the adoption of such an amendment, to comprehensively revise the entire taxing machinery, including an adjustment of real estate values to meet existing conditions. . . . Whether the Constitution is amended or not, it will be necessary in my judgment, to secure at least, in part, a more equitable distribution of the tax burdens, and that legislation be enacted to

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<sup>51</sup> Ninth Biennial Report of the State Tax Commissioner at v-vi.

<sup>52</sup> Thirteenth Biennial Report of the State Tax Commissioner at v.

provide for a special reappraisalment of all property to be made by officers particularly qualified for this purpose.<sup>53</sup>

As demonstrated above, between 1872 and 1932, the State's tax system went through a significant period of development. Indeed, as evidenced by the creation of the Office of the State Tax Commissioner, lawmakers were very concerned with equality and attempted to ensure that taxes were uniform. Also, the State struggled with providing sufficient resources necessary to pay for its expenses and policies. As the economy developed, the Legislature attempted to solve this problem by creating indirect forms of taxation at the State level with the Business and Occupation Tax. Finally, as time passed, a belief emerged that the Constitution of 1872, with respect to property taxation, was too limited and restrictive upon the Legislature.<sup>54</sup> This development, along with several studies of West Virginia's existing tax structure, set the stage for the 1932 Tax Limitation Amendment to the Constitution.

### **C. The Great Depression and the 1932 Property Tax Limitation Amendment**

In the early 1930s, the Great Depression had a significant effect on West Virginia's economy and the tax structure. Many citizens could not afford to pay property taxes and lost their homes. The resultant deterioration of the property tax base caused significant revenue shortfalls. Additionally, the State of West Virginia finally passed a constitutional amendment in 1932 regarding property taxes. Although the Constitution did call for different classifications of property, it restricted the classifications and imposed significant restrictions on property tax rates.

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<sup>53</sup> *Id.* at v-vi.

<sup>54</sup> The State Tax Commission again reviewed and made recommendations to the Legislature in 1927. The first and foremost of the recommendations related to the classification of property, again setting forth the argument that the provisions of the West Virginia Constitution requiring all property to be classed equally were antiquated. Report of the West Virginia State Tax Commission to the Legislature of the State of West Virginia: 1927 Session at 173-204. See also Roy G. Blakey, Report on Taxation in West Virginia at 1-37 (1930).

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Several developments of this structure are key. First, the Legislature provided for four classifications of property:

- Class I – Intangible personal property, personal property used for agricultural purposes, and other certain agricultural products.
- Class II – Owner-occupied residential property and agricultural property.
- Class III – All other property outside municipalities.
- Class IV – All other property inside municipalities.

The classes could be taxed differently, but taxation was to be uniform within the class. Second, maximum rates were established for each class. For Class I the maximum rate was \$0.50 per \$100 in value; for Class II \$1.00 per \$100; for Class III \$1.50 per \$100; and for class IV \$2.00 per \$100.

Although these maximums could be exceeded by excess levies, such levies could only exist for three years and only upon approval by 60 percent of the votes cast. This structure, with significant limitations on taxation of property, led to a further reduction in local revenues and, as one commentator stated, had the following purpose: “to reduce the tax burdens for farmers and homeowners and to increase it for commercial and industrial interests.”<sup>55</sup> The amendment was successful, having led to a significant and further reduction in local revenues. Finally, the State’s ability to use property taxes as a revenue source was severely limited. The effect of the 1932 Tax Limitation Amendment was summed up thirty years later in the following manner:

A radical change in West Virginia’s structure developed as a consequence of the tax limitation amendment of 1932. The adoption of the amendment, together with the necessity for increased services at the State level, required a shift away from the property tax to indirect taxation. Also, the tax limitation amendment coincided,

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<sup>55</sup> Bastress at 240.

unfortunately, with a deterioration in property tax assessments and the property tax base was somewhat eroded.<sup>56</sup>

Moreover, the revenues resulting from the State Business and Occupation Tax peaked in Fiscal Year 1927 (which, coincidentally, was the first full year of collections), and revenues declined steadily thereafter, with the Great Depression, beginning in 1929, further depressing revenues.

In response to the Tax Limitation Amendment of 1932 and the problems caused by the Great Depression, the State turned to statewide indirect taxation to sustain itself. First, the Business and Occupation Tax was significantly changed.<sup>57</sup> The Business and Occupation Tax was expanded to encompass additional business activities through broadened definitions. Also, the \$10,000 exemption of gross receipts was modified significantly. Specifically, most taxpayers were only permitted a \$25 credit against their tax liability.<sup>58</sup> Other significant features of the 1933 law included the taxation of electric power production, which was not produced by public utilities previously subject to the tax, and the placement of taxes on "transportation" activities into a new article of the West Virginia Code.<sup>59</sup> Finally, in 1933, an emergency surtax was enacted as an addition to the Business and

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<sup>56</sup> Thirty-Second Biennial Report of the State Tax Commissioner at 1.

<sup>57</sup> The State, in 1933, also adopted the Chain Store Tax, which required that all persons, firms, corporations, associations, and partnerships register and obtain a license from the State Tax Commissioner. Twentieth Biennial Report of the State Tax Commissioner at xx. The Chain Store Tax was replaced with a similar Store Tax in 1957, with dramatically increased fees. Twenty-Seventh Biennial Report of the State Tax Commissioner at 727. Finally, a license tax, requiring further registration for certain entities, was passed in 1957. *Id.* at 742.

<sup>58</sup> Sixteenth Biennial Report of the State Tax Commissioner at xi (citing Article 12 of Chapter 33, Acts of the First Extraordinary Session of the 1933 Legislature). Other than these changes, this act "provided for substantially the same rules and regulations regarding the administration of the" Business and Occupation Tax.

<sup>59</sup> Although the "transportation" activities were accorded a new article in the Code, the revenue was reported together with the Business and Occupation Tax.

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Occupation Tax in the amount of 50 percent.<sup>60</sup> In 1933, the Business and Occupation Tax rates escalated substantially.<sup>61</sup> These changes, all occurring between 1933 and 1935, had a significant impact on State revenues. In Fiscal Year 1927, the State Business and Occupation Tax yielded \$1.7 million. When these changes were fully realized in Fiscal Year 1937, \$13.1 million was collected.

To provide additional revenues, lawmakers also implemented a consumers sales tax in 1933. The Consumers Sales and Service Tax, which became effective April 1, 1934, was imposed on all retail sales of tangible personal property in West Virginia and also on the furnishing of all services except personal and professional services, and required vendors to collect the tax from consumers and remit all receipts to the State Tax Department. When the Consumers Sales and Service Tax was introduced, it was imposed at a rate of two percent and was to be a “temporary tax.” The “temporary tax” was reenacted each year until made permanent, at the two percent rate, in 1937.

The reforms continued. In 1935, the West Virginia Personal Income Tax Act was passed by the Legislature, together with modification of gross income taxes passed as part of the Business and Occupation Tax reform of 1933.<sup>62</sup> The Personal Income Tax was based on federal income tax law and provided that “all residents must file an income tax return who have a gross income in excess of \$1,000, if single, or \$2,500 if married.”<sup>63</sup>

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<sup>60</sup> Sixteenth Biennial Report of the State Tax Commissioner at xiv. The 50 percent surtax was applicable to all taxpayers “with the exception of retailers, water companies, contractors, banks, all businesses taxable under subsection H of Article 12 of Chapter 33... and the operations of telephone systems.” *Id.* In 1935, the surtax was reduced to 30 percent. *Id.* at xv.

<sup>61</sup> Sixteenth Biennial Report of the State Tax Commissioner at xiv-xv.

<sup>62</sup> Sixteenth Biennial Report of the State Tax Commissioner at xi.

<sup>63</sup> Nineteenth Biennial Report of the State Tax Commissioner at 1096. Partnerships were also required to file returns disclosing net income paid to partners and all estates and trusts were required to file if gross income exceeded \$1,000.00. *Id.*

Obviously the 1930s saw significant change in the State's tax structure. Prior to 1932, a significant majority of revenues was raised at the local level. By 1937, local revenues plummeted and State indirect taxes increased both in number and in rate. During the remainder of the 1930s, 1940s, and 1950s, the State continued to modify and enhance the State Business and Occupation Tax, the Personal Income Tax (until its repeal in 1943), and the Consumers Sales and Service Tax on an almost annual basis. For example, in 1943, the State increased the exemption for each taxpayer under the Business and Occupation Tax from \$25 to \$50 and provided a 10 percent credit on any tax due thereafter.<sup>64</sup> In fact, throughout the history of the Business and Occupation Tax, until its overhaul in 1985, the structure and scope of the tax was changed many times. The changes included expansions and reductions in the definitions of taxable activity and income, implementation of credits against the tax, and revision of the tax rates. The method of change has ranged from a simple alteration in definition or tax rate for a particular activity to the complete overhaul of the statute.

With respect to the Consumers Sales and Service Tax, the initial statute provided exemptions for the following isolated transactions: professional and personal services; public utility services; gasoline; public school textbooks; sales for resale; and sales to federal, State and local governments. In 1937, an exemption was created for sales of motor vehicles, which were subject to the State's Title Privilege Tax; and, in 1941, certain food products were exempted from the Consumers Sales Tax and Service Tax. The list of food items that were exempt was modified several times over the next ten years and, in 1951, all exemptions for food products were repealed.

Two amendments to the Constitution from the 1940s are relevant. First, in 1942, the voters of the State ratified an amendment to the Constitution mandating that certain revenues be dedicated to roads. Specifically,

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<sup>64</sup> Twentieth Biennial Report of the State Tax Commissioner at ix.



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Revenue from gasoline and other motor fuel excise and license taxation, motor vehicle registration and license taxes, and all other revenue derived from motor vehicles or motor fuels shall, after the deduction of statutory refunds and cost of administration and collection authorized by legislative appropriation, be appropriated and used solely for construction, reconstruction, repair and maintenance of public highways, and also the payment of the interest and principal on all road bonds heretofore issued or which may be hereafter issued for the construction, reconstruction or improvement of public highways, and the payment of obligations incurred in the construction, reconstruction, repair and maintenance of public highways.

Thus, the State “permanently establishe[d] a fund dedicated to the improvement of the state’s highway and road system.”<sup>65</sup> And, in 1946, the voters of this State ratified the Forestry Amendment to our Constitution. The amendment provided as follows:

The Legislature may by general law define and classify forest lands and provide for cooperation by contract between the state and the owner in the planting, cultivation, protection, and harvesting thereof. Forest lands embraced in any such contract may be exempted from all taxation or be taxed in such manner, including the imposition of a severance tax or charge as trees are harvested, as the Legislature may from time to time provide. But any tax measured by valuation shall not exceed the aggregate rates authorized by section one of article ten of this constitution.<sup>66</sup>

Thus, the Forestry Amendment provided for a tax preference property tax program, and if so desired by the Legislature, for the full exemption of such property from property taxation.

Additionally, as explained below, the 1940s and 1950s saw the creation of specialized taxes and fees that were dedicated for particular purposes. For

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<sup>65</sup> Bastress at 183-84.

<sup>66</sup> W. Va. Const. art. VI, § 53.

example, 1947 saw the creation of the Cigarette Tax – specifically intended to raise money for the General Revenue Fund, payment of veterans’ bonus bonds, and additional revenue for the support of free schools.<sup>67</sup> In 1951, the State adopted a Soft Drinks Tax, which was an excise tax on the sale, use, handling, or distribution of soft drinks and soft drink syrups. The tax, as initially imposed, was to be used solely for the construction, maintenance, and operation of a four-year school of medicine, dentistry, and nursing.<sup>68</sup> Also in 1951, a Use Tax was passed to complement the Consumers Sales and Service Tax. It was established as a two percent tax on the price of all tangible personal property purchased outside West Virginia for use in this State.<sup>69</sup> In 1959, a Motor Carrier Road Tax was passed, requiring operators of heavy vehicles to purchase as much gasoline in West Virginia as they used in West Virginia.<sup>70</sup>

The Great Depression and the Tax Limitation Amendment of 1932 had a significant impact on West Virginia’s tax structure. Property taxes, the dominant portion of State and local revenues, were significantly reduced and indirect State taxes were increased. Throughout the 1940s and 1950s, State taxation, as a percentage of revenues, continued to enlarge as West Virginia modified its major State taxes and created new specialized taxes. The 1960s would continue that development.

#### **D. The 1960s and Continued Development of State Taxation**

In the late 1950s, the State of West Virginia again decided to engage in a tax study. The State Tax Study Commission was created by Senate Concurrent Resolution No. 3 of the 1959 Legislature “for the purpose of considering all phases

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<sup>67</sup> Twenty-Fourth Biennial Report of the State Tax Commissioner at 872.

<sup>68</sup> *Id.* at 873.

<sup>69</sup> *Id.* at 866.

<sup>70</sup> Twenty-Eighth Biennial Report of the State Tax Commissioner at 725. Finally, in 1958, the Legislature modified the Constitution by adding a new section to Article X of the Constitution. The section provided as follows: “Notwithstanding the provisions of [Section 1] bank deposits and money shall not be subject to *ad valorem* taxation.”

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of the tax structure of the State and to make recommendations for improvements.”<sup>71</sup>

The Commission expressed the concern that the State tax system was comprised of numerous taxes and fees that had “grown up’ like Topsy” over the prior ten to twenty years.<sup>72</sup> The following four main objectives were identified:

1. To study [the] tax structure (State, county, and municipal), including requirements, sources, yield, inequities and impact, having due regard to the effect on the State’s economic growth and development;
2. That after such study, a tax plan or program be formulated in the form of a recommendation to the legislative session of 1961, and in the interim to furnish statements of findings and progress to the Joint Committee on Government and Finance and Commission on Interstate Cooperation at six month intervals;
3. That to this end, suggestions be invited from all State, county, and municipal officers and from all interested groups, associations, businesses, organizations, individuals, and the public generally; and
4. That a series of public meetings be held throughout the State, to which would be invited representatives of various organizations and the public generally to attend and present their views.<sup>73</sup>

By its conclusion, three reports were submitted by the 1959 Commission. The first, submitted November 13, 1959, and the second, submitted May 16, 1960, were labeled “preliminary” to the full report, submitted November 28, 1960. As a broad summary, the Commission concluded that the improvement of highways and

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<sup>71</sup> First Report of the State Tax Commission at 1 (1959) (“1959 First Report”).

<sup>72</sup> Second Report of the State Tax Commission at 1 (1960) (“1960 Second Report”).

<sup>73</sup> 1959 First Report at 1.

educational facilities was “probably the prime prerequisite to economic growth and for the attraction of industry,” and that “any attempt to attract industry by extreme tax concessions is certainly not the answer...”<sup>74</sup> The Commission favored industrial expansion to promote increases in personal income, corporate income, and property valuations to broaden the tax base, and was not of the opinion that tax incentives played a feasible part in achieving that goal. Nevertheless, some of the more notable recommendations with respect to the tax structure are described below.

The 1959 Commission began its final report by noting several facts concerning the tax system and West Virginia’s economy.<sup>75</sup> It noted that, in 1933, substantial costs for schools, highways, and public welfare were shifted from the local to the State level. Indeed, the Commission noted that the significant increases in the State’s budget were caused by three particular expenses – education, highways, and public assistance. Between 1940 and 1957, annual expenditures rose from \$92 million to \$318 million. The Commission reported that, according to a Commerce Department study based on 1957 data, West Virginia’s tax burden was below the national average, with total state and local revenues ranking 47th of the 48 states on a per capita basis, or 38th on a percentage of income basis.<sup>76</sup> It was noted that the State ranked 38th in ability to raise taxes, with per capita income for 1957 at \$1,554, compared to the national average of \$2,027.

With respect to the tax structure, the Business and Occupation Tax received particular attention from the Commission. The 1959 Commission determined that the effective rates for the Gross Sales Tax were not based on impact, ability to pay,

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<sup>74</sup> Final Report of the State Tax Study Commission (1960) (“1960 Final Report”).

<sup>75</sup> 1960 Final Report at 3.

<sup>76</sup> 1960 Final Report at 10. Comparatively, it was noted that taxes on businesses were near average, after taking into account low property tax rates.

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or other equitable measures.<sup>77</sup> The rate variation was considered extreme among various classes, impacting newer and smaller firms to a greater degree than established and larger companies, and the tax was estimated to amount to an 11 percent levy on net income for those businesses filing returns for the Gross Sales Tax – a significantly higher rate than corporate income taxes in other states. However, citing the ease and economy of administration of the Business and Occupation Tax, the 1959 Commission recommended keeping the tax rather than replacing it with the Corporation Net Income and Personal Income Taxes, both of which would have, in the Commission’s determination, involved high rates of taxation.

With respect to property taxes, the 1959 Commission concluded that West Virginia’s property tax collections were a significantly smaller percentage of the tax load than in other states, a factor that the Commission found to be an impediment to moving from a sales and excise base to a net income base. (As mentioned above, the Personal Net Income Tax enacted in 1935 was repealed by the Legislature in 1943.) Among the concerns related to property taxation were inequitable assessment and the need for uniform appraisal. Focusing on the concern that West Virginia’s property tax was lower than that imposed by other states (ranking 45th on a per capita basis, and 46th as a percentage of income), and noting that 71 percent of taxes were collected at the State level, in comparison with an average of 50 percent among all other states, the 1959 Commission dedicated a substantial portion of its report to a discussion of county taxes.<sup>78</sup> In 1958, the Legislature had provided for the reappraisal of all non-utility property throughout the State, with 90 percent of the program cost borne by the State. The 1959 Commission recommended furtherance of the property revaluation program to

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<sup>77</sup> This was confirmed by other sources: “Without detailing the desirability or undesirability of the tax, it should be noted that various tax studies and the report of the State Tax Study Commission indicated that the rate structure has not remained consistent with economic changes which have occurred in the various classifications over the past thirty-six years.” Thirty-second Biennial Report of the State Tax Commissioner at 3.

<sup>78</sup> 1960 Final Report at 37.

reduce property assessment inequities, and further concluded that the property tax should be used to bear the growing costs for local government and for schools.

Some discussion was offered on the issue of municipal finance, as well, perhaps due to the decreasing reliance of municipalities on property taxation, and the increase of the Business and Occupation Tax. Municipalities had heretofore been given discretion as to the businesses on which to levy the Business and Occupation Tax. It was the recommendation of the 1959 Commission that municipalities be required to levy the same percent of the maximum rates on all businesses, and that municipalities be required to grant businesses across-the-board a percentage of the allowed \$50 State tax credit equal to the percent of the tax levied. Both measures were intended to curb inequity.

Additionally, without significant discussion, the 1959 Commission noted its disfavor toward the dedication of the proceeds of particular taxes, the imposition of nuisance taxes that would discourage business on the State border or encourage out-of-state purchases, and the authorization of a percentage of proceeds of specific taxes for administrative expenses.

Although it did not recommend specific action, the 1959 Commission did set forth several possible potential changes that would create sources of revenue for the State.<sup>79</sup> Some of those sources included: imposing a personal net income tax; raising the Consumers Sales and Service and Use Taxes to three percent; extending the Business and Occupation Tax to all professional income and salaries and wages not covered; increasing the ratio of property tax assessments over the 50 percent required by law; imposing a corporation net income tax; and adding a percentage increase of the Business and Occupation Tax through a surtax.

Not long after the 1960 report, the Legislature took action.<sup>80</sup> In 1961, the Legislature enacted the modern day West Virginia Personal Income Tax. The law

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<sup>79</sup> *Id.* at 47-50.

<sup>80</sup> As for the Consumers Sales and Service Tax, a temporary additional one percent Sales Tax was passed in 1961. This temporary additional tax was continued for Fiscal

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adopted the provisions of the federal Internal Revenue Code, as in effect on January 1, 1961, relating to the determination of income and deductions. The basis of the tax was federal adjusted gross income, with certain modifications, minus personal exemptions and standard or itemized deductions.

With the exception of minor tax base changes brought about by annual routine legislation updating the State law to conform to changes in the federal tax code, the Personal Income Tax base remained essentially unchanged from its enactment in 1961 through 1972. However, the Legislature created several new decreasing modifications to income and retirement exclusions beginning in 1973.

In 1967, the Legislature adopted the Corporation Net Income Tax, to be imposed upon domestic and foreign corporations doing business in West Virginia or earning income from property or activity within the State.<sup>81</sup> From the time the tax was enacted until 1983, the tax rate remained at six percent of allocated and apportioned federal taxable income with certain statutory modifications.

Until 1983, the Corporation Net Income Tax was a fairly minor tax because businesses subject to either the Business and Occupation Tax or the Carrier Income Tax could apply such tax paid as a dollar-for-dollar credit against their Corporation Net Income Tax liability. Such credit generally resulted in a zero Corporation Net Income Tax liability for most taxpayers, because only non-business income was effectively subjected to tax.

In an attempt to stimulate economic development, the Legislature passed an act providing for a credit against the Business and Occupation Tax for qualified investment for industrial expansion. The credit permitted those taxpayers subject to tax under the manufacturing class to claim a credit equal to 10 percent of the cost of the qualified investment to be used over a ten-year period, provided that the credit could not exceed 50 percent of the tax due.

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Years 1963 through 1965, and a permanent three percent Consumers Sales and Service Tax became effective July 1, 1965.

<sup>81</sup> 1967 W. Va. Acts 1159.

In the 1970s, the Legislature again modified the West Virginia Constitution with respect to taxation. First, in 1972, the Legislature exempted household goods and personal effects, so long as those items were not held or used for profit, from *ad valorem* property taxation.<sup>82</sup> Then, in 1973, the Legislature created a homestead exemption that provided as follows:

Notwithstanding any other provision of this Constitution to the contrary, the first \$5,000 of assessed valuation of any real property used exclusively for residential purposes and occupied by the owner or one of the owners thereof as his residence who is a citizen of this State and who is sixty-five or older shall be exempt from *ad valorem* property taxation, subject to such requirements, limitations, conditions, as prescribed by general law.<sup>83</sup>

Again, the Legislature's concern with the amount of taxation on real and personal property is apparent. As explained below, in Section 5, this trend continued in the 1980s.

Also, at the end of the decade, in 1979, State legal issues developed that would spark years of struggle for compliance. After hearing the appeal from the Circuit Court of Kanawha County of five public school students' parents, the Supreme Court of Appeals of West Virginia determined that a "thorough and efficient" education is a fundamental constitutional right and that "under our equal protection guarantees any discriminatory classification found in the educational

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<sup>82</sup> Specifically, the revision was to Article X, section 1a of the West Virginia Constitution. After the amendment, section 1a provided as follows:

Notwithstanding the provisions of [section 1, article x], bank deposits, money, and personal effects if such household goods and personal effects are not held or used for profit, shall be exempt from *ad valorem* property taxation.

<sup>83</sup> In 1980, the provision was expanded to \$10,000. Mobile homes were made subject to the exemption and a provision was incorporated to provide that the Legislature would reimburse the local governmental entities for the lost revenue caused by increasing the exemption from \$5,000 to \$10,000.



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financing system cannot stand unless the State can demonstrate some compelling State interest to justify the unequal classification.”<sup>84</sup> A “thorough and efficient” education, according to the Court, necessitates the development in each schoolchild, to his individual capacity, of a number of skills and abilities. Furthermore, various “support services” are required to ensure appropriate development. The Supreme Court remanded the case for additional findings consistent with its guidelines, and Special Judge Arthur Recht issued a 244-page final order, on May 11, 1982, setting forth a number of standards that he found necessary to achieve a thorough and efficient school system. Judge Recht also found that the school financing system was unconstitutional, thereby raising the question of how county school districts should finance their systems of education.<sup>85</sup>

According to Judge Recht, many school districts were unable to meet their educational responsibilities because the amount of money that could be collected by the excess levy varied largely based on the amount and type of wealth in the county, and the counties were forced to rely on the excess levy – an inadequate funding source – as an essential component of finance.<sup>86</sup> Moreover, a county unable to pass an excess levy would face a monumental challenge in providing a thorough and efficient education to its schoolchildren. As described in further detail below, the State grappled with the school-funding issue over a number of years, insofar as the excess levy for educational finance is directly affected by the uniformity – or lack thereof – of assessed property values.<sup>87</sup>

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<sup>84</sup> *Pauley v. Kelly*, 162 W. Va. 672, 707, 255 S.E.2d 859, 878 (W. Va. 1979).

<sup>85</sup> The 1999 Commission on Fair Taxation at 3-848 through 3-861.

<sup>86</sup> *Id.* at 3-864 and 865.

<sup>87</sup> Judge Recht ultimately dismissed the case in 2002, upon finding that legislation had been enacted to ensure that a thorough and efficient system of free schools. See W.Va. Code § 18-1-1 *et seq.*

### E. The 1980s: Recession, Reform, and Instability

One change enacted near the end of the 1970s should be mentioned prior to our review of the 1980s. In 1979, the Legislature passed a measure calling for the elimination of the sales tax on food for home consumption. The plan required a three-year phase out of the tax.<sup>88</sup> Thus, beginning on July 1, 1979, food for home consumption was taxed at a two percent rate while all other items remained subject to the three percent Consumers Sales and Service Tax rate. Under the statute, the rate fell to one percent effective July 1, 1980, and was eliminated entirely on July 1, 1981. The State, however, was unable to afford the repeal and, on June 1, 1981, the tax rate for the Consumers Sales and Service Tax was increased from 3 percent to 5 percent on all taxable items except mobile homes and food.<sup>89</sup> This increase was made effective July 1, 1981, the same day the full repeal of the sales tax on food took effect.

The State again began moving to alter its Constitution with respect to property taxes as 1982 approached. This constitutional change was apparently the result of a decision by the Supreme Court of Appeals of West Virginia decision in *Killen v. Logan County Commission*.<sup>90</sup> In that case, the court interpreted Section 1 of Article X to require all property to be assessed at full value. Because property had apparently not been so assessed prior to *Killen*, this decision seems to have caused uproar over a fear of significant property tax increases upon appropriate assessment.<sup>91</sup> Thus, later that year, the Legislature met in Extraordinary Session to propose the following amendments:

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<sup>88</sup> 1979 W. Va. Acts 400-09

<sup>89</sup> 1981 W. Va. Acts 1331-36.

<sup>90</sup> 295 S.E.2d 689 (W. Va. 1982).

<sup>91</sup> Bastress at 241 (“The court held that ‘value’ means ‘worth in money’ or ‘market value’ and that a system in which assessments could vary among the counties at some fraction of market value could not produce equal and uniform taxation. Assessment at 100 percent of true and actual value is required, the court said. That conclusion provoked an

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1. All property must be assessed, not at 100 percent, but at 60 percent of actual value unless two-thirds of the Legislature pass a higher rate;
2. The Legislature is from time to time to provide for a statewide reappraisal;
3. The homestead exemption was to be raised to \$20,000;
4. Any increases from a statewide reappraisal had to be phased in equal amounts over a ten-year period; and
5. The Legislature was given the authority to require local school districts to levy rates at the maximum rate allowed under Section 1, Article X.

These proposals were ratified by the people of West Virginia in November of that year.

Also by 1982, the nation's economy fell into recession. By Fiscal Year 1983, the full effects of the national recession hit the State. For example, total Business and Occupation Tax revenue for Fiscal Year 1983 was only \$479.0 million, a decline of \$39.5 million or 7.6 percent from the previous year. Wage and salary income actually declined by 2.2 percent while personal income grew only 1.3 percent. In response, the Legislature in 1983 enacted several measures, including significant personal and business tax increases. The maximum Personal Income Tax rate was increased from 9.6 percent to 13 percent.<sup>92</sup> An additional 12 percent surtax on taxable income in excess of \$10,000 (\$20,000 if a joint filer) was also included within this rate structure. Accordingly, the top rate was actually 14.56 percent with the inclusion of the surtax. Additionally, a Personal Income Tax minimum tax provision was established, making the State tax equal to at least 25

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immediate popular and legislature response that let to the passage of the Property Tax Limitation and Homestead Amendment of 1982.”).

<sup>92</sup> 1983 W. Va. Acts 919, 926-36.

percent of an individual's federal minimum tax liability.<sup>93</sup> Finally the personal exemption for individuals, heads of households, and joint taxpayers was increased from the original \$600 to \$700 in 1983 and \$800 in 1984.

Significant changes were also made to the Corporation Net Income Tax. As mentioned previously, the Corporation Net Income Tax was not of significant consequence prior to 1983 because the law provided for a 100 percent credit against the tax for Business and Occupation Tax liabilities. In 1983, however, the Business and Occupation Tax credit application was reduced from 100 percent to 50 percent of Corporation Net Income Tax liability.<sup>94</sup> Additionally, the tax rate on a taxpayer's net income in excess of \$50,000 was increased to 7 percent. This caused a significant increase in Corporation Net Income Tax revenues. Those revenues increased from \$12.7 million in Fiscal Year 1982 to \$73.6 million by Fiscal Year 1984. These measures, along with significant changes in the Personal Income Tax, helped the State to deal with the large budget deficit caused by the recession.

At the same time, however, the State began an attempt to reduce the high rates associated with the Business and Occupation Tax. Specifically, in 1983 the Legislature enacted provisions that called for a 5 percent reduction in the tax rates for the Business and Occupation Tax (except for the additional tax on the severance, extraction, and production of coal designated for local governments) for five consecutive years.<sup>95</sup> The first 5 percent reduction was to take place July 1, 1985, and the last reduction was scheduled for July 1, 1989. The act also provided for a transitional period for the increase in the annual credit from tax from \$50 in 1983 to \$500 for the period after June 30, 1985.

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<sup>93</sup> Separate tax brackets and tax rates were created for head of household filers. These new rates generally provided most head of household filers with a slightly lower tax liability for a given amount of taxable income than provided to the single filer.

<sup>94</sup> 1983 W. Va. Acts 919, 937-42.

<sup>95</sup> *Id.*

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As the State's finances deteriorated during the recession, the Legislature decided once again to review the State's system of taxation. The West Virginia Tax Study Commission, created by the Legislature in 1982, was directed to study State and local tax structures and administrative processes and report its recommendations to the Legislature in 1984.<sup>96</sup> In its Report, the 1982 Commission remarked that State and local governments were dependent on the three "big" taxes – property, business and occupation, and personal income. The major challenges faced by the government were said to be shrinking State and local revenues, federal cutbacks, and "court decisions with expensive implementation costs."<sup>97</sup> It was further noted that State citizens had "very reasonable appetites for average or above average public goods," even though State government was drawing from a "below average tax base."<sup>98</sup>

One area of evaluation concerned the adequacy of local taxing authorities. The report reflected 1978 data that showed per capita own-source municipal revenue was only \$110, compared to a range of \$144 to more than \$300 in neighboring states. The primary sources for larger municipalities, accounting for approximately 90 percent of revenue, were the Business and Occupation Tax, user and service fees, the two percent Utility Excise Tax, and Property Tax. The 1982 Commission determined that West Virginia's reliance on Property Tax for municipal

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<sup>96</sup> A Tax Study for West Virginia in the 1980s: Final Report to the West Virginia Legislature (the "1984 Report").

<sup>97</sup> 1984 Report at 2.

<sup>98</sup> *Id.* at 4. The proposed reform did not promise immediate reductions for all taxpayers, but instead was intended to result in a broader, strengthened tax base stemming from the encouragement of economic development. The Report advised that the Legislature should act at the earliest possible time, but warned, "The Commission has addressed West Virginia's tax structure systematically, recognizing the interrelationship of [S]tate taxes to each other and to federal and local taxation. Only in the rarest of instances, and then only with the greatest of caution, should the Legislature consider individual items in this report outside the context of the entire report." In all, the 1982 Commission's report contained eighty-seven specific, enumerated recommendations.

revenue was far below that of other states, while the reliance on Business and Occupation Tax was far greater.<sup>99</sup>

With respect to property taxes, the 1982 Commission noted that the role of Property Tax had significantly declined, accounting for only 13 percent of State and local own-source revenue. The Commission said that property tax should be applied equitably and, to this end, said that further homestead exemptions should not be instituted inasmuch as Class II owner-occupied residential rates were significantly lower than Class III and IV commercial and industrial property rates. It suggested a “circuit breaker” program to provide relief for renters or owners occupying property, with benefits based on the proportion of income dedicated to housing.<sup>100</sup>

Seeking diversification of revenues for the following municipalities and county governments, the 1982 Commission recommended: giving local governments the authority to impose a personal income tax, a sales tax in lieu of the Utility Tax, and a business franchise tax in lieu of the Business and Occupation Tax; allowing a hotel and occupancy tax and an extension of the Amusement Tax; and permitting the implementation of user fees. It suggested that local governments “cooperate in the collection of taxes to save administrative costs” and be authorized, but not obligated, to maintain certain bridges and roadways not in the State system.<sup>101</sup>

With respect to business taxes, the 1982 Commission concluded that “[t]he structure of business taxes in West Virginia is in urgent need of reform.”<sup>102</sup> Most notably, it advocated the abolition of the Business and Occupation Tax, together with elimination of the Carrier Tax. This recommendation was significant, given that the Carrier, Business and Occupation, and Corporation Net Income Taxes

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<sup>99</sup> 1984 Report at 5.

<sup>100</sup> *Id.* at 11.

<sup>101</sup> *Id.* at 6.

<sup>102</sup> *Id.* at 7.

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accounted for 40 percent of the General Fund, and the Business and Occupation Tax generated stable yield. But various activities were subject to different rates, and transactions were taxed well below the retail level, leading the Commission to conclude that there was no apparent rationale in the Business and Occupation Tax structure.<sup>103</sup>

It sought to supplant the Business and Occupation Tax with “a system of privilege taxes that would contain (1) a severance tax on the privilege of extracting natural resources [based on gross receipts less certain limited exemptions for third-party transportation expenses]; (2) a utilities and carrier tax on the privilege of conducting certain types of business in the State [using a basis of gross receipts with possible selected rates for classification]; and (3) a general, apportioned franchise tax for the privilege of conducting all other business activities in the State [based on an apportioned measure of the wealth of business activity].”<sup>104</sup> It was necessary that an entire system be engaged as a replacement for the Business and Occupation Tax, according to the Commission, because no single tax could cover the burden it had borne.<sup>105</sup>

Together with this significant recommendation, the 1982 Commission also addressed the Corporation Net Income Tax, suggesting that it continue to be based generally on federal income tax structure, with some adjustments made necessary by the elimination of the Business and Occupation Tax. The new privilege taxes were to be allowed only as deductions when determining West Virginia taxable income. The Commission further suggested that the Legislature consider broadening the base of the Corporation Net Income Tax to compensate for

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<sup>103</sup> *Id.* at 7.

<sup>104</sup> Doing so, the 1982 Commission reasoned, would serve its goals of generating adequate revenue, compelling businesses to pay for the privilege of doing business while achieving consistency with each business’ ability to pay, and improving the economic neutrality of business taxes.

<sup>105</sup> 1984 Report at 7 through 8.

revenues that might be lost through elimination of the Business and Occupation Tax.<sup>106</sup>

The 1982 Commission recommended that the Personal Income Tax continue to have progressive rates; all income be included as taxable, except income denoted by the Legislature for special equity considerations; and adjustments be made to the tax tables to remove inequities for single, as opposed to joint, taxpayers.<sup>107</sup>

The State Road Fund, the 1982 Commission found, did not produce sufficient revenues to maintain the State highway system. It had been supported almost entirely by the Gasoline and Motor Carrier, Privilege, and License Taxes, and the Commission noted that a Consumers Sales Tax on gasoline had been added to offset General Fund transfers to the Road Fund. West Virginia was responsible for maintaining about 88.9 percent of the roads and bridges in the State – significantly more than some states, but less revenue per mile was generated than in neighboring states. Additionally, the buying power of the Road Fund had decreased significantly in little more than a decade, with 1981 tax revenues capable of purchasing only 76.6 percent of what was purchased in 1970, despite a revenue increase.<sup>108</sup>

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<sup>106</sup> 1984 Report at 8.

<sup>107</sup> 1984 Report at 12. According to the report, the Personal Income Tax was the largest revenue source for the General Fund, generating \$310.6 million for 1982-83, or nearly 25 percent of the fund. Having increased the nominal tax rates in 1983 to attack revenue shortfalls, West Virginia rates for lower-income families (under \$25,000) were below any neighboring State except Ohio, and for higher-income families (above \$50,000) those rates were equal to or greater than those of neighboring States except Ohio.

<sup>108</sup> 1984 Report at 13. Included in the 1982 Commission's report were recommendations that the Legislature index registration fees and motor fuel excise taxes to federal construction or maintenance indexes, and adjust the rates at least every two years to ensure that revenues keep pace with the cost of maintenance. Also, the 1982 Commission suggested that counties be authorized to maintain roads and bridges in unincorporated areas, the government seek additional support from Congress, and the Legislature dedicate additional revenue sources to the road fund. Some proposed sources for additional dedicated revenue included increased license and registration fees to near those of surrounding States with the highest fees, periodic review of exemptions and



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As the Report neared completion in 1984, the Legislature again modified the taxation provisions of the Constitution. Specifically, Section 1a of Article X was amended at the General Election of 1984. After the amendment, Section 1a authorized the Legislature to exempt any amount of certain intangible personal property, or all of it, so long as the tax applied evenly throughout the State.

Inspired by the 1984 Report, the Legislature, in 1985, also enacted House Bill 1693, which revised the major business taxes imposed by the State.<sup>109</sup> As it applied to the Business and Occupation Tax, House Bill 1693 rescinded the five percent rate reduction plan passed by the 1983 Legislature. The legislation also provided that, effective July 1, 1987, the Business and Occupation Tax would become a tax on public utilities and electric power generators only. Those individuals or entities formerly subject to taxation as natural resource producers would become subject to the Severance Tax on July 1, 1987. Everyone else (i.e., corporations and partnerships in the non-utility and non-natural resource production categories) became subject to a new tax on net equity, the Business Franchise Tax.

The 1985 Legislature also passed an act creating the Research and Development Credit and the Business Investment and Jobs Expansion Credit (later to become known as the "Super Credit").<sup>110</sup> To stimulate the use of coal in generating electricity, the 1986 Legislature passed an act providing for a tax credit for electric power producers who increase power generation in West Virginia, thereby consuming coal produced in mines employing miners who were residents of West Virginia.

Significant changes to the State tax structure also occurred in 1986. First, the Constitution was amended again. Specifically, a new provision, Section 1c, was

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refunds of the motor fuel excise and *ad valorem* taxes, introduction of a third-tier tax, and dedication of new revenues resulting from severance taxation. The 1982 Commission also said that some highway-connected revenues could be "reassigned" from the General Fund to the Road Fund, but discouraged General Fund transfers as an ongoing source of support for the highway system.

<sup>109</sup> 1985 W. Va. Acts 1472-1561.

<sup>110</sup> 1985 W. Va. Acts 1567-71.

added to Article X of the Constitution, to exempt certain personal property of inventory and warehouse goods from *ad valorem*. Section 1c provided as follows:

Notwithstanding any other provisions of this Constitution, tangible personal property which is moving in interstate commerce through or over the territory of the State of West Virginia, or which was consigned from a point of origin outside the State to a warehouse, public or private, within the State for storage in transit to a final destination outside the State, whether specified when transportation begins or afterward, but in any case specified timely for exempt status determination purposes, shall not be deemed to have acquired a tax situs in West Virginia for purposes of *ad valorem* taxation and shall be exempt from such taxation, except as otherwise provided in this section. Such property shall not be deprived of such exemption because while in the warehouse the personal property is assembled, bound, joined, processed, disassembled, divided, cut, broken in bulk, relabeled, or repackaged for delivery out of State, unless such activity results in a new or different product, article, substance or commodity, or one of different utility. Personal property of inventories of natural resources shall not be exempt from *ad valorem* taxation unless required by paramount federal law.

The exemption allowed by the preceding paragraph shall be phased in over a period of five consecutive assessment years, at the rate of one fifth of the assessed value of the property per assessment year, beginning the first day of July, one thousand nine hundred eighty-seven.

This section, commonly known as the “Freeport” amendment, was designed to prevent federal Commerce Clause violations and to encourage the shipment and storage of goods in the State, thus encouraging business and employment opportunities in West Virginia.<sup>111</sup>

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<sup>111</sup> More changes were underway for 1986. Importantly, the Federal Tax Reform Act of 1986 made sweeping tax changes to the Internal Revenue Code, including broadening the definition of federal adjusted gross income to include the full amount of dividends, unemployment compensation and capital gains received. Because West Virginia's tax

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By late 1987, however, the State's tax structure was unable to meet the needs of government, and significant tax increases were passed. Specifically, certain business exemptions for the Consumers Sales and Service Tax were removed. Then, on June 1, 1988, the Consumers Sales and Service Tax rate was "temporarily" increased to 6 percent for the period June 1, 1988, through June 30, 1989.<sup>112</sup> The additional revenue from the one percent tax increase was dedicated for the payment of Public Employee Insurance Agency benefits and to repay a loan to the General Revenue Fund from the coal-workers' pneumoconiosis fund.

In 1989, the State was in a financial crisis and the Fiscal Responsibility Act of 1989 was passed.<sup>113</sup> Approximately \$400 million in revenue enhancements were necessary to balance the State budget, and were as follows: the permanent adoption of the "temporary" rate increase to six percent on Consumers Sales and Service Tax; the repeal of the exemption for food for home consumption; an additional narrowing of business exemptions for the Consumers Sales and Service Tax; and the subjection of all purchases by contractors to the Consumers Sales and Service Tax. Rates on business taxes were also increased. The Business Franchise Tax, for example, increased from 0.55 to 0.75 percent or \$50, whichever is greater. Severance Tax rates increased by 25 percent. The State Business and Occupation Tax rate, applicable only to public utilities and electric power generators, was significantly increased. These tax changes helped to resolve the

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structure was coupled to the federal tax structure, the Federal Tax Reform Act of 1986 had powerful consequences for the State. In particular, the State was presented with a choice of either adopting or rejecting the federal changes. Simple adoption would have meant a revenue enhancement of up to \$47 million due to changes relating to capital gains at the federal level. The Legislature chose to adopt the federal changes, but revise the State tax structure to return any potential windfall to the taxpayers. The results were the most significant changes to the Personal Income Tax since its inception in 1961. Several modifications to adjusted gross income, including itemized deductions, were eliminated, while the personal exemption was increased from \$800 to \$2,000. Tax rates were also reduced significantly.

<sup>112</sup> 1988 W. Va. Acts 992.

<sup>113</sup> 1989 W. Va. Acts 1699 – 1735.

State's financial crisis. These reforms were the last major changes to our system of taxation.

**F. The 1990s and Current Tax Modernization in the State of West Virginia**

Although the State has not engaged in any landmark “tax reform” recently, that is not to say that there have been no significant revisions to our system of taxation since 1989. The State through the years has made substantial changes to the tax system. The highlights are as follows:

1. The West Virginia Health Care Provider Medicaid Enhancement Tax was imposed in 1991 on various health care providers to enhance State Medicaid reimbursement levels;<sup>114</sup>
2. The West Virginia Health Care Provider Tax was enacted to replace the Medicaid Enhancement Tax in 1993;<sup>115</sup>
3. The minimum coal severance tax rate was increased from 50 cents per ton to 75 cents per ton in 1993;<sup>116</sup> and
4. The \$10,000 low-income earned-income provision was enacted in 1996, as was a reduction in the Business Franchise Tax rate from 0.75 percent to 0.7 percent.<sup>117</sup>

Despite the numerous changes, state leaders continued to evaluate the system in search of improvement. Governor Cecil H. Underwood created the Commission on Fair Taxation in July 1997, charging it to review the State's system of taxation to determine whether that system adequately embodied the principles and values of West Virginia citizens, and to propose any modifications that the

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<sup>114</sup> 1991 W. Va. Acts 65-98.

<sup>115</sup> 1993 W. Va. Acts 1804 -1898.

<sup>116</sup> 1993 W. Va. Acts 1132, 1139-40.

<sup>117</sup> 1996 W. Va. Acts 1914-20.

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Commission may have found necessary to promote those principles and values. The Commission filed a status report on February 2, 1998, outlining the values it had identified. An “Agenda for Fair Taxation” followed on July 2, 1998. Finally, the Commission filed a document entitled “Executive Report” on January 11, 1999, outlining its ultimate recommendations. In its plan, the 1999 Commission on Fair Taxation identified six general goals and, for each, set forth between one and three objectives meant to help achieve the broader goal. The goals were:

- 1) A simple broad-based tax system with fewer taxes and limited tax preferences;
- 2) A less regressive tax system;
- 3) A stable tax system that reflects the shift in the State’s economy;
- 4) Local flexibility to generate revenues;
- 5) Improved tax appeals systems; and
- 6) A constitutional method of funding education.<sup>118</sup>

The 1999 Commission on Fair Taxation first challenged lawmakers to make a “philosophical choice” and embrace a new approach: the attraction of capital investment, meant to broaden the tax base, through the use of a simple, fair, stable, and accountable tax structure with little reliance on credits.<sup>119</sup> A number of recommendations detailing this strategy were set forth in the Commission’s report.

The 1999 Commission recommended the repeal of the Business Franchise Tax and the Corporation Net Income Tax and the adoption of a new tax – the Single Business Tax at a rate of two percent on all business enterprises in West Virginia, reasoning that such a broad-based tax would ensure that a company’s burden more accurately reflected the benefits it receives from government. The Commission proposed that the tax base for such a tax consist of the amount of compensation,

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<sup>118</sup> 1999 Commission on Fair Taxation’s Executive Report at 5-6.

<sup>119</sup> *Id.* at 6.

rents, royalties, and interest paid, together with a consideration of profits made and business depreciation each year. Deductions would be permitted for the cost of capital expenditures in the State. In addition, some relief would be offered for small businesses in order to encourage the growth of start-ups, but any such exemption was to decrease as the company's tax base or as its gross receipts increased.<sup>120</sup>

The 1999 Commission on Fair Taxation also proposed that the Consumers Sales and Service and Use Taxes be replaced by a broader general excise tax at a rate of six percent, together with the elimination of most of the exemptions theretofore applied. This proposal flowed from the Commission's determination that the State's Consumers Sales and Service and Use Tax system complicated compliance and administration and "unfairly and arbitrarily . . . lift[ed] the burden of taxation from certain sectors which benefit as much from government services as do those who have to pay the tax."<sup>121</sup>

Looking to expand the progressive nature of the State tax system, the 1999 Commission on Fair Taxation advised the establishment of exemptions for some goods and services, specifically mentioning health care and medicine. It also sought to avoid double and pyramid taxation through the exemption of employee compensation and certain transactions like the purchase of advertising or the purchase of goods and services specifically intended for resale or for use in production. Exemption of the purchase of goods and services by government entities and, in some cases, non-profit organizations, also was proposed. However, the Commission specifically advocated for the inclusion of some items like non-health care professional services and various utility services.<sup>122</sup> The Commission also recommended that the sales tax on food remain.

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<sup>120</sup> *Id.* at 15.

<sup>121</sup> 1999 Commission on Fair Taxation's Executive Report at 11.

<sup>122</sup> *Id.* at 12.

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The 1999 Commission on Fair Taxation sought to preserve the progressive state of the Personal Income Tax by curing two ills that it believed plagued the tax structure: first, a failure to provide adequate tax relief for low-income households and, second, the existence of discriminatory exclusions for some types of retirement income. The Commission's proposed solution was the institution of a two-rate system (5.0 percent on the first \$40,000 of taxable income and 6.5 percent on the taxable income in excess of \$40,000), and "the use of generous exemptions in order to achieve an effective measure of progressivism."<sup>123</sup> It suggested that the use of exemptions be linked to the federal poverty level, which exemptions would decrease as personal income increased.<sup>124</sup>

The retention of a number of special revenue sources was advised to offset burdens beyond government's "usual or customary responsibilities."<sup>125</sup> Those particular taxes, fees, and proceeds were: gasoline excise, gasoline sales, severance, liquor, nonintoxicating beer, wine, estate, racing, bingo, and lottery. The 1999 Commission on Fair Taxation also suggested expansion of the Cigarette Tax to a tobacco products tax that would include a wider range of products, and restructuring of the Excess Acreage Tax, for which the rate had been unchanged since 1905, to be collected at a higher rate and on an annual basis rather than on a single occasion.

The 1999 Commission recommended the "orderly discontinuation of the use of tax credits," which it found to "violate most of the values of fair taxation" and to be of doubtful effectiveness.<sup>126</sup> It further questioned the ability of credits to withstand Commerce Clause scrutiny. Additionally, this Commission, like some before, recommended the establishment of an independent State board of tax appeals,

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<sup>123</sup> *Id.* at 8.

<sup>124</sup> *Id.*

<sup>125</sup> *Id.* at 16.

<sup>126</sup> *Id.* at 19-20.

along with various other administrative changes. The Commission recommended the “immediate” repeal of the personal property tax on vehicles, which it labeled as “one of the most despised levies in the State.”<sup>127</sup>

But the 1999 Commission noted that the broad principles it established would be violated by the continued dependence on the revenue sources on which local governments were most reliant. It proposed that counties and cities be “held harmless” for the loss of the personal property tax by permitting them to use the vacated education real property levy and to use the Severance Tax on coal and natural gas. It also suggested that localities “piggyback” on the personal income tax and the proposed general excise tax, and that municipalities be permitted to retain the ability to impose their Business and Occupation Taxes uniformly to all businesses. Finally, cities and counties could impose excess real property levies if passed by a majority of voters in the jurisdiction, but the law would be amended to require only 50 percent voter approval, rather than the 60 percent then in effect.<sup>128</sup>

Beyond its recommendations with regard to the tax structure, the 1999 Commission on Fair Taxation detailed its conclusion that the State Constitution should be amended to permit the reauthorization of only the taxes ultimately retained in the reformed tax structure. It further suggested that each tax base be specifically defined to assure accountability, simplicity, consistency, and stability,

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<sup>127</sup> *Id.* at 22.

<sup>128</sup> 1999 Commission on Fair Taxation’s Executive Report at 22 through 26. The 1999 Commission on Fair Taxation looked to improve fairness in the tax structure related to the raising of revenue for public schools and ensure Constitutional compliance in the process. Three measures were suggested to achieve these goals: (1) eliminating the local regular education levy as a source of funding and replacing that portion of the budget supported by local property taxes with State level funding; (2) providing that local voters retain the right to approve excess levies to pay for educational programs that are not required to be furnished or supported by the State; and (3) amending the Constitution to empower the Legislature to determine the necessary spending plan for a thorough and efficient school system. The 1999 Commission recommended providing additional State funding through (1) the reformed State tax structure proposed by the Commission; (2) a State education levy upon real property that would consist of 10 percent of a board of education’s then-current maximum levy allocation; and (3) all property tax revenues then attributable to public utilities.



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while at the same time remaining sufficiently general to allow for adjustment in response to changing economic circumstances. The Commission had opined that provisions of the West Virginia Constitution, while purporting to limit the power of taxation, had “not effectively assured adherence to the fundamental principles that the people of West Virginia expect in their tax structure.”<sup>129</sup>

The State did not opt for wholesale implementation of the recommendations of the 1999 Commission on Fair Taxation, but a few points should be made. First, the 1999 Commission, in a very thorough and sincere manner, identified several problems that exist with respect to our system of taxation. In so doing, even without implementation, the Commission helped to frame a number of issues for West Virginia policymakers and to continue the long debate that has existed in this State concerning our system of taxation. That alone is an accomplishment. The 1999 Commission on Fair Taxation’s Report has also been a valuable tool for the Tax Modernization Project members in identifying issues and in recommending changes.

Finally, the Legislature has dealt with at least two of the issues identified by the 1999 Commission. First, the Legislature in 2002 overhauled its tax credit system, eliminating ten ineffective tax credits and refining and overhauling three others.<sup>130</sup> Second, the Legislature established the Office of Tax Appeals, an independent, quasi-judicial body that provides taxpayers with a new avenue to seek redress on certain issues related to taxation.<sup>131</sup>

In 2003, the State of West Virginia also became a part of the Streamlined Sales Tax Project. The Streamlined Sales Tax Project

is an effort created by state governments, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and

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<sup>129</sup> 1999 Commission on Fair Taxation’s Executive Report at 36.

<sup>130</sup> 2002 W. Va. Acts at 776-923.

<sup>131</sup> *Id.* at 2269-2306.

administration. The Project's proposals include tax law simplifications, more efficient administrative procedures, and emerging technologies to substantially reduce the burden of tax collection. The Project's proposals are focused on improving sales and use tax collections for both Main Street and remote sellers of all types of commerce.<sup>132</sup>

The goal of the Streamlined Sales Tax Project is to provide the following key features with respect to Consumers Sales and Service Taxes: uniform definitions; rate simplification; state level tax administration of all state and local sales and use taxes; uniform sourcing rules; simplified exemption administration for use-based and entity-based exemptions; uniform audit procedures; and state funding of the system. Additionally, the Streamlined Sales Tax Project set forth a mechanism in which businesses with no physical presence in West Virginia – i.e., remote sellers who sell products to West Virginia – can collect and remit sales tax without an additional burden. This key feature will help to offset reductions in the Consumers Sales and Service Tax base that has been created due to the proliferation of remote purchases by West Virginians from businesses with no physical presence in West Virginia. And in taking steps to provide that sales destined for West Virginia are subject to the appropriate tax, the State is ensuring that West Virginia businesses who are obligated to collect and remit sales taxes are competing on a level playing field.

During the enactment of the legislation implementing workers' compensation privatization, several taxes were increased to help reduce the multi-billion dollar workers' compensation debt. Effective December 1, 2005, additional Severance Taxes equal to 56 cents per ton of coal, 4 and 7/10 cents per 1,000 cubic feet of natural gas, and 2.78 percent of timber severance gross receipts<sup>133</sup> were

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<sup>132</sup> Streamlined Sales Tax Project, "Executive Summary," available online at <http://www.streamlinedsalestax.org/execsum0105.pdf>.

<sup>133</sup> The Regular Timber Severance Tax rate will decrease from 3.22 percent to 1.22 percent effective January 1, 2007. See W. Va. Code § 11-3A-6b (2005).

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imposed.<sup>134</sup> The total yield of these new taxes is expected to average roughly \$92 million per year. Additionally, \$45 million of Personal Income Tax collections each year have been dedicated to pay down the workers' compensation debt. On September 1, 2005, the rate of the sales tax on food for home consumption fell from 6 percent to 5 percent.<sup>135</sup>

Finally, a landmark administrative change is currently underway at the State Tax Department. In early 2005, after a three-year analysis and investigation of the tax accounting systems available in the market, as well as a review of actions of other states in updating tax accounting systems, the State Tax Department developed a plan to upgrade its 30-year-old computer processing system and to replace the 22 stand-alone systems for tax administration. During the 2005 Regular Session of the Legislature, the Legislature approved the upgrade and modernization, appropriating \$22 million to secure the implementation of a new integrated tax accounting system. The State Tax Department immediately began the process, and during 2005 successfully procured a vendor to develop a modern integrated tax system for personal income and business taxes.

In 2006, the State Tax Department officially dubbed the system upgrade the "RAPIDS Project" (i.e., the Revenue Accounts Processing Integrated Development System Project), and began implementation of its new tax system, known as GenTax<sup>®</sup>. GenTax<sup>®</sup> is built specifically to support revenue agency business processes and functions, and is in production at multiple North American jurisdictions. It runs on industry standard hardware, is designed for performance and scalability, and



<sup>134</sup> These taxes, along with the statutory provisions implementing the privatization of the State-run workers' compensation system, were passed in the First Extraordinary Session of the Legislature in 2005. S. B. 1004, 77<sup>th</sup> Leg., 1st Extraordinary Sess. (W. Va. 2005).

<sup>135</sup> The reduction on the sales tax on food for home consumption was enacted during the Fourth Extraordinary Session of the Legislature in 2005. S. B. 401, 77<sup>th</sup> Leg., 4th Extraordinary Sess. (W. Va. 2005).

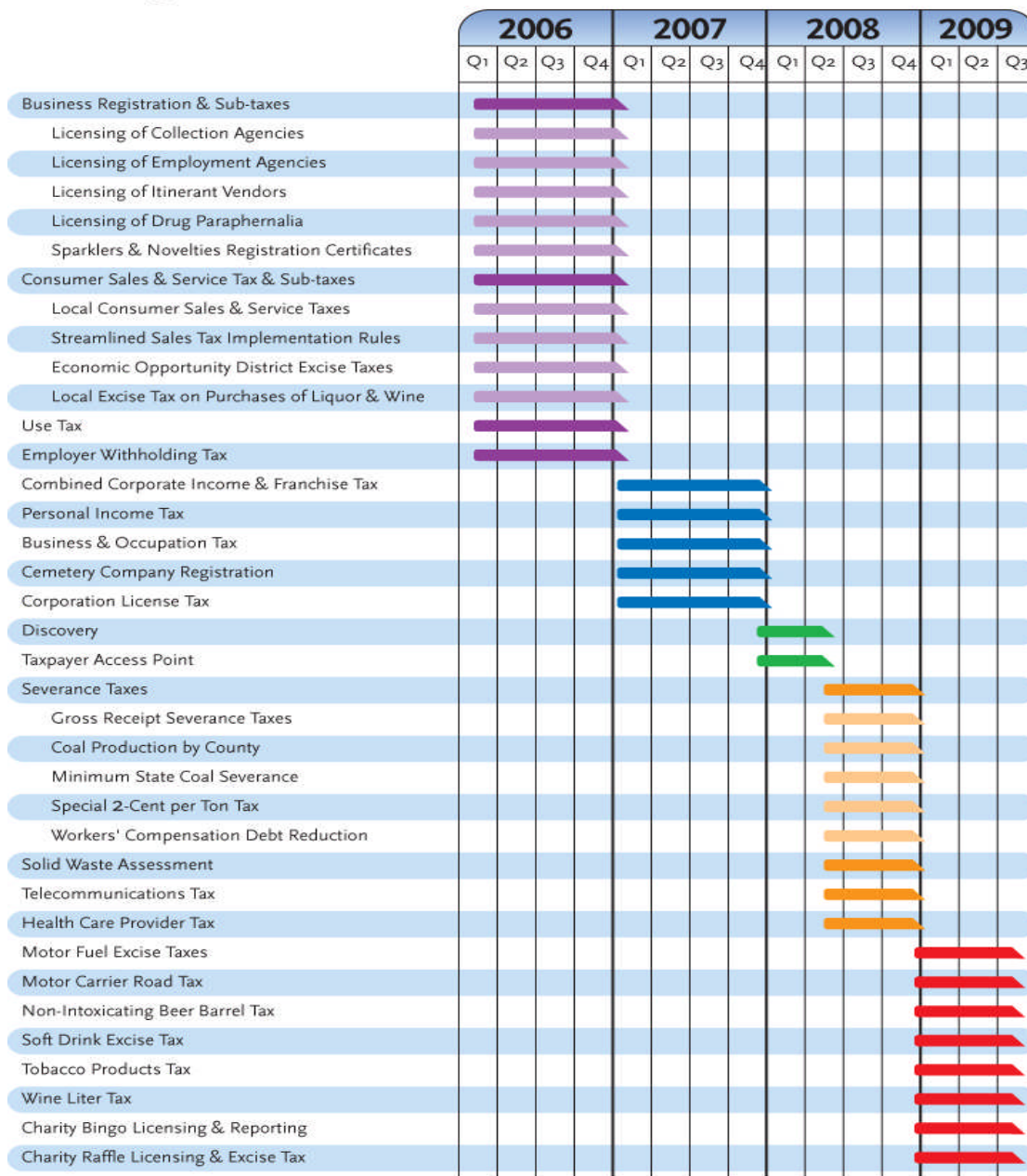
supports multiple database management systems. Indeed, the West Virginia State Tax Department is not alone in its employment of GenTax<sup>®</sup>. The Department joins a number of other state revenue agencies including: Idaho, Montana, New Mexico, Louisiana, Wisconsin, North Dakota, Alabama, Georgia, Utah, and Illinois.

At the conclusion of the RAPIDS Project, planned for August 2009, the State Tax Department will have converted 36 tax types to the new accounting system; implemented stand-alone audit and compliance modules to support field operations and enforcement; established a discovery “data warehouse” for information analysis and gathering; and provided taxpayers with a fully functional internet service center for transacting business with the Department. As shown below, the project is divided into five rollouts.

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**TABLE 1**

**West Virginia**



Each rollout concentrates development efforts around a specific group of taxes. At the end of each rollout, the taxes go “live” in production and the Department will begin utilizing GenTax<sup>®</sup> to administer those taxes.

The resources dedicated to the RAPIDS Project are significant. Currently, 20 State Tax Department employees are working with 18 employees of the vendor. In addition to the project staff, the State Tax Department has dedicated several senior executives to oversee RAPIDS. Dana Miller serves as State Project Director. The RAPIDS sponsor is Deputy Tax Commissioner Chris Morris. Mr. Morris provides direction, approves significant decision requests, and has the final say in resolving issues. Commissioner Virgil Helton and Director of Fiscal Policy Mark Muchow are the “project champions.” As project champions, they promote RAPIDS both internally and externally, with private and public business partners, various revenue agencies, and other stakeholders. Nine senior and executive-level managers within the Department make up the RAPIDS steering committee. The steering committee meets monthly, monitors the status of the project, and resolves management, policy, and directional issues that impact the project. Two independent project oversight advisors monitor the progress of the project and report to the State Tax Commissioner and the State’s Chief Technology Officer. Five employees in the Department are serving on a “letters committee.” The letters committee reviews all printed documents that the Department generates and determines how they should be worded. As time progresses, many employees in the Department will become involved in the RAPIDS Project. Twelve Department employees have been trained to instruct internal users how to utilize GenTax<sup>®</sup>. Also, approximately 25 Department employees are involved in system unit testing to ensure that GenTax<sup>®</sup> has been properly configured to administer West Virginia’s taxes.

The RAPIDS Project is an extensive, complicated, and daunting task. The implementation of this new, state-of-the-art system, however, will allow the State Tax Department to become a much more efficient service provider and will bring the West Virginia revenue collection process into the 21st century.

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**G. Summary: Reflections and Conclusions About Our Tax System**

The review of West Virginia's system of taxation leads to a few inescapable conclusions. First, the citizens of West Virginia place great interest in their real property. In the 1930s, when the economy was in chaos and many individuals were losing their homes due to the inability to pay taxes, West Virginians responded with a constitutional amendment designed to ensure that real property taxes on owner-occupied homes would not increase. And in the 1980s, in the wake of potential residential real property tax increases due to reappraisals of property, the people of the State again sought to limit the extent of real property taxation.

Moreover, the State has a history of increasing indirect state taxes in times of trouble (and to compensate for low real property taxes). In the 1930s, the yield for the State Business and Occupation Tax increased six fold. And in the late 1980s, when the State was again in financial crisis many indirect taxes were increased.

The system of taxation has seen a great deal of turbulence. Many times the State has enacted changes designed to improve the tax system. On several of those occasions, the initial reforms contained reductions which the State in the long term was unable to sustain, and lawmakers were required to either undo reforms or find other sources of revenue. For example, in 1969, the State provided a tax credit to manufacturers – only to double their Business and Occupation Tax rate two years later. And in 1979, the State called for the phase out of the sales tax on food, only in 1981 to be forced to raise the regular sales tax rate to offset revenue losses. And in 1985 and 1986, the State cut taxes that ultimately reduced revenues for the General Revenue Fund by fifteen percent. Three years later, the State was in financial crisis and was forced to enact a \$400 million tax increase.

Finally, the fact that real owner-occupied property taxes in West Virginia are significantly lower than other states (and are a lesser percentage of total revenues than in other States) means that the State and local governments must derive their revenues from other sources. Those other sources include a broad Consumers

Sales and Service Tax, a Personal Income Tax, and higher than average taxes on businesses. The lack of revenues from owner-occupied residential real property also deprives local governments of a key revenue source that is available in many other states. Without such revenue, the State of West Virginia has to make up the difference. As a result, West Virginia is one of the most centralized states in the nation with respect to tax administration and tax sourcing.





## **Chapter V**

# ***An Overview of West Virginia's Current Budget and General Revenue Collections***

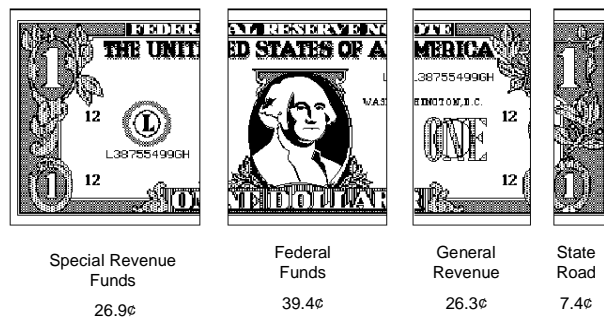


**V. An Overview of West Virginia's Current Budget and General Revenue Collections**

The State of West Virginia receives approximately \$14 billion in total revenue for operations and programs each year, excluding funds held in trust such as public employee, State Police, and judicial retirement system contributions.

**CHART 1**

**Total Estimated Revenue FY 2007  
\$13.96 Billion**



Revenues received by the State are divided into four general categories.

**1. General Revenue Fund.** The General Revenue Fund is comprised of Personal Income Taxes, Consumers Sales and Service Taxes, Use Taxes, Business and Occupation Taxes, Tobacco Taxes, Corporation Net Income Taxes, Business Franchise Taxes, Severance Taxes, and various other taxes of a lesser nature. All money in the General Revenue Fund must be appropriated by the Legislature and is used to provide most of the basic services required of state government, including public and higher education, basic health services, public safety, and the payment of debt. It also provides for basic government functions such as legislative and judicial operations, tax collections, public defender services, personnel administration, and general administrative services. The following table shows the amount each tax contributes to the General Revenue Fund:

**TABLE 1**  
**WEST VIRGINIA GENERAL REVENUE FUND COLLECTIONS**  
 Net Revenue for Fiscal Year 2005-2006

Revenue Source	State Tax Collections	Percentages	
		Component	Group
<b>Initial Business Taxes</b>			
Business Registration	1,818,860	0.05%	
Corporate License	5,361,113	0.15%	0.20%
<b>Business Taxes</b>			
Corporation Net Income	347,569,611	9.49%	
Business Franchise Tax			
Severance	314,726,682	8.60%	
Business and Occupation	185,456,897	5.07%	
Telecommunications	-430,021	-0.01%	
Insurance	95,655,187	2.61%	25.75%
<b>Consumers Sales and Service and Use Taxes</b>			
Consumers Sales and Service	1,012,450,612	27.65%	
Use	113,315,058	3.09%	30.75%
<b>Personal Taxes</b>			
Personal Income	1,297,720,394	35.44%	
Estate & Inheritance	591,724	0.02%	35.46%
<b>Excise Taxes</b>			
Liquor Profit Transfers	11,508,649	0.31%	
Beer Tax & Licenses	8,547,760	0.23%	
Tobacco Products Excise Tax	112,027,627	3.06%	3.61%
<b>Miscellaneous Fees and Transfers</b>			
Racing Fees	1,089,011	0.03%	
Departmental Collections	13,834,314	0.38%	
Interest Income	34,411,122	0.94%	
Lottery Transfers	77,900,000	2.13%	
Lottery Reimbursement for Senior Citizen Tax Credit	4,035,650	0.11%	
Miscellaneous Fees and Transfers	5,563,296	0.15%	3.74%
<b>Taxes Collected by Counties</b>			
<b>For the State</b>			
Property (State Share Only)	4,590,635	0.13%	
Property Transfer (State Share Only)	13,658,145	0.37%	0.50%
<b>Total*</b>	<b>3,661,402,326</b>	<b>100.00%</b>	<b>100.00%</b>

\*Percentage totals may not equal 100.00% due to rounding.

**2. Special Revenue Funds.** Special Revenue Funds are created by statute and allow agencies to charge specific fees for particular services, with the fees dedicated to the providing agencies to cover service costs. For example, a person staying in a cabin or lodge at a State park operated by the Division of Natural Resources pays a fee for the cabin or room. The money collected is earmarked and used to defray the cost of operating the entire park system. The collections do not become part of the General Revenue Fund, but instead, by statute, stay with the Division of Natural Resources. The payment of tuition to colleges and universities is another example. Lottery funds also are considered special revenue.

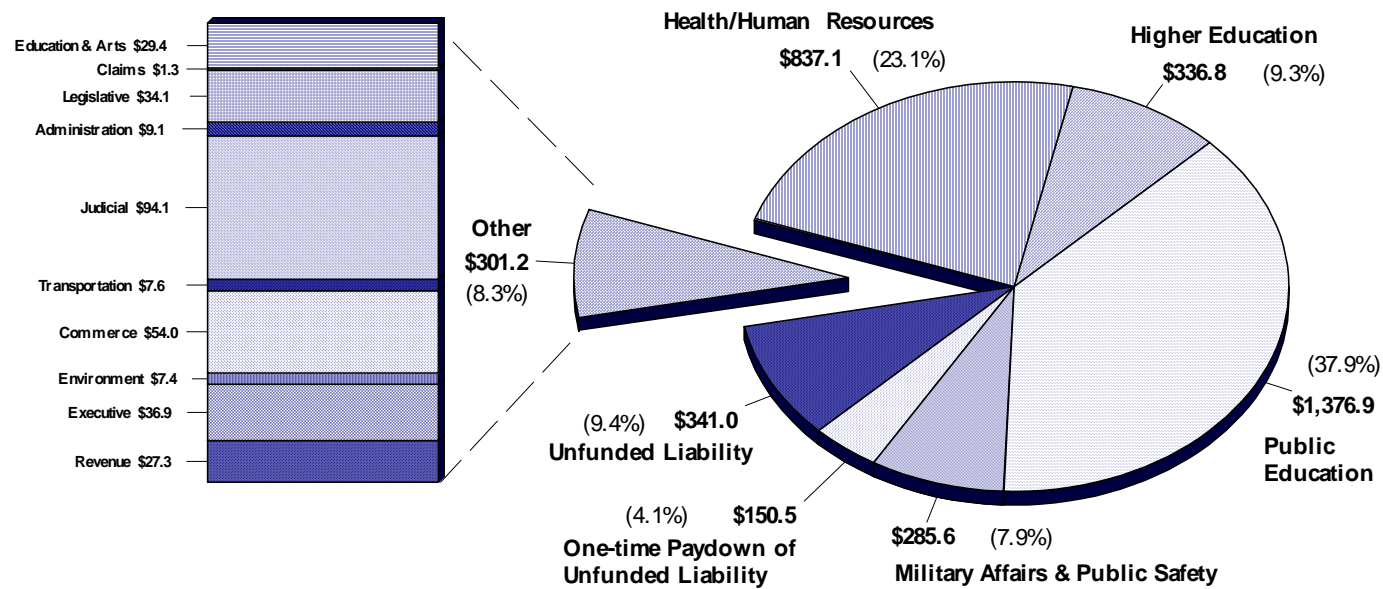
**3. Federal Funds.** Federal Funds are received from the federal government and may only be expended for the specific purposes allowed by federal law. Federal funds are provided to the State for a wide variety of projects. Most federal funds in West Virginia are dedicated to the building and maintenance of highways and the Department of Health and Human Resources's Medicaid program. The State also receives federal grants for many other projects such as environmental protection, nutrition services for the aged, behavioral health services, homeland security, and many other areas. In all cases, the federal funds are restricted and may only be expended in accordance with the terms of the federal grant.

**4. State Road Fund.** State Road Funds are made up of taxes on gasoline and motor fuels, privilege taxes, and vehicle registration fees. Under the West Virginia Constitution, these taxes and fees are devoted solely to building and maintaining the State road system and may not be used for other purposes.

As mentioned above, much of the attention in this document has focused on the General Revenue Fund. The following chart indicates the General Revenue Fund Appropriations by Department for Fiscal Year 2007.

CHART 2

# General Revenue Fund Appropriations Fiscal Year 2007 (In Millions of Dollars)



Prepared by: State Budget Office  
May 2006

**Total FY 2007 \$3.629 Billion**

The General Revenue Fund of \$3.6 billion pays for many of the basic services that citizens require of government. Of this fund, 47.2 percent is used to provide both public and higher education, not including the unfunded liability attributed to the Teachers' Retirement System.

Public health (e.g., Medicaid, behavioral health, child protective services, women-infants-children (WIC) and public health hospitals) and public safety (e.g., State Police, correctional and juvenile facilities, parole services, emergency services, and homeland security) account for another 31 percent.

The payments to the unfunded liability in the State retirement systems are 13.5 percent, (\$491.5 million). Of this amount, \$484.5 million is for the Teachers' Retirement System.

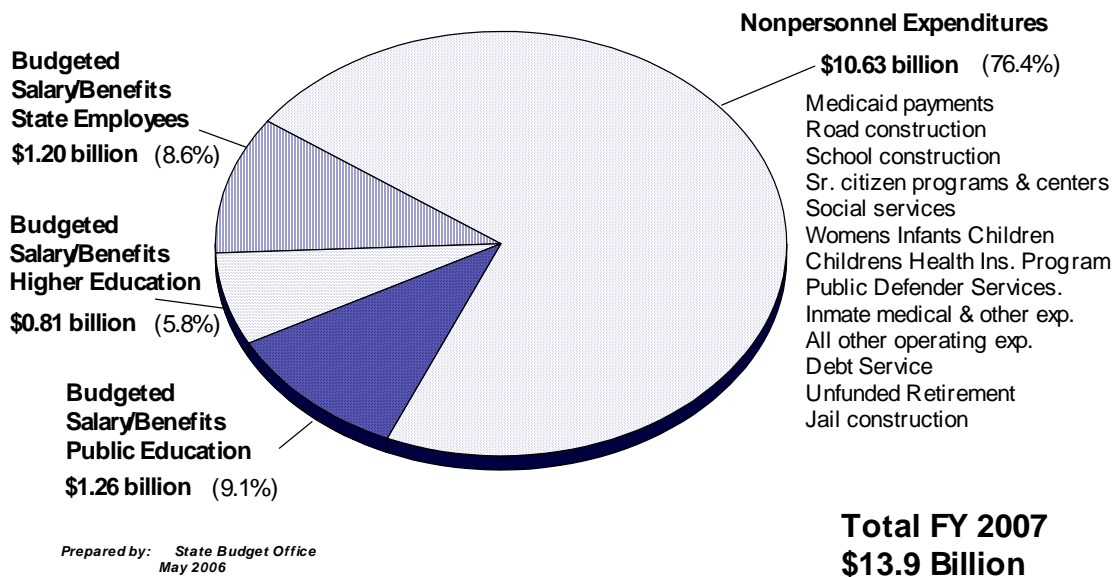
All remaining government services provided from the General Revenue Fund constitute only 8.3 percent of the total General Revenue budget. These services are the operation of the Legislature; the Supreme Court; the Departments of Administration, Transportation, Commerce, Environment, Revenue; and the elected Constitutional offices of the Governor, Auditor, Treasurer, Commissioner of Agriculture, Secretary of State, and the Attorney General.



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Finally, it is often suggested that significant tax cuts could be enacted if the State reduced its workforce. Although it is certainly beyond the scope of the Project’s mission and expertise to comment on the appropriate staffing levels for the State of West Virginia, the following chart illustrates the amount of revenues that are actually expended on personnel:

**CHART 3  
Total Estimated Expenditures  
All Funds  
Fiscal Year 2007**



Although the number of personnel the State employs is significant and all efforts should be made to provide services in the most efficient manner using the fewest employees possible, the total cost of personal services and benefits, including public education, is less than 25 percent of total State expenditures. More than 75 percent of all funds expended by the State are for non-personnel related items such as debt service; Medicaid payments; road, school, and correctional

facility construction; social services; Children’s Health Insurance Program; senior citizen programs and centers; and other items of a service nature.

Indeed, the State of West Virginia provides myriad services to the citizens of the State, including education, public safety, health, environment, senior services, judicial, commerce, and other services. Providing the needed services requires approximately 35,000 employees. Of this number, approximately 10,800 are employed by colleges and universities and another 11,500 are employed in various health and public safety areas. The State also funds basic aid to counties for public education, including salary and benefits for approximately 32,900 public school teachers and school service personnel.

Finally, many individuals have suggested that the State of West Virginia would have the ability to enact significant tax cuts if it decided to reduce governmental programs. Again, the members were tasked with reviewing the State’s tax system. Although members are aware of the amounts necessary to fund governmental programs, and have kept those amounts in mind when reviewing the State’s tax system, it is really beyond the scope of the Project to review and recommend program cuts as part of this Report. Many individuals suggested that the State of West Virginia cut programs, but few actually singled out any significant programs to be eliminated.

The Project members thought it was very important to recognize the State of West Virginia’s recent fiscal discipline in paying down the significant unfunded accrued liabilities (UAL) of the State. As is common knowledge, this State is saddled with an extremely low-funded Teachers’ Retirement System, as well as a significant workers’ compensation debt. By identifying a revenue stream sufficient to manage the workers’ compensation liabilities, and by using one-time surplus dollars to pay down debt in the Teachers’ Retirement System (as well as the State’s additional pension systems), the State has saved hundreds of millions of future taxpayer dollars over the next few decades. In so doing, the State has prudently directed current revenue collections to provide more long-term flexibility with respect to taxation and spending. The following chart is indicative of the significant sums of

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money appropriated by the Legislature to pay down long-term debt for the State's retirement systems:

**CHART 4**

**UNFUNDED RETIREMENT LIABILITIES  
(In Millions)**

<u>System</u>	<u>UAL</u>	<u>%Funded</u>	<u>Surplus Contributions *</u>
Teachers Retirement System			\$408.4
7/1/2003	5,052.9	19.1%	
7/1/2004	5,013.3	22.2%	
7/1/2005	4,990.4	24.6%	
Public Safety Plan A			\$294.0
7/1/2003	348.5	22.2%	
7/1/2004	344.0	25.6%	
7/1/2005	124.0	74.4%	
Judges Retirement System			\$0.0
7/1/2003	43.9	54.6%	
7/1/2004	22.2	74.1%	
7/1/2005	15.8	82.6%	

\* Will save \$700+ million over the life of the retirement plans

Again, these unprecedented efforts to address the unfunded liabilities in the various State retirement systems have resulted in additional contributions or appropriations in excess of \$700 million to those accounts as of May 2006. All of the additional funding has taken place since April 2005, using surplus funds from the General Revenue Fund, generated from a stronger than anticipated economy, and Lottery proceeds. The surplus funding available was not used to enlarge existing programs or to create new programs, but was used almost exclusively to assist in reducing the unfunded liability, thereby saving the taxpayers an estimated additional \$700 million in future payments.

## **Chapter VI**

# ***Analyzing West Virginia's System of Taxation***



## VI. Analyzing West Virginia's System of Taxation

Members of the Tax Modernization Project divided into subgroups to focus on four main areas of taxation in West Virginia: Business Taxes, Personal Taxes, Property Taxes and Local Government Finance, and the State Road Fund. Each group was tasked with comprehensively reviewing the applicable taxes and fees and providing recommendations for change, as well as identifying areas for further study. The members of the Tax Modernization Project hope that this Report takes the first significant steps toward modernization and provides a blueprint for further analysis. The Tax Modernization Project members know that much work remains to be done and this Report is simply a starting point for continued analysis. Engaging in a comprehensive review of a tax system and making proposals to correct all issues related to that system takes significant time, energy, effort, and resources. It also takes a judicious approach to realizing what can be accomplished and what necessitates further study before modifications can be successfully implemented. Members of a recent study in the Commonwealth of Virginia made comments which echo the thoughts of members of this Tax Modernization Project:

While this [Project] endeavored to consider during the course of its study each of the issues referred to it for consideration, not all are the subject of recommendations subsequently found in this report. Time constraints and inadequacy of available data precluded our ability to offer recommendations on all [issues]. The issues submitted to this Commission for consideration were too consequential for our submission of recommendations where the potential ramifications could not be examined to our satisfaction. Alternatively, the recommendations that are presented in this report rest upon our judgment that they are substantiated by relevant evidence and that they clearly serve the interest of the [State] and its citizenry.<sup>136</sup>

With those thoughts in mind, the following are the conclusions, recommendations, and areas identified for further study by each of the four subgroups. Finally, please note that an additional chapter has been added, relating to the Consumers Sales

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<sup>136</sup> Report on the Commission on Virginia's State and Local Tax Structure for the 21<sup>st</sup> Century.

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and Service Tax and excise taxes. Each subgroup considered various portions of the Consumers Sales and Service Tax and excise taxes as they related to the particular group. Recommendations were then compiled into the following Chapters.

# **Chapter VII**

## ***Personal Income Tax***





## VII. Personal Income Tax

### A. Introduction

Before proceeding into the specific proposals of the members of the Personal Income Tax Subgroup, it is important to note a few aspects of the West Virginia's Personal Income Tax. As previously mentioned, the Personal Income Tax was enacted in 1961. It is a significant source of revenue for the State of West Virginia. Almost \$1.3 billion was collected during Fiscal Year 2006 through the Personal Income Tax. That amounted to over 35 percent of all collections for the General Revenue Fund.

West Virginia's Personal Income Tax is imposed on West Virginia taxable income of resident individuals, estates, and trusts, regardless of where their income is earned. Nonresident individuals, estates, and trusts are also subject to this tax on income from West Virginia sources. Most taxpayers who file Personal Income Tax returns file only one return per year. Only those individuals who have non-wage income must file quarterly returns and pay estimated taxes.

The West Virginia Personal Income Tax is based on federal income tax law. Specifically, any term used under West Virginia law for purposes of the Personal Income Tax has the same meaning as when used in a comparable context in federal income tax law unless a different meaning is clearly required. Moreover, the computation of West Virginia taxable income begins with federal adjusted gross income. Using that figure as a baseline, specific increasing and decreasing modifications required by West Virginia law are then applied. Federal adjusted gross income is modified by several increasing and decreasing adjustments for West Virginia Personal Income Tax computation purposes.<sup>137</sup>

Taxpayers are entitled to a Personal Income Tax exemption in the amount of \$2,000 for each federal income tax exemption to which the taxpayer is entitled for the taxable year. A husband and wife who file a joint federal return, but separate

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<sup>137</sup> For a summary of these increasing and decreasing modifications, see The Forty-Sixth Biennial Report of the State Tax Commissioner of West Virginia.

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West Virginia returns, may each claim only the exemptions to which they would have been entitled as individuals if they had filed separate federal returns. A surviving spouse is allowed one additional \$2,000 exemption for two taxable years following the year of the death of his or her spouse. Those claimed as dependents on another's return are entitled to a \$500 exemption. Estates and trusts are allowed only one \$600 exemption. With the exception of those who are married but filing separately, all taxpayers with federal adjusted gross income of \$10,000 or less may claim an exclusion for earned income of up to \$10,000 per year. Married filing separate taxpayers, with federal adjusted gross income of \$5,000 or less, may claim an exclusion for earned income of up to \$5,000.

Personal Income Tax rates differ with each taxable income category. Although the rates increase as taxable income increases, each rate is independent of every other rate. For example, for an individual taxpayer, an income of \$24,000 falls into the over \$10,000, but not over \$25,000, category. However, only \$14,000, or the amount by which the income exceeds \$10,000, is taxed at the four percent rate. The tax liability for the first \$10,000 is \$300. The tax rate tables follow.

TABLE 1

<b><u>Single, Head of Household, and Married Filing Jointly Returns</u></b>					
<b>Taxable Income</b>			<b>Tax Liability</b>		
Over		But Not Over		Plus	Of Excess Over
\$0	-	\$10,000	\$0.00	3.0%	\$0
10,000	-	25,000	300.00	4.0%	10,000
25,000	-	40,000	900.00	4.5%	25,000
40,000	-	60,000	1,575.00	6.0%	40,000
60,000	-		2,775.00	6.5%	60,000

TABLE 2

<b><u>Married Filing Separate Returns</u></b>					
<b>Taxable Income</b>			<b>Tax Liability</b>		
Over		But Not Over		Plus	Of Excess Over
\$0	-	\$5,000	\$0.00	3.0%	\$0
5,000	-	12,500	150.00	4.0%	5,000
12,500	-	20,000	450.00	4.5%	12,500
20,000	-	30,000	787.50	6.0%	20,000
30,000	-		1,387.50	6.5%	30,000

Once the amount of tax liability is determined using the above rates, West Virginia provides certain credits against tax liability. If certain conditions are met, a West Virginia resident may be entitled to a credit because of income tax imposed by another state, but not for taxes imposed by any city, township, borough, or political subdivision of a state. Likewise, some credit may be granted to nonresident West

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Virginia taxpayers when income they receive from West Virginia sources is also subject to income taxation by their state of residence, provided their state has entered into a written reciprocal agreement with West Virginia. Third, a one-time credit against Personal Income Tax liability is allowed for non-family adoptions. The credit is equal to \$2,000, which may be taken in the year of the adoption of each non-family child who, at the time of the adoption, is under 18 years of age.

A tax credit is also available for certain low-income taxpayers who are eligible for the Homestead Exemption for property tax purposes. The tax credit is based on the amount of *ad valorem* property taxes paid on the first \$10,000, or portion thereof, of the taxable assessed value over the \$20,000 Homestead Exemption. In order to qualify for the credit, the taxpayer must meet all of the following criteria:

- (A) He or she must incur and pay a property tax liability on the Homestead Exemption eligible home;
- (B) His or her federal adjusted gross income must meet the low income test, and
- (C) He or she must file a document to verify the annual income and the amount of the credit.

Importantly, “low income” is defined as federal adjusted gross income for the year that is 150 percent or less of the federal poverty guideline for the corresponding household size for the year.<sup>138</sup>

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<sup>138</sup> Several additional tax credits may be available to some taxpayers. These include the Economic Opportunity Tax Credit, the Strategic Research and Development Tax Credit, the Historic Rehabilitated Buildings Credit, the Credit for Qualified Rehabilitated Residential Building Investment, the West Virginia Capital Company Credit, the Military Employment Incentive Credit, the Neighborhood Investment Credit, and the Environmental Agricultural Equipment Credit. Taxpayers that had gained entitlement to the Alternative-Fuel Motor Vehicles Credit as of June 2006 may continue to use the credit. A similar situation is true for taxpayers that had gained entitlement to the Business Investment and Jobs Expansion Credit. Those taxpayers who had placed qualified investment into service or use prior to January 1, 2003, may continue to use the credit.

The Personal Income Tax Subgroup believes that West Virginia's Personal Income Tax has a number of favorable characteristics. First, because the tax is based on the federal income tax system, it is relatively easy to enforce and, as a general matter, easy to administer when compared with most other taxes.<sup>139</sup> And second, West Virginia is in the majority of states in using federal adjusted gross income as the starting point of taxation. Therefore, any proposed changes to West Virginia's Personal Income Tax structure should continue to use federal adjusted gross income as the starting point for the calculation of Personal Income Tax, as does the current Personal Income Tax structure.

The current Personal Income Tax structure also produces relatively competitive tax liabilities when compared to those of surrounding states, and the current top marginal rate is competitive as well.<sup>140</sup> The following chart indicates that West Virginia's Personal Income Tax is competitive at most income levels with other states.

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<sup>139</sup> There is a potential drawback to the linkage to the federal income tax system. As the 1999 Commission on Fair Taxation concluded: "[C]hanges in the federal income tax system can cause problems with the stability and predictability of revenues produced by the State system. Moreover, realization of a potential overhaul of the federal system might create the need for a massive revision of the State system in order to maintain necessary revenues." 1999 Commission on Fair Taxation Report at 2-53.

<sup>140</sup> For additional information concerning personal income tax rates across the country, see Appendix D to this Report.

**TABLE 3**

**AVERAGE STATE AND LOCAL INCOME TAX DEDUCTION-2003**

SOURCE: IRS-Statistics of Income

<b>STATE</b>	<b>Average Income Tax Deduction</b>	<b>\$39,000 Income Tax Deduction</b>	<b>\$61,000 Income Tax Deduction</b>	<b>\$86,000 Income Tax Deduction</b>	<b>\$131,500 Income Tax Deduction</b>
NEW YORK	\$8,130	\$2,221	\$3,642	\$5,116	\$8,851
CALIFORNIA	6,638	1,398	3,014	3,993	7,703
MARYLAND	6,053	2,346	3,805	5,451	8,632
KENTUCKY	5,112	2,430	3,816	5,362	8,157
NORTH CAROLINA	4,930	2,022	3,267	4,766	7,812
OHIO	4,913	2,037	3,321	4,896	8,158
VIRGINIA	4,726	1,680	2,720	3,959	6,530
WEST VIRGINIA	4,614	1,708	2,779	4,199	7,104
PENNSYLVANIA	3,974	1,773	2,652	3,650	5,559
<b>AVERAGE ALL STATES</b>	<b>\$5,085</b>	<b>\$1,725</b>	<b>\$2,833</b>	<b>\$4,007</b>	<b>\$6,738</b>

Because the Personal Income Tax rates in West Virginia are competitive, the Personal Income Tax Subgroup does not recommend an increase in the top marginal rate, as it could hinder capital formation. Finally, as previously referenced, the Personal Income Tax generates over 35 percent of the State's general revenue fund dollars. This Subgroup recommends that the revised Personal Income Tax structure should generate roughly as much revenue as the current Personal Income Tax structure, so that the State has the ability to continue to balance its budget.

Despite several positive aspects of the Personal Income Tax, there is significant improvement to be made. The Personal Income Tax Subgroup's review of the Personal Income Tax structure has led to the identification of four primary objectives for West Virginia Personal Income Tax modernization:

1. West Virginia's Personal Income Tax changes should relieve families with income below federal poverty guideline from an income tax liability.
2. To the extent allowed by Federal law, personal income tax changes should provide equitable tax treatment to all pensioners, regardless of the source of their pension.
3. The "marriage penalty" <sup>141</sup> inherent in the current Personal Income Tax structure should either be reduced or eliminated.
4. The State should continue efforts to simplify the Personal Income Tax.

## **B. Recommendations**

Based on these objectives, the Personal Income Tax Subgroup developed both short-term and long-term proposed Personal Income Tax changes:

### **1. The Family Tax Credit**

One of the significant problems with the Personal Income Tax relates to the taxation levels of low income individuals and families. Two aspects of the tax highlight this problem. First, the \$2,000 personal exemption has not been changed in 20 years and the "effects of inflation have diminished the relief the exemption is designed to provide."<sup>142</sup> The Legislature, in 1996, attempted to rectify this inequity by enacting a provision that exempted from income tax the earned income of taxpayers whose federal adjusted gross income was \$10,000 or less. Similar to the conclusions of the 1999 Commission on Fair Taxation, the Personal Income Tax Subgroup believes that this exemption level is too low and, contrary to its intended

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<sup>141</sup> A so called "marriage penalty" occurs where, under a bracketed progressive tax structure, the combined income of a married couple reaches a higher tax bracket than the brackets that would apply if the tax were imposed on two single individuals filing separately with the same combined income.

<sup>142</sup> 1999 Commission on Fair Taxation at 3-101.



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purpose, the exemption benefits “individuals who work part-time or have seasonal employment and not the working poor.”<sup>143</sup> Moreover, the \$10,000 threshold creates a rather high marginal rate in that a taxpayer who earns just under \$10,000 owes no tax, while a taxpayer that earns just over \$10,000 is faced not only with full taxation on the amount of income over \$10,000, but also on the first \$10,000 dollars of income as well.

To cure this problem, the Personal Income Tax Subgroup recommends that the State implement an indexed family tax credit, based on family size and federal poverty guidelines, to eliminate West Virginia Personal Income Tax on families with incomes below the federal poverty guideline. The Personal Income Tax Subgroup recommends the creation of an indexed tax credit modeled after a similar program in Kentucky. The credit would be available to lower income individuals and families, and the credit would phase out as modified federal adjusted gross income<sup>144</sup> levels rise. This credit would affect 100,000 West Virginians, but would cost the General Revenue Fund approximately \$20 to \$24 million. The indexed family tax credit would eliminate West Virginia Personal Income Tax on families with incomes below the federal poverty guideline.

The federal poverty guideline is based on family size, and is adjusted each year by federal authorities. The following table shows the federal poverty guideline for 2006.

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<sup>143</sup>

*Id.*

<sup>144</sup> Modified federal adjusted gross income is equal to federal adjusted gross income, plus any increasing West Virginia modifications, and any tax exempt interest income reported on the federal tax return.

TABLE 4

<b>2006 Federal Poverty Guidelines<sup>145</sup></b>	
<b>Number of Federal Exemptions</b>	<b>Income Level</b>
1	\$9,800
2	13,200
3	16,600
4	20,000
5	23,400
6	26,800
7	30,200
8	33,600
For each additional person, add	3,400

Starting at the dollar amount of the federal poverty guideline applicable to the taxpayer's family size, the taxpayer gets a 100 percent credit against the West Virginia Personal Income Tax for modified federal adjusted gross income equal to or below the federal poverty guideline. The amount of credit decreases by 10 percent for each \$300 of modified federal adjusted gross income that is above the federal poverty guideline, until the credit reaches zero.

<sup>145</sup> *Federal Register*, Vol. 71, No. 15, January 24, 2006, pages 3848-3849.

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The following tables show the relief that the proposed Family Tax Credit would provide:

**TABLE 5**

**Personal Income Tax – Family Tax Credit  
Tax Proposal Impact on Hypothetical Taxpayers**

**Married Couple with 2 Children and Income at Federal Poverty Guideline**

	Current Law	Family Credit
Exemptions	4	4
Federal Adjusted Gross Income	\$20,000	\$20,000
Additions to Income	\$0	\$0
Subtractions from Income	\$0	\$0
West Virginia Adjusted Gross Income	\$20,000	\$20,000
Low-Income Earned Income Exclusion	\$0	\$0
Exemptions (\$2,000 per exemption)	\$8,000	\$8,000
Taxable Income	\$12,000	\$12,000
Tax Before Credit*	\$382	\$382
Credit Phase-out Factor	n/a	100%
Credit	n/a	\$382
Tax Due	\$382	\$0
Tax Change Under Family Credit		<b><u>-\$382</u></b>

**TABLE 6**

**Single Parent with 2 Children and Income at Federal Poverty Guideline**

	Current Law	Family Credit
Exemptions	3	3
Federal Adjusted Gross Income	\$16,600	\$16,600
Additions to Income	\$0	\$0
Subtractions from Income	\$0	\$0
West Virginia Adjusted Gross Income	\$16,600	\$16,600
Low-Income Earned Income Exclusion	\$0	\$0
Exemptions (\$2,000 per exemption)	\$6,000	\$6,000
Taxable Income	\$10,600	\$10,600
Tax Before Credit*	\$326	\$326
Credit Phase-out Factor	n/a	100%
Credit	n/a	\$326
Tax Due	\$326	\$0
Tax Change Under Family Credit		<b><u>-\$326</u></b>

\* Tax from Tax Tables

This credit would be superior to the current \$10,000 earned income exclusion because the value of the credit rises as family size increases. Under the indexed tax credit structure, the taxpayer is no longer abruptly subject to full taxation beginning with the first dollar of income above the \$10,000 earned income exclusion cut-off point. Moreover, under the Personal Income Tax Subgroup's proposal, the amount of the credit would be adjusted each year to reflect changes in the federal poverty guideline.

## 2. The Personal Income Tax Alternative Minimum Tax

The Personal Income Tax Subgroup recommends repeal of the State Personal Income Tax alternative minimum tax provisions. Under West Virginia law, West Virginia's personal income is also subject to an alternative minimum tax. Specifically, the West Virginia Code imposes a minimum tax, which is the "excess, if any, by which an amount equal to 25 percent of any federal minimum tax or alternative minimum tax for the taxable year exceeds the sum of the primary tax and the temporary surtax imposed by this section for the taxable year."<sup>146</sup> Thus, this provision guarantees that liability for Personal Income Tax must be equal to at least 25 percent of any federal minimum tax or alternative minimum tax for the taxable year. If a person's West Virginia Personal Income Tax liability does not equal the 25 percent minimum, then the minimum tax for West Virginia purposes becomes 25 percent of that federal minimum or alternative minimum tax.

As of today, only a few taxpayers are subject to the alternative minimum tax. The Personal Income Tax Subgroup has identified a key problem with respect to the West Virginia minimum tax: it is tied to the federal government's alternative minimum tax. Because the federal government's alternative minimum tax is not adjusted for inflation, more and more taxpayers at the federal level are becoming subject to this tax. Accordingly, more and more citizens of West Virginia will become

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<sup>146</sup> W. Va. Code § 11-21-3(a)(3) (2005). This alternative minimum tax was made effective on April 1, 1983, as part of the Personal Income Tax increases necessary to meet budget deficits that year. *Id.* at 11-21-3(a)(4).

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subject to this alternative minimum tax, and it could grow to apply to West Virginia citizens of only average incomes. The Personal Income Tax Subgroup, therefore, believes that the alternative minimum tax should be repealed. This is a tax simplification measure that will continue to ensure the progressive nature of West Virginia's Personal Income Tax and will cost the State approximately \$1 million.

### **3. Senior Citizens' Personal Income Tax Credit for Property Tax**

In the Report by the 1999 Commission on Fair Taxation, the Commission recognized not only the plight of the working poor, but also the burdens on individuals above the age of 65 and those with permanent and total disabilities. Specifically, those individuals may have limited capacity to earn additional income (or may be on a fixed income), yet must shoulder additional expenses, particularly with respect to medical care and transportation.<sup>147</sup> This problem can be compounded if property in the area in which the eligible citizen lives increases in value, thereby causing an increase in *ad valorem* real property taxes.

In 2001, the Legislature responded to this problem and enacted legislation providing for the Senior Citizens' Tax Credit for Property Tax paid on the first \$10,000 of taxable assessed value of a homestead in West Virginia. The credit is essentially a refundable credit applied against the Personal Income Tax liability for *ad valorem* property taxes paid on the first \$10,000 of taxable assessed value of a homestead in this State. To provide some form of relief to senior citizens that may be faced with this problem, the Personal Income Tax Subgroup proposes that this credit be expanded by increasing the amount of credit to an amount equal to the amount of property taxes paid on "up to" the first \$20,000 of taxable assessed value. The following tables provide hypothetical examples of the relief provided by this proposed modification:

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<sup>147</sup> 1999 Commission on Fair Taxation at 2-35. The 1999 Commission on Fair Taxation recommended the following "to relieve the burden of the tax on low-income families and the aged: a vanishing tax credit based on the poverty level that would apply to the working poor and the elderly alike." *Id.*

**TABLE 7**  
**Senior Citizens Tax Credit for Property Taxes Paid –**  
**Credit for Tax Paid on First \$20,000**  
**Above Homestead Exemption**  
**Tax Proposal Impact on Hypothetical Taxpayers**

**Homeowner in Rural Kanawha County**

	Current Law	Proposed Law
Residence Appraised Value	\$100,000	\$100,000
Assessed Value at 60%	\$60,000	\$60,000
Homestead Exemption Deduction	\$20,000	\$20,000
Taxable Assessed Value	\$40,000	\$40,000
Levy Rate (cents /\$100)	120.08	120.08
Local Property Tax Paid	\$480	\$480
Senior Citizens Income Tax Credit for Property Tax Paid	\$120	\$240
Net Tax Effect	\$360	\$240
Tax Change Under Proposal		<b><u>-\$120</u></b>

**TABLE 8**  
**Homeowner in Charleston**

	Current Law	Proposed Law
Residence Appraised Value	\$100,000	\$100,000
Assessed Value at 60%	\$60,000	\$60,000
Homestead Exemption Deduction	\$20,000	\$20,000
Taxable Assessed Value	\$40,000	\$40,000
Levy Rate (cents /\$100)	145.34	145.34
Local Property Tax Paid	\$581	\$581
Senior Citizens Income Tax Credit for Property Tax Paid	\$145	\$291
Net Tax Effect	\$436	\$290
Tax Change Under Proposal		<b><u>-\$146</u></b>

Some may suggest that the appropriate mechanism with respect to *ad valorem* real property taxes would be to provide relief at the local level instead of

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forcing the individual to pay the tax at the local level and then seek a credit. However, to prevent local jurisdictions from suffering lower net property tax revenues resulting from offset of property taxes at the local level by a tax credit, a credit against Personal Income Tax is the chosen alternative. Also, for administrative ease, the Personal Income Tax Subgroup would establish eligibility for the credit at a minimum of ten dollars. This small threshold would eliminate issuance of *de minimis* tax credits that exceed certain basic costs of administration of this program by the State. The cost of this expansion is approximately \$2.5 million.

### **4. Withholding Tax Changes**

The Personal Income Tax Subgroup believes that an administrative change is necessary. Most joint filer taxpayers use the income tax withholding tables for single filers instead of the two-earner table. This causes the amount withheld from taxpayers to fall short of actual tax due at the end of the year. The Personal Income Tax Subgroup proposes that the State Tax Department administratively replace the current income tax withholding tables for joint filers with the two-earner table. This is not a tax increase, and the taxpayer may still opt for the lower withholding option. By implementing this change, the year-end Personal Income Tax bill for taxpayers will decrease, and fewer taxpayers will pay a significant amount of taxes to the State on April 15 of each year.

### **5. Withholding Compliance Mechanisms**

West Virginia law currently provides that “a partnership, S corporation, estate or trust, which is treated as a pass-through entity for federal income tax purposes and which has taxable income for the taxable year derived from or connected with West Virginia sources any portion of which is allocable to a nonresident partner, nonresident shareholder, or nonresident beneficiary, as the case may be, shall pay a withholding tax” for Personal Income Tax purposes.<sup>148</sup> Our law also provides that “the amount of withholding tax payable by any such partnership, S corporation,

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<sup>148</sup> W. Va. Code § 11-21-71a (2005).

estate or trust,” is only 4 percent of “the effectively connected taxable income of the partnership, S corporation, estate or trust, as the case may be, which may lawfully be taxed by this State and which is allocable to a nonresident partner, nonresident shareholder, or nonresident beneficiary of a trust or estate.”<sup>149</sup> The withholding rate for such non-residents is therefore below the maximum tax rate of 6.5 percent. The Personal Income Tax Subgroup believes that, as a compliance measure, the withholding rate should be increased from 4 percent to 6.5 percent. It is important to note that this measure is not a tax increase. It is instead an enforcement measure designed to ensure that non-residents who derive income attributable to West Virginia pay their fair share. As always, the taxpayer can file a return and obtain a refund of any amount withheld in excess of the taxpayer’s liability for the year.

Additionally, the Personal Income Tax Subgroup recommends applying Personal Income Tax withholding provisions at the 6.5 percent rate to capital gains on non-residents’ transfers of West Virginia real estate. This is a compliance measure designed to ensure that the State of West Virginia receives the appropriate level of taxation from such income earned related to the transfers of West Virginia real estate. For administrative ease, the taxpayer would be provided with an option to not file a Personal Income Tax return if that individual has no other source of West Virginia income. And of course, the taxpayer can file a return and obtain a refund of any amount withheld in excess of the taxpayer’s liability for the year.

#### **6. The Rehabilitated Residential Building Investment Credit**

The Rehabilitated Residential Building Investment Credit is allowed for rehabilitation of owner-occupied certified historic residential structures. An individual is allowed to take as a credit 20 percent of eligible rehabilitation expenses incurred in rehabilitating a certified historic residential structure.

The Tax Modernization Project recommends that the Rehabilitated Residential Building Investment Personal Income Tax credit should be eliminated. The credit has a significant administrative burden: The Division of Culture and

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<sup>149</sup> *Id.* at 11-21-71a(b)(1).



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History must review and approve all rehabilitation expenditures for the credit. A review by the State Tax Department reveals that the credit has only been “somewhat effective.”<sup>150</sup> This proposed modification by the Tax Modernization Project constitutes a realignment of State tax credit policy to cause a more effective and more targeted credit structure, and it also represents a tax simplification measure. Elimination of this tax credit would save approximately \$1 million.

### **7. Issues for Further Study and Analysis**

In addition to the changes referenced above which may be implemented in the immediate phases of tax modernization, the Personal Income Tax Subgroup has also identified several areas that need additional study and refinement before implementation. These changes would be considered for the later phases of tax modernization.

The first order of business for the long-term phase of study for the Personal Income Tax is further consideration and potential implementation of a reduction in the number of tax brackets and a change in the overall rate structure. Such a move would have several beneficial aspects. First, a reduction of this sort would provide simplification by reducing the number of brackets into which a Taxpayer may be categorized. Second, West Virginia’s Personal Income Tax structure currently contains a marriage penalty. By realigning tax brackets as described above, the maximum marriage penalty could be reduced if there were fewer tax rate brackets and a narrower difference between the lowest and highest marginal tax rate. The marriage penalty could potentially be further reduced or eliminated through a tax rate convergence (similar to the tax bracket realignment described above), or through the creation of a two-earner couple tax credit based upon a calculation associated with the second income, or through a combination of both. The Personal Income Tax Subgroup will investigate mechanisms to further reduce the “marriage penalty.”

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<sup>150</sup> Analysis and Recommendations for West Virginia Tax Incentives, West Virginia Department of Tax and Revenue and West Virginia Development Office (January 9, 2002).

Finally, the Tax Modernization Project suggests investigating mechanisms to provide equitable treatment of all public and private pension income under the Personal Income Tax. Under current State law, several pensions receive favored status. Such an array of retirement benefit exclusions from income causes significant problems. First, the exclusions are based upon the source of income among retirees. As the 1999 Commission on Fair Taxation concluded: “By providing discriminatory exclusions, the present Personal Income Tax structure has created inconsistencies not only among public employees, but also among retirees in general.”<sup>151</sup> Additionally, with varying requirements, the exclusions are difficult for the State Tax Department to administer. Finally, “as the population in West Virginia ages, more taxpayers will become eligible for these exclusions, thus providing further erosion of the tax base.”<sup>152</sup> Accordingly, the Personal Income Tax Subgroup recommends that pension income exclusions and related retirement income exclusions be the subject of long-term study.

Finally, the Personal Income Tax Subgroup believes that the Personal Income Tax structure should be reviewed to determine whether additional mechanisms can be established which will ensure that the taxable income received by non-residents that is attributable to West Virginia is properly collected on income such as royalties and related income.

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<sup>151</sup> 1999 Commission on Fair Taxation Report at 3-101.

<sup>152</sup> 1999 Commission on Fair Taxation Report at 2-68.



# **Chapter VIII**

## ***Business Taxes***



## VIII. Business Taxes

### A. Introduction

As a result of economic globalization, capital now migrates more easily than ever before, and it migrates to those geographic areas with the greatest potential for return on investment. The current West Virginia tax structure on businesses, however, creates artificial barriers that prevent the flow of capital into West Virginia. This, in turn, hinders the growth and development of the West Virginia economy. Specifically, the West Virginia tax structure places a much heavier burden on business capital, and on business in general, than other states' structures impose on their respective enterprises.

As previously mentioned in the Historical Perspective, West Virginia's State and local tax structure was largely established during the midst of the Great Depression. During that era, the major objective of enacting and implementing tax changes was to reduce the property tax burden on farmers and homeowners. The Tax Limitation Amendment of 1932 largely accomplished this objective by shifting the tax burden away from farms and homeowners to business personal property and businesses in general.

This property tax change coincided with a significant shift from local government financial control to State financing of most government services. To pay for these services and to compensate for the real property limitations embedded in the Constitution, State taxes were drastically increased. For example, the State Consumers Sales and Service Tax was created in 1934, and the State Business and Occupation Tax burden (i.e., the broad tax on business gross receipts) was increased by more than six fold to raise sufficient revenues. Thus, during the 1930s, property taxes on businesses and State taxes were significantly increased.

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In contrast to low property taxes on houses and farms, the typical tax burden on industrial personal property is significantly above the median state level. Moreover, municipal business and occupation taxes are in place primarily to compensate for the lack of significant local property tax revenues for municipalities. Thus, businesses are bearing a large portion of the burden necessitated by reduced real property taxes. A comparison of property tax burden, using information from a Minnesota Taxpayers Association study, also indicates a significantly higher than median level of tax burden on business personal property, particularly business inventory property and industrial personal property.<sup>153</sup>

It is also important to note that, since 1932, the State's taxes on business have been dramatically altered. Primarily, in 1987, the State of West Virginia repealed its Business and Occupation Tax for most business activities. The State, however, replaced the Business and Occupation Tax with alternative sources of business tax revenue. Those changes did not reduce the overall burden on capital formation. In fact, according to the results of a comparative analysis of state and local tax burden on business, West Virginia's combined Corporation Net Income Tax and Business Franchise Tax burden, as a share of private sector gross state product, is roughly 70 percent greater than the average state. A comparison using hypothetical taxpayers illustrates a tax burden that is roughly 70 percent greater than the median tax burden imposed by surrounding states.<sup>154</sup>

In summary, the comparative tax burden studies indicate that current tax policy greatly favors investment in residential property over business capital formation. As a possible consequence, the resident population level is high relative to economic activity in West Virginia.

Based on these facts, the Business Tax Subgroup has identified key objectives regarding business tax policy in West Virginia. First, and foremost, the goal of modernizing the tax system should be to reduce the tax burden on capital formation

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<sup>153</sup> Minnesota Taxpayers Association, 50-State Property Tax Comparison Study (May 2003).

<sup>154</sup> For these comparisons, see Appendix E.

and job creation. The reduction of the tax burden on such capital formation will promote long-term growth and will allow West Virginia's economy to compete with surrounding states as well as on a global scale.

In addition to reducing the tax burden on capital formation and job creation, the second goal should be to reduce compliance costs and promote a friendlier tax environment. This simplification, which can be accomplished through the elimination of certain "nuisance taxes," has the added bonus of simplifying the administration of the tax system and, in turn, allows the State Tax Department to be a more responsive and better service provider. The third goal identified by the Business Tax Subgroup is the elimination of certain tax loopholes and credits. By eliminating ineffective or inefficient tax credits, the State will broaden the tax base and allow for an overall reduction in tax on business capital formation.

Although business taxes certainly would include certain local property taxes, it is important to note that this section addresses only certain State taxes and licensing fees. Local property taxes have been left to the Property Taxes and Local Government Finance Chapter of this Report. The following taxes, fees, and related tax incentives and credits – all of which apply to businesses – have been reviewed: (1) Business Franchise Tax; (2) Corporation Net Income Tax; (3) Business Registration Tax; (4) Corporate License Tax; (5) Attorney-in-Fact Fee; (6) State Business and Occupation Tax; (7) Telecommunications Tax; (8) Health Care Provider Tax; (9) various severance taxes; and (10) various credits.

The Business Tax Subgroup has developed several recommendations that may be implemented immediately in the initial phase of tax modernization to reform the business tax structure in West Virginia. Additionally, the Subgroup has set forth several goals toward which the State should strive during the latter phases of Tax Modernization.



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**B. Recommendations**

**1. The Business Franchise Tax and the Corporation Net Income Tax**

*a. Introduction*

The State of West Virginia imposes two primary business taxes: the Corporation Net Income Tax and the Business Franchise Tax. In Fiscal Year 2006, these two taxes combined to produce almost \$350 million for the State's General Revenue Fund. In terms of percentages, the Corporation Net Income Tax and the Business Franchise Tax accounted for almost nine and one-half percent of the total collections for the General Revenue Fund. Both taxes have been a significant focus of the Tax Modernization Project, and much of the public input concerning business taxes was directed at them. As explained below, the Business Tax Subgroup believes that both taxes are in need of significant change.

**(A) The Business Franchise Tax**

The Business Franchise Tax, created in 1987 as a replacement for the State Business and Occupation Tax, is a tax on the privilege of engaging in business in West Virginia. It applies widely to a plethora of entities. Specifically, all partnerships and corporations, including S corporations, are subject to the Business Franchise Tax. Moreover, the Business Franchise Tax applies to all domestic corporations, corporations that have a commercial domicile in West Virginia, and foreign or domestic corporations or partnerships that own or lease real or tangible personal property or do business in West Virginia.

When initially established in 1987, the Business Franchise Tax rate was established at 0.55 percent of apportioned net equity or \$50, whichever is greater. In 1989, the rate was increased to 0.75 percent. In the 1990s, the rate was reduced to its current rate of 0.70 percent. The \$50 minimum alternative remains in place today.

The Business Franchise Tax is essentially a tax on net equity. In West Virginia, net equity is generally defined as the average annual value of capital stock,

paid-in surplus, and retained earnings, as reflected within the federal balance sheet of the corporation or partnership. More specifically, for corporations, the measure of the tax is their capital.<sup>155</sup> With respect to apportionment and the Business Franchise Tax, corporations subject to taxation in West Virginia and one or more other states must use a three-factor apportionment formula to determine the portion of total capital subject to taxation in West Virginia. The three factors consist of property, payroll, and sales. The sales factor is given a 50 percent weight while the other two factors each receive a weight of 25 percent. Special apportionment rules apply to multi-state financial organizations as a one-factor customer location gross receipts factor is applied to apportion the tax base of such organizations.<sup>156</sup>

West Virginia is one of only ten states imposing both a franchise tax based upon net equity and a net income tax on corporations, and the 0.7 percent tax rate on net equity is the highest in the country.<sup>157</sup> The tax may discourage capital formation in

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<sup>155</sup> These items of capital are taken from Schedule L of the corporation's federal form 1120 or the partnership's federal form 1065, as filed with the Internal Revenue Service for the taxable year.

<sup>156</sup> In addition to the entities that are exempt from the Business Franchise Tax, the State has a variety of credits against the Business Franchise Tax. Specifically, taxpayers subject to the State Business and Occupation Tax may take a credit equal to the amount of West Virginia Business Franchise Tax liability multiplied by the percentage that gross income subject to Business and Occupation Tax is of total West Virginia gross receipts. Additionally, a parent corporation may take credit for its proportional share of Business Franchise Taxes paid by a partnership in which it is a member or by a subsidiary corporation if a consolidated return is not filed.

Moreover, the West Virginia Code provides for a variety of other tax credits that may be applied against Business Franchise Tax liability in some cases. These include the Economic Opportunity Tax Credit, the Manufacturing Investment Tax Credit, the Strategic Research and Development Credit, the Industrial Expansion and Revitalization Credit for electric power producers, the West Virginia Capital Company Credit, and the Neighborhood Investment Program Credit. Taxpayers that gained entitlement to the Business Investment and Jobs Expansion Credit, the Industrial Expansion and Revitalization Credit, the Residential Housing Development Projects Credit or the Research and Development Credit prior to January 1, 2003, may continue to use those credits until they are exhausted or otherwise expire.

<sup>157</sup> Those states include Pennsylvania, Massachusetts, Alabama, South Carolina, Louisiana, Mississippi, Tennessee, North Carolina and Oklahoma.

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this State, and may be a detriment to expanding West Virginia's economy. It is also subject to some manipulation and can arguably be an inequitable tax.

The 1999 Commission on Fair Taxation aptly summed up the problems associated with the Business Franchise Tax:

[T]he business franchise tax is clearly an anti-growth, anti-capital formation tax especially for small firms. Furthermore, the relatively high rate decreases the state's competitive position and apportionment is difficult. The business franchise tax is not based on the ability to pay and does not embody the value of the benefits received. Lastly, extensive enforcement problems persist due to the ability of taxpayers to manipulate the tax base to avoid the tax.<sup>158</sup>

Finally, in comparison with other states with similar taxes (e.g., North Carolina and Tennessee), the West Virginia tax base is more narrowly defined and does not include borrowed capital. Thus, net equity is taxed but debt is not. This narrow tax base results in some degree of inequity between similarly situated business entities and it encourages entities to use debt financing over equity financing.

At public meetings throughout the State, business representatives singled out the Business Franchise Tax as the most unfair State level tax on business. Complaints against the Business Franchise Tax centered upon three or four major themes. The tax applies regardless of whether a business makes a profit or suffers a loss. The tax is a disincentive to capital investment, particularly equity investments, in the State. Our border states, with the exception of Pennsylvania, do not impose such a tax. Certain businesses may largely avoid this tax through tax planning maneuvers. Finally, and of great significance, the majority of business responses in both public forums and on the Informational Questionnaire favor a more aggressive approach to reduction in the Business Franchise Tax than a reduction in the Corporation Net Income Tax.

The Business Tax Subgroup recommends reduction in the current Business Franchise Tax rate, which would reduce the level of taxation on capital investment.

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<sup>158</sup> 1999 Commission on Fair Taxation at 2-59 to 2-60.

Providing relief by reducing the Business Franchise Tax would have the effect of lowering the ultimate tax burden on a broad spectrum of businesses.

Each reduction of 0.1 percentage point of the Business Franchise Tax rate would result in a reduction in General Revenue Fund collections by approximately \$17 million. Accordingly, a reduction in the tax rate from 0.7 percent to 0.3 percent would cost roughly \$69 million. A smaller reduction in the tax rate to 0.55 percent would cost roughly \$26 million. The Business Tax Subgroup believes that a responsible reduction in the Business Franchise Tax percent would be beneficial to businesses across the State. **Of course, any reduction in the Business Franchise Tax must be considered simultaneously with any other changes or reductions planned for taxes providing revenues for the State.**

In the long term, if the State has the ability, this Subgroup believes that the Business Franchise Tax should ultimately be repealed. The Business Tax Subgroup, however, does not recommend that the Business Franchise Tax be repealed immediately. The estimated \$120 million yield that would be lost from the complete repeal of the Business Franchise Tax is far too large for the State's General Revenue Fund to absorb and still provide sufficient resources for the State to meet its mandated expenses.

On this point, the Business Tax Subgroup again would like to emphasize that fiscal stabilization is a key for future economic growth, and it makes little fiscal sense to cut business taxes today only to raise the business tax burden tomorrow in some other fashion. Therefore, when the State has the ability to reduce the Business Franchise Tax, it should do so. If, however, the State budget is unable to fully absorb a \$120 million tax reduction over the long run, but West Virginia policymakers still desire to repeal the Business Franchise Tax, alternative policies need to be explored to avoid a repeat of West Virginia's all too familiar past – a tax reduction followed in one or two fiscal years by tax increases. As explained below, the Business Tax Subgroup – as part of its long term goals – will be exploring alternative sources of revenue to replace the Business Franchise Tax.

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(B) Corporation Net Income Tax

West Virginia is one of 45 states imposing a net income or equivalent tax on corporations. Domestic and foreign corporations doing business in West Virginia, or deriving income from property, activity or other sources within the State, are subject to the Corporation Net Income Tax. The tax also applies to the unrelated business income of nonprofit corporations. The Corporation Net Income Tax is imposed at the rate of nine percent of allocated and apportioned federal taxable income as modified by West Virginia statute.

A taxpayer may claim deduction for West Virginia net operating loss carryovers. In addition, gains from pre-1967 property are excluded from taxation. Corporations generally use a three-factor apportionment formula to determine the portion of their total income that is subject to taxation in West Virginia. The three factors consist of property, payroll, and sales. The sales factor is given a 50 percent weight while the other two factors each receive a weight of 25 percent. Any factor with a zero denominator is eliminated from the apportionment computation.

The Business Tax Subgroup has identified several problems with the Corporation Net Income Tax. The current 9 percent Corporation Net Income Tax rate is among the highest in the country, sharing the distinction of being tied for seventh place with New Jersey and Rhode Island, as indicated in the following table:

**TABLE 1**  
**STATE CORPORATION NET INCOME TAX RATES<sup>159</sup>**

<u>RANK</u>	<u>STATE</u>	<u>TOP MARGINAL TAX RATE (PERCENT)</u>	<u>RANK</u>	<u>STATE</u>	<u>TOP MARGINAL TAX RATE (PERCENT)</u>
1	Iowa	12.00%	24	Illinois	7.30%
2	Pennsylvania	9.99%	25	Kentucky	7.00%
3	Dist. Of Columbia	9.98%	25	Maryland	7.00%
4	Minnesota	9.80%	25	North Dakota	7.00%
5	Massachusetts	9.50%	28	Arizona	6.97%
6	Alaska	9.40%	29	North Carolina	6.90%
7	New Jersey	9.00%	30	Montana	6.75%
7	Rhode Island	9.00%	31	Oregon	6.60%
<b>7</b>	<b>West Virginia</b>	<b>9.00%</b>	32	Alabama	6.50%
10	Maine	8.93%	32	Arkansas	6.50%
11	Vermont	8.90%	32	Tennessee	6.50%
12	California	8.84%	35	Hawaii	6.40%
13	Delaware	8.70%	36	Missouri	6.25%
14	Indiana	8.50%	37	Georgia	6.00%
14	New Hampshire	8.50%	37	Oklahoma	6.00%
14	Ohio	8.50%	37	Virginia	6.00%
17	Louisiana	8.00%	40	Florida	5.50%
18	Wisconsin	7.90%	41	Mississippi	5.00%
19	Nebraska	7.81%	41	South Carolina	5.00%
20	Idaho	7.60%	41	Utah	5.00%
20	New Mexico	7.60%	44	Colorado	4.63%
22	Connecticut	7.50%	45	Kansas	4.00%
22	New York	7.50%			

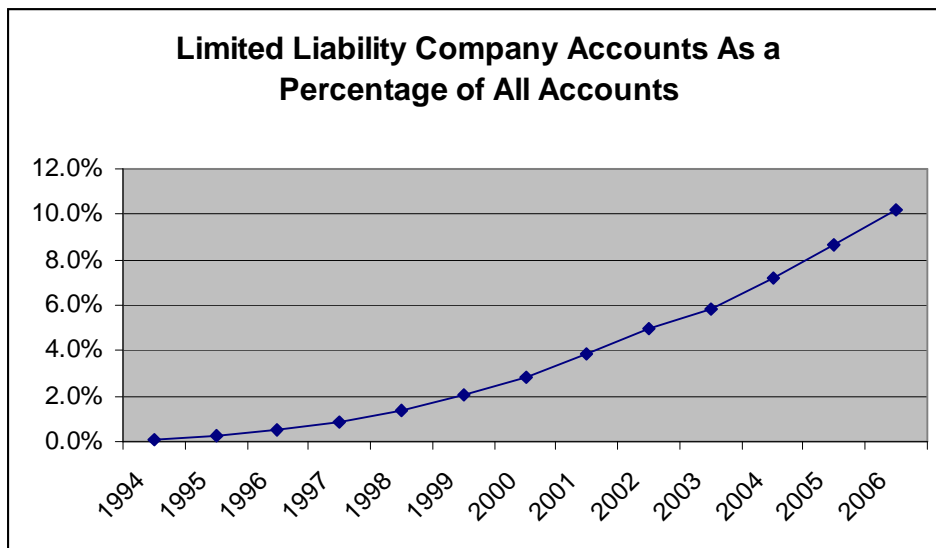
<sup>159</sup> Federation of Tax Administrators, March 2006. Non-traditional business activity taxes are imposed in Michigan, Nevada, Texas and Washington. Additionally, Ohio is in the process of phasing out its corporate franchise tax and replacing it with a gross receipts tax.

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With respect to our surrounding states, only Pennsylvania has a higher Corporation Net Income Tax rate. The high tax burden caused by the high rate for Corporation Net Income Tax is only compounded by West Virginia’s Business Franchise Tax.

Second, as the Corporation Net Income Tax is only applicable to corporation entities, it has a significantly narrowed tax base. The proliferation of limited liability partnerships and limited liability companies instead of corporations has only served to further narrow its base. While the number of C corporations expected to file Corporation Net Income Tax returns has actually declined over time, the number of limited liability companies on the State Tax Department’s Business Master File has increased by at least 22 percent annually from 1994 to 2006. As shown in the chart below, limited liability companies now comprise over 10 percent of all active accounts registered with the State Tax Department.

**CHART 1**

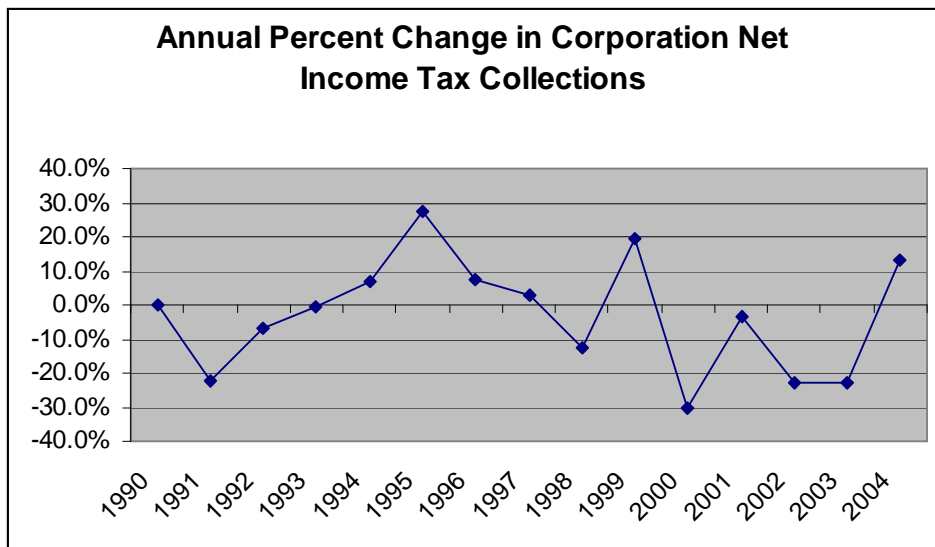


Additionally, studies have indicated that corporations have been shifting income from West Virginia into lower tax (or no tax) jurisdictions; thus, the State of West Virginia is losing a significant amount of revenue through the current tax structure for income that would be properly attributable to West Virginia. The Multistate Tax Commission, for example, published an analysis in 2003 in which it examined corporation tax sheltering and its effect on corporation income tax

collections.<sup>160</sup> In that study, the Multistate Tax Commission concluded, “it is apparent that various corporations are increasingly taking advantage of structural weaknesses and loopholes in the state corporation tax systems.” And, in particular, the study concluded that West Virginia was losing significant revenue due to this problem.

Because the tax is based on net income, it is an unstable tax from a revenue perspective. As shown in the chart below, Corporation Net Income Tax collections were lower than the previous year over one-half of the time, and one-third of the time the collections were more than 10 percent below the prior year.

**CHART 2**



In the short term, a reduction in the Corporation Net Income Tax rate would reduce the level of taxation on capital investment. Each one percentage point reduction would equate to a reduction in the General Revenue Fund of approximately \$20 million. A reduction in the tax rate to 6.5 percent, the same rate that applies to personal income, would equate to a \$50 million reduction.

<sup>160</sup> Multistate Tax Commission, Corporation Tax Sheltering and the Impact on State Corporate Income Tax Revenue Collections (July 15, 2003).



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Because the Corporation Net Income Tax Rate is significantly high compared with other states, the Business Tax Subgroup recommends a modest reduction in the Corporation Net Income Tax rate at the present time. Because it is more important from an economic standpoint to reduce the Business Franchise Tax, the group recommends that the Corporation Net Income Tax rate be reduced to not less than 8.5 percent. Even a small reduction in tax rate – from 9 percent to 8.5 percent – would substantially lower the State’s current corporation tax rate ranking from the 7th highest to 14th highest percentage in the country.

One additional short-term recommendation to broaden the corporation net income tax base is to repeal the statutory exclusion for pre-1967 gain income. Pre-1967 gains largely arise from real property sales by corporations in West Virginia. The Business Tax Subgroup recommends repeal of this provision in favor of lower corporate tax rates to stimulate economic growth within the State.

With respect to the future phases of study, the Business Tax Subgroup suggests review of two different options for potential reform of the Corporation Net Income Tax. The State should attempt to revise the Corporation Net Income Tax structure to increase fairness and improve administration. For example, as of now, combined reporting for corporations is not required in this State, but could help to solve some of the problems associated with the Corporation Net Income Tax. Thus, as a long-term project, the Corporation Net Income Tax should be reviewed for additional ways to broaden the tax base, lower the tax rate, and enhance tax compliance in the long term. The State has already taken steps to improve Corporation Net Income Tax collections.

The West Virginia Legislature began addressing abusive tax avoidance transactions, and abusive tax shelters with legislation enacted in 2006 relating to requiring disclosure of certain tax shelters used to avoid paying state income taxes; extending the statute of limitations for issuing assessments related to failures to disclose a listed transaction; and imposing penalties for promoting abusive tax shelters relative to failing to report listed transactions, reportable transaction

understatements, failing to participate in the voluntary disclosure program, and for failing to register a tax shelter or maintain required lists.

In addition to the abusive tax avoidance transactions legislation that was passed in 2006, the Tax Modernization Project group recommends further study of potential legislative measures to counteract abusive tax avoidance transactions and abusive tax shelters and trust arrangements designed to evade or avoid the West Virginia Corporation Net Income Tax.

First, the Legislature could enact a so called "throwback" rule in place of the "throw out" rule currently in effect in the West Virginia Corporation Net Income Tax statute. This would cause profits earned in West Virginia that are not subject to an income tax in another state to be taxed by West Virginia. Second, the State could consider provisions to counteract corporate tax avoidance involving passive investment companies or other related entities to prevent the artificial creation of royalty expenses, intangibles licensing expenses and trademark expenses as deductions for West Virginia Corporation Net Income Tax purposes to transfer taxable income earned in West Virginia out of the State and into a jurisdiction where the payments are not taxed.

Third, the State could enact certain statutory definitions relating to allocable and apportionable business income to enhance West Virginia's ability to tax certain capital gains resulting from the sale of corporate subsidiaries or other assets, and other extraordinary income such as damage awards resulting from litigation or reversions of over-funded pension plans. Finally, the Legislature may deem it desirable to enact certain provisions relating to the filing of consolidated Corporation Net Income Tax returns in West Virginia and authorization of the State Tax Commissioner to exercise more wide ranging discretion to mandate certain consolidated, composite, separate, or integrated filing configurations for purposes of the Corporation Net Income Tax and Business Franchise Tax.

As explained below, the State could also move toward some sort of alternative tax structure. Again, the Business Tax Subgroup believes that these

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options need significant study and should not be attempted in the initial phase of tax modernization.

### *b. Potential Alternatives for the Business Franchise Tax and the Corporation Net Income Tax*

The Business Tax Subgroup suggests examining alternative business tax structures for potential implementation in West Virginia. At this time, there are some alternatives to the Business Franchise Tax and the Corporation Net Income Tax. At least two warrant further examination. The first alternative is one which is becoming more popular in at least a few states. The State could return to a gross receipts tax. The State of Ohio, for example, undertook a complete overhaul of its tax system and enacted a new broad-based gross receipts tax. Ohio phased out its tangible personal property tax, reduced individual income taxes, cut the sales tax rate, and increased the cigarette excise tax.<sup>161</sup> Ohio also repealed its corporation franchise tax. The corporation franchise tax was based on alternatives of either a tax on a company's net worth or a company's net income, depending on which resulted in a higher tax. In place of the corporation franchise tax, Ohio adopted a commercial activity tax (the "CAT" tax). The CAT tax is imposed on gross receipts generated from commercial activities. The rate for the CAT tax will ultimately be set at a rate of 0.26 percent of gross receipts.<sup>162</sup>

Ohio's decision to move away from the corporation franchise tax and toward a gross receipts tax was based in part on a decline in revenue generated by the corporation franchise tax. The belief apparently existed that the tax was no longer a stable, consistent source of revenue for the state. Specifically, there was a belief that entities were manipulating the amount of tax owed by shifting income to jurisdictions with lower taxes and by the use of illegal tax shelters. Additionally, policy makers in Ohio believed that the tax credits given for the corporation franchise

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<sup>161</sup> Ohio Department of Taxation, Ohio Reforms Tax System, available online at [http://tax.ohio.gov/divisions/communications/news\\_releases/news\\_release\\_063005.stm](http://tax.ohio.gov/divisions/communications/news_releases/news_release_063005.stm).

<sup>162</sup> Texas is abandoning its tax on earned surplus and net worth in favor of a new tax on gross margins.

tax were inappropriate, ineffective, and inequitable. Based on Ohio's experience, one commentator confirmed the reasons that states have seen a decline of revenues for corporation net income and franchise taxes nationally: "Some of the reasons include the increased use of tax incentives, not requiring combined reporting, the increase in tax shelters, and the lack of uniformity in tax laws."<sup>163</sup>

The Business Tax Subgroup does not believe that a return to some form of a gross receipts tax would be in the best interest for West Virginia, for the following reasons. First, the State of West Virginia abandoned its statewide gross receipts tax – the Business and Occupation Tax – in 1987, because it had significant problems. Reimplementation of a tax that was abandoned only 20 years ago should be considered in a very cautious manner. Second, the tax burden imposed by a broad-based business gross receipts tax tends to pyramid, thereby distorting and improperly influencing economic behavior. Third, as mentioned above, most states use some form of a corporation net income tax. By moving to a gross receipts tax, West Virginia would become one of a small minority of states. Additionally, a gross receipts tax is not based on the ability to pay, but instead on the amount of an entity's receipts. Therefore, it is subject to some of the same criticisms that plague the Business Franchise Tax. Finally, the Business Tax Subgroup notes that a number of responses received from the Informational Questionnaires contend that the most problematic tax currently imposed in West Virginia is the Municipal Business and Occupation Tax that is based upon gross receipts. Moving to an expansive gross receipts tax would, therefore, be contrary to the input received from the citizens of West Virginia.

The second alternative to the Corporation Net Income Tax and the Business Franchise Tax is a value-added tax. Michigan and New Hampshire currently have different versions of a value-added tax. The 1999 Commission on Fair Taxation proposed such a tax known, as the "Single Business Tax." The Single Business Tax

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<sup>163</sup> Brian Sigriz, Examining Ohio's Commercial Activity Tax, Tax Analysts (February 20, 2006) at 567, 571.

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proposed in 1999 was similar to Michigan's version, and was proposed as a tax on the privilege of doing business in West Virginia measured by the entity's economic value. In other words, West Virginia's proposed Single Business Tax "base would consist of compensation, rents and royalties paid, interest paid, depreciation and profits made in a given year," and be applicable to a broad range of businesses in West Virginia.<sup>164</sup>

Some in New Hampshire have raved about that state's version of the value-added tax, the "Business Enterprise Tax," which has been suggested as an answer to state tax reform.<sup>165</sup> Specifically, those favoring New Hampshire's value-added tax assert that it is economically neutral. Proponents of the tax assert that the tax is simple to compute and administer, inasmuch as consumption in an economy may be measured in several ways. Proponents also contend that New Hampshire's Business Enterprise Tax is a "fair tax." In other words, in New Hampshire, the Business Enterprise Tax was "enacted specifically to 'broaden the base' so that all business entities that use labor and capital in the state would be required to contribute to supporting the cost of government." Moreover, some have contended that the base of New Hampshire's tax is "not susceptible to the income-shifting transactions that have reduced corporate income taxes." Finally proponents believe that value-added taxes tend to be both financially and politically stable.

Seventy nations including the European Economic Community (EU) have abandoned corporate income taxes in favor of some form of value-added tax.<sup>166</sup> Among the reasons are ease of collection and administration as there are fewer

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<sup>164</sup> 1999 Commission on Fair Taxation at 3-335 to 3-347.

<sup>165</sup> Stan Arnold and William F. J. Ardinger, Top Ten Reasons Why New Hampshire's BET May Provide an Answer to State Tax Reform, State Tax Notes (November 29, 2004). The authors conclude that "[e]fforts to shore up traditional tax systems may simply be prolonging the inevitable demise of these systems." It is important to note that New Hampshire's value-added tax was an "income style" tax while the Michigan value-added tax and the proposed Single Business Tax were "consumption-style" taxes.

<sup>166</sup> For a recent review see Schenk and Oldman, Oliver (2006) *Value Added Tax: A comparative Approach*, New York: Cambridge Law Series.

exemptions and deductions. It is also impossible to move the value-added tax from a higher tax to a lower tax jurisdiction. All forms of business are taxed which eliminates the problems of “pass through” entities such as partnerships and limited liability corporations avoiding the corporate income tax as is now the case in both the United States and West Virginia. Because the value-added tax is a much broader-based tax than the corporate levy tax, it raises more revenue at a lower rate.

The Tax Modernization Project, however, does not believe that the Corporation Net Income Tax and the Business Franchise Tax structure should be repealed in favor of a value-added tax **at this time**. Only two states currently have attempted what could be called a value-added tax: Michigan and New Hampshire. Michigan recently repealed its version because of apparent dissatisfaction with that tax. By moving toward a value-added tax, West Virginia would be unique among the states. As emphasized above, the Business Tax Subgroup has attempted to remove from West Virginia’s tax system unique or unfamiliar taxes that could serve to hinder the attraction of companies to this State.

Notwithstanding the initial rejection in the short term of a value-added tax, a value-added tax may be appropriate for West Virginia at some point in the future. If, for example, the United States Government were to abandon its current income tax structure in favor of a value-added tax, then the entire analysis would be different. The Business Tax Subgroup also notes that recent federal tax reform study efforts and suggested federal tax changes would likely move the country away from the traditional business income tax toward a value-added tax concept. If the federal government successfully moves in that direction, we would expect most states to follow. The Business Tax Subgroup recommends that, so long as the United States Government retains its income tax, the State should be very cautious before abandoning the Corporation Net Income Tax.

Instead of replacing the Corporation Net Income Tax with a new tax structure, the State of West Virginia may move toward an alternative minimum tax to complement the corporation net income tax. In any given year, more than half of all

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corporations report net income of \$0 or less because of net operating losses or other factors. As illustrated in the table in Appendix F, at least 33 states impose a minimum tax, an alternative minimum tax, or a secondary tax (e.g., the West Virginia Business Franchise Tax) to guarantee some minimum tax payment from corporations. Roughly 26 states impose a minimum annual fee ranging from \$10 in Oklahoma and Oregon to \$800 in California. Another 11 states impose one or more alternative minimum taxes on corporations. Some states tie their minimum taxes to the federal minimum tax. Kentucky, Ohio, and Texas recently moved to eliminate their capital-based franchise taxes by replacing such structures with alternative structures that generally guarantee a minimum tax payment even when the corporation reports \$0 net income. Roughly 16 states, including West Virginia, impose a secondary tax on capital stock (Arkansas), net equity and long-term debt (North Carolina), or a Business Enterprise Tax (New Hampshire).

In fact, unlike Michigan's value-added tax, New Hampshire's Business Enterprise Tax is an alternative tax to its corporate profits tax. Such an alternative minimum or "complementary business" tax has several advantages if structured properly, including stabilizing the state tax base, helping to capture growth in the economy, and broadening the base to include businesses other than corporations.<sup>167</sup>

The Business Tax Subgroup advocates exploring these potential long-term alternatives to the current Corporation Net Income Tax and Business Franchise Tax structure. Prior to replacing those taxes with any new major business tax, an appropriate system for modeling should be used to determine tax incidence. Indeed, the various alternatives will require significant additional research and contemplation before implementation. These alternatives should be considered for long-term analysis.

A fundamental tax reform should be accompanied by a thorough analysis of its economic consequences and distribution of the new tax burden over time. A good understanding of how taxes can impact the economy involves a sophisticated

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<sup>167</sup> Daphne A. Kenyon, "A New State VAT? Lessons from New Hampshire." State Tax Notes, December 2, 1996.

analysis of consumer and business behavioral responses to changes in the tax structure and environment. This kind of analysis is often synonymous with dynamic scoring. Dynamic scoring analyzes how current tax changes affect individual behavior and the entire economy over an extended period of time.

In other words, dynamic scoring incorporates the economic feedback or behavioral responses on various parts of the market due to changes in the tax structure and rates.

Therefore, dynamic scoring can potentially result in a more accurate forecasting of future economic impact and tax burden (incidence) of the proposed changes compared to a short run static analysis.

As a hypothetical example, a reduction in the Business Franchise Tax may lower tax revenues by a given amount in one fiscal year. Longer term, however, the lower tax rate might lead to more new businesses as well as an expansion in existing business, along with increasing employment and income opportunities in the State. This long-term expansion in economic activity may generate additional business and Personal Income Tax revenues. Dynamic scoring would enable an economist to estimate the additional revenue and economic activity relative to the short-run reduction in the tax rate.

Dynamic scoring can be accomplished through the use of economic modeling programs such as IMPLAN<sup>168</sup> and REMI Policy Insights.<sup>169</sup> These programs can be used for economic impact and tax revenue forecasting under a variety of scenarios regarding tax rate structures and changes in the economy. IMPLAN is based on the input-output framework that shows how changes in the final demand or specific industries impact the economy. REMI is a long-term dynamic macroeconomic hybrid model that captures the advantages of computable general equilibrium, input-output, and econometric modeling. Because REMI is a long-term model, it is not very useful for short-term or over-the-business cycle forecasting. IMPLAN is less

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<sup>168</sup> [www.implan.com](http://www.implan.com).

<sup>169</sup> [www.remi.com](http://www.remi.com).



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costly to learn and operate than REMI, but it requires additional work outside of IMPLAN to calculate the tax effects on final demand and convert the resulting economic impacts back into tax revenue.

Analysis of tax incidence involves estimating who ultimately bears the burden of any change in the tax rate or structure. Estimating the tax burden can be fairly complex and may require the use of dynamic scoring as well. Economists argue that the true economic burden of a tax may not be the same as the legal tax liability. Who actually bears the tax burden depends on how much individuals or firms can change their behavior in response to taxation. For example, businesses might be able to shift the entire tax burden to workers (in terms of lower wages and/or fringe benefits) or to consumers (in the form of higher prices). Moreover, the ultimate tax burden or tax incidence may change over time as people age, change their consumption patterns, and move up or down the income distribution.<sup>170</sup> Therefore, policymakers need to be aware of who actually bears the tax burden at a particular moment and how this will change over individuals' lifetime. This knowledge requires a sophisticated tax incidence analysis that considers economy-wide (national or state) ramifications of a tax change. In other words, the analysis of who actually bears the tax burden can be made more precise with the use of dynamic scoring.

However, dynamic scoring is not without its problems. Despite potential improvements in the accuracy of economic impact and tax revenue analysis that dynamic scoring can bring, the benefits of a more accurate economic insight from a complex dynamic model may not outweigh its costs.<sup>171</sup> Moreover, the estimates obtained from dynamic scoring are dependent on the modeling assumptions and scenarios, which could be chosen for political rather than economic reasons.

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<sup>170</sup> Entin, S. J. "Tax Incidence, Tax Burden, and Tax Shifting: Who Really Pays the Tax?" Center for Data Analysis Report, #04-12, November 5, 2004; available online at <http://www.heritage.org/Research/Taxes/cda04-12.cfm>

<sup>171</sup> Charney, Alberta H., and Marshall J. Vest. "Modeling Practices and Their Ability to Assess Tax/Expenditure Economic Impacts," Prepared for the AUBER Conference, New Orleans, October 2003; available online at <http://ebr.eller.arizona.edu/research>

Regardless of the theoretical issues involved in economic analysis of the proposed tax changes, the reliability of economic estimates will ultimately depend on the amount and quality of the available economic and tax data; hence the need for informational reports from the business community.

## 2. Business and Registration Related Fees and Taxes

All businesses are required to register to do business in West Virginia. Related to this registration requirement, West Virginia has three primary taxes or fees that impose requirements on businesses in West Virginia. They are as follows: the Business Registration Tax, the Corporation License Tax, and the Attorney-in-Fact Fee. Additionally, the State of West Virginia has continuous renewal requirements for its businesses. A comparative analysis of registration and other annual fees imposed upon business indicates an above-average level of complexity in West Virginia. In fact, West Virginia and Nevada are the only two known states to require a periodic renewal of the business registration and additional renewal fees. These registration and related taxes are in urgent need of reform in West Virginia.

### a. *Business Registration Tax*

Persons or corporations intending to do business in West Virginia must first apply for a Business Registration Certificate and pay a Business Registration Tax. If business income for a person or corporation was more than \$4,000 in all states for the previous filing year, there is a \$30 registration fee due for each two-year certificate. Moreover, a separate certificate is required for each fixed business location from which property or services are offered for sale or lease or at which customer accounts may be opened, closed, or serviced. The Business Registration Certificate is important – not necessarily because of the revenue it produces directly, but because registration requires the taxpayer to describe his or her business so that the State Tax Department can correctly identify the various taxes to which the business is subject or that the business must collect and remit to the State. Once a Business Registration Certificate is issued, the taxpayer will receive all tax forms and

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information necessary to pay State taxes before the due dates. This procedure of requiring an initial certification and payment of a fee or tax is common throughout the United States.

Unlike most other states, however, the Business Registration Certificate is only valid for two years, usually beginning July 1 and ending June 30. Every person or corporation intending to do business in West Virginia at a specific business location must re-register every two years and pay the Business Registration Tax.

The two-year business registration renewal requirement is both burdensome and unnecessary for proper notification to the State Tax Department. Indeed, there are more efficient, alternative ways to maintain and update registration data including direct correspondence with those taxpayers who have such changes.

The administrative and compliance costs associated with the approximately 100,000 filings each year are disproportionately large relative to the revenue yield of roughly \$1.8 million. The Business Tax Subgroup therefore recommends that the ongoing requirement to renew the Business Registration Certificate be repealed. Removal of the registration renewal requirement and the \$30 renewal fee is consistent with the Tax Modernization Project's goal of simplifying the tax structure.

Removing the requirement that a business register biennially would not hinder the proper functioning of the State Tax Department. **It is important to note that, under this plan, the State would continue to impose an initial registration fee for new business registrations.** Indeed, businesses would still be required to display their Business Registration Certificate at all times at the place of business. Similarly, the Business Tax Subgroup would recommend that contractors also be required to have a copy of their Business Registration Certificate available at each of their construction sites until the work at that site is completed, as they are required to do under current law. Likewise, the State should retain its initial filing and bonding requirements to transient vendors. Accordingly, the business registration certification process should be overhauled to require a one-time registration and fee with no renewal requirements.

b. *Corporate License Tax and Attorney-in-Fact Fee*

In addition to the requirements related to the Business Registration Certificate, domestic and foreign corporations must also pay a Corporate License Tax before engaging in any business activity in West Virginia.<sup>172</sup> The tax is levied for a license year that begins July 1 of each year and ends the following June 30. As explained below, the measure of the tax depends on whether the corporation is domestic (i.e., a West Virginia chartered corporation) or a foreign corporation (i.e., a corporation that is chartered in another state).

For every domestic corporation, the annual corporate license tax is based on the stated par value of the corporation's authorized capital stock. The higher the capital stock, the higher the rate levied.

The following chart provides the current tax rates for the Corporate License Tax.

**TABLE 2**  
**Capital Stock**

<u>More Than</u>	<u>But Not More Than</u>	<u>Tax</u>
\$ 0	\$ 5,000	\$20
5,000	10,000	30
10,000	25,000	40
25,000	50,000	50
50,000	75,000	80
75,000	100,000	100
100,000	125,000	110
125,000	150,000	120
150,000	175,000	140
175,000	200,000	150
200,000	1,000,000	180*
1,000,000	15,000,000	\$340**
15,000,000		\$2,500

\*plus \$0.20 for each \$1,000 or fraction of it in excess of \$200,000

\*\*plus \$.15 for each \$1,000 or fraction of it in excess of \$1 million

<sup>172</sup> Nonprofit corporations are exempt from the Corporate License Tax.

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Every foreign corporation (i.e., a corporation that is not chartered in West Virginia) must remit an annual corporate license tax based on that proportion of its issued and outstanding capital stock that is attributable to West Virginia. The tax is to be assessed on the prorated stock value using the same rates as domestic corporations multiplied by 1.75. The annual fee for a foreign corporation may not be less than \$250.

Coupled with the Corporate License Tax is the Attorney-in-Fact Fee. Under West Virginia law, the West Virginia Secretary of State is attorney-in-fact for foreign corporations, domestic corporations, and limited partnerships. For this service, an annual Attorney-in-Fact Fee of \$25 must be paid by all corporations and partnerships.

There are several problems associated with the Corporate License Tax and the Attorney-in-Fact Fee. When measured against the goals stated for business taxes for the State, the Corporate License Tax and the Attorney-in-Fact Fee fail in all respects. As explained below, the Corporate License Tax is a deterrent against capital formation. Additionally, both the Corporate License Tax and the Attorney-in-Fact Fee are contrary to principles of ease of doing business in West Virginia, and are an administrative nightmare for the State Tax Department and the Secretary of State's Office. Finally, West Virginia is one of only seven states imposing an annual license tax on corporations, and is the only State to impose both the annual license tax and an additional Business Franchise Tax based on net equity.

Corporations have great difficulty understanding and complying with the annual license tax requirements. As evidence of this fact, more than 20 percent of the annual tax yield is attributable to delinquent billings. Moreover, the Corporate License Tax is subject to a significant amount of litigation before the Office of Tax Appeals. For Fiscal Year 2005, 64 petitions were filed challenging the application of the Corporate License Tax.<sup>173</sup> It is the third most litigated tax at the Office of Tax

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<sup>173</sup> West Virginia Office of Tax Appeals, Annual Activity Report to the Legislature 2005, <http://www.wvota.gov/docs/ANNUALACTIVITYREPORT2004.pdf>.

Appeals, despite the fact that it only generates approximately \$6.5 million in revenue. In contrast, the Consumers Sales and Service Tax generated only 132 petitions during Fiscal Year 2005, though it was responsible for generating nearly \$1 billion in revenue that year. The administrative and compliance costs of the Corporate License Tax are significant relative to the revenue yield of only an approximate \$6.5 million.

Finally, the administration of the Corporate License Tax and Attorney-in-Fact Fee is unnecessarily complicated. To begin the process, all taxes and fees that are due must be paid when a corporation applies for a certificate of incorporation or authority to do business in West Virginia. The Secretary of State collects the Corporate License Tax for the first year before issuing a certificate of incorporation. For each succeeding year, however, the State Tax Commissioner collects the Corporate License Tax and the Attorney-in-Fact Fee. But there is an exception: for applications made between May 2 and July 1 of each year, the Secretary of State must collect the Corporate License Tax for the full year beginning July 1, in addition to the initial amount of tax due.

After the first year, the State Tax Commissioner is also responsible for providing the necessary tax returns to the taxpayer for the Corporate License Tax and the Attorney-in-Fact Fee. Then, the State Tax Commissioner must forward the returns to the Secretary of State, along with a list of all corporations that paid the Corporate License Tax.

In the first year, the Secretary of State collects payments of the Corporate License Tax and deposits one-half of the revenue into the General Revenue Fund and one-half into a special revenue account for the operation of the Office of the Secretary of State. Payments of the tax in subsequent years are collected by the State Tax Department and deposited into the General Revenue Fund.<sup>174</sup>

In consideration of the above, the Business Tax Subgroup recommends repealing the Corporate License Tax. It is a nuisance tax that fails to generate a

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<sup>174</sup> See W. Va. Code § 11-12C-3(b) (2003).

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substantial amount of revenue. The Business Tax Subgroup proposes a simplified fee structure for the future registration of corporations in West Virginia. The fee would be \$50 for the initial registration of a domestic corporation and \$100 for the initial registration of a foreign corporation. Thereafter, an annual fee of \$25 would apply for the combined purpose of the annual report filing and the Attorney-in-Fact Fee. This simplified fee structure would be competitive with similar fees in other states. In order to keep the budget for the Secretary of State's Office whole, the Business Tax Subgroup recommends that the Secretary of State be authorized to retain the full \$25 Attorney-in-Fact Fee, as opposed to keeping only half the fee as under current law. The additional funds would offset any loss of revenue to the Secretary of State's Office associated with the first-year Corporate License Tax revenue. Also, future annual report due dates could be staggered to limit peak period volumes.

**3. Specialized Business Taxes and Credits**

In addition to the Corporation Net Income Tax and Business Franchise Tax, which are applicable to a significantly broad base of businesses, the State of West Virginia also depends on a number of taxes on businesses that apply to a much narrower base and are applicable only to specific industries or types of businesses. The taxes include: the State Business and Occupation Tax on specialized industries, Severance Taxes, the Telecommunications Tax, and Health Care Provider Taxes.

*a. State Business and Occupation Tax on Specialized Industries*

Over a period of years, the State Business and Occupation Tax (B&O Tax) has evolved from a broad-based business privilege tax based upon gross receipts to a narrow-based business privilege tax with an assortment of alternative tax bases. A brief description of these taxes follows:

**TABLE 3**

<u>Tax Type</u>	<u>Tax Base</u>	<u>Approximate Tax Yield</u>
Electric Power Generation	Generation Capacity	\$147 million
Electric Power Distribution	Kilowatt-hours Sold	3 million

Natural Gas Utility Service	Gross Receipts	19 million
Water Utility Service	Gross Receipts	5 million
Other Public Utility Service	Gross Receipts	<1 million
Natural Gas Storage	Net Dekatherms	8 million
Coal-Based Synthetic Fuel	Tons of Production	11 million

Almost 80 percent of total Business and Occupation Tax collections are attributable to the capacity tax on electric power generation. While West Virginia taxes the generation of electricity, most other states impose consumption taxes on sales of electricity to ultimate consumers either through a gross receipts tax or a general sales tax. However, the tax yield from the current generation tax exceeds the potential tax yield from an alternative consumption tax by at least a two-to-one margin. West Virginia currently exports roughly 70 percent of its generation to other states. Electric power generators annually utilize roughly \$25 million in Industrial Expansion and Revitalization Tax Credits against their Business and Occupation Tax. These tax credits generally equal 10 percent of capital investment in power plants in West Virginia.

The general rate of tax is \$22.78 per kilowatt of taxable capacity. A lower tax rate of \$20.70 per kilowatt of taxable capacity exists for power units utilizing desulfurization equipment. The taxable capacity for existing power plants in service prior to 1995 generally equals the actual average capacity utilization level in kilowatts for the period between 1991 and 1994. Most new power plants are taxed at 40 percent of nameplate capacity in kilowatts. Peaking plants and wind power plants are taxed at 5 percent of nameplate capacity. Municipally-owned plants are exempt from the Business and Occupation Tax.

With respect to changes for the Business and Occupation Tax, the Business Tax Subgroup believes that changes may be warranted with respect to the taxable capacity rate on peaking plants, wind power, and municipal power plants. For example, wind power plants operate at 20 to 30 percent of nameplate capacity. With a taxable rate of 5 percent of nameplate capacity, those plants have an effective rate



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of just 16.7 percent (5 percent/30 percent) of actual capacity utilization. Most other plants, however, are taxed at an effective operating capacity of 40 percent or more of nameplate capacity. A fairer approach may be to change the taxable percentage factor for wind power plants and peaking plants from 5 percent to a percentage factor reflective of approximate actual average capacity usage.

The Business Tax Subgroup does not recommend any other potential changes to current policy regarding either the Capacity Tax or the Industrial Expansion and Revitalization Tax Credit for electric power producers.<sup>175</sup> The tax credit promotes additional investment in West Virginia facilities, including pollution abatement investment. Even after the application of available tax credits against tax liability, the West Virginia electric power industry's State tax burden is still greater than similar tax burdens in other states. In the absence of these tax credits, West Virginia consumers would face higher prices for electric power. As stated, the Project does recommend additional evaluation of the tax equity associated with existing preferential tax provisions afforded wind power plants, peaking plants, and municipal power plants.

The 4.29 percent Business and Occupation Tax on natural gas utility gross receipts only applies to public utility firms. In a deregulated environment, non-utility gas marketing firms compete for sales with public utility firms. Sometimes, the only difference in sales price offered between the public utility and the non-utility marketers relates directly to difference in tax treatment. The Business Tax Subgroup recommends a long-term study of a more equitable alternative consumption tax on natural gas sales.

The Business Tax Subgroup also recommends further study as to whether the natural gas storage tax and related Natural Gas Industry Jobs Retention Tax Credit should be repealed. The Business and Occupation Tax on natural gas storage applies only to storage fields in operation prior to March 1, 1989. The tax is

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<sup>175</sup> However, a long-term study of an alternative tax structure for electric power may be beneficial.

imposed at a rate of 5 cents multiplied by the net monthly total of the lesser of daily net withdrawals or daily net injections of gas, measured in dekatherms, or the average monthly difference between injections and withdrawals for the five-year period between 1990 and 1994. The resulting tax yield is reduced by the application of the Natural Gas Industry Jobs Retention Tax Credit, a credit equal to \$1,000 multiplied by the number of individuals employed by the taxpayer in West Virginia. A portion of any lost tax revenue associated with the repeal of the Natural Gas Storage Tax would be offset by additional Business Franchise Tax collections from this industry. Under current law, Business and Occupation taxpayers are generally exempt from Business Franchise Tax on activities subject to the Business and Occupation Tax.

The 50 cent per ton B&O Tax on coal-based synthetic fuel is currently scheduled to sunset on December 31, 2007, the date that corresponds to the expiration of the federal Section 29 tax credits for coal-based synthetic fuel production. The industry cannot survive absent the federal tax credit. The Business Tax Subgroup recommends no changes with regard to this tax statute.

*b. Severance Taxes*

The regular Severance Tax is a gross receipts tax imposed upon the privilege of coal, natural gas, oil, and other mineral extraction, certain coal processing activities, and timber extraction. The general tax rate for coal, natural gas, oil, limestone, sandstone, sand, and other minerals is 5 percent. However, the tax rate on qualified thin-seam coal mines is either 1 percent for average underground seams below 37 inches or 2 percent for average underground seams below 45 inches. An alternative Minimum State Coal Severance Tax of 75 cents per ton applies whenever the regular State Severance Tax yield falls below 75 cents per ton. The 5 percent regular Coal Severance Tax rate includes both a State tax rate of 4.65

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percent and a local tax rate of 0.35 percent.<sup>176</sup> The regular Severance Tax rate on timber is 3.22 percent (1.22 percent on or after January 1, 2007), and the regular Severance Tax rate on waste coal is 2.5 percent. In addition to the regular Severance Tax, the State imposes a 56 cent per ton tax on coal production, a 4.7 cent per 1,000 cubic feet tax on natural gas production and a 2.78 percent gross receipt tax on timber production to fund workers' compensation debt. The State also imposes a separate 7 cent fee per ton of coal to fund coal reclamation projects, a separate 2 cent fee per ton of coal to fund mining inspectors, and a separate 5 cent fee per ton on coal truck haulers to fund coal road transportation road improvements. A brief description of these taxes follows:

**TABLE 4**

<u>Tax Type</u>	<u>Tax Base</u>	<u>Approximate Tax Yield</u>
Regular Coal Severance	Gross Receipts	\$315 million
Minimum Coal Severance	75 cents per clean ton	0 million
Waste Coal	Gross Receipts	< 1 million
Workers' Comp Coal	56 cents per clean ton	81 million
Coal Reclamation	7 cents per clean ton	10 million
Coal Mine Inspector Fee	2 cents per clean ton	3 million
Coal-Roads Fee	5 cents per ton	3 million
Regular Natural Gas	Gross Receipts	60 million
Workers' Comp Gas	4.7 cents per Mcf	9 million
Oil	Gross Receipts	3 million
Regular Timber	Gross Receipts	2 million
Workers' Comp Timber	Gross Receipts	3 million
Other Natural Resources	Gross Receipts	1 million

In excess of 80 percent of all West Virginia severance taxes are attributable to the coal industry. Assuming an average market price of \$48 per ton, the current average combined effective tax rate associated with all of the above listed coal severance taxes and fees is roughly 6 percent of gross receipts. If the price of coal

<sup>176</sup> Seventy-five percent of the local tax remains in the county where the coal is produced and the remaining 25 percent is distributed across West Virginia on the basis of population, to be used exclusively for recreational and economic development purposes.

decreases below \$48 per ton, the overall effective tax rate increases due to the fixed fee per ton tax attributes of the workers' compensation tax and other taxes and fees. West Virginia is the largest coal-producing state east of the Mississippi River, and its coal severance tax burden is also highest of any state east of the Mississippi River. For comparison purposes, the state east of the Mississippi River imposing the second highest severance tax burden, Kentucky, imposes its coal severance tax at a rate of 4.5 percent. Over the past three decades, West Virginia has lost some of its domestic coal market share to Wyoming and other western states. The West Virginia market share gradually fell from roughly 23.7 percent in 1970 to 13.5 percent in 2005. The loss of market share is attributable both to changes in environmental laws regarding sulfur dioxide emissions from power plants and to a growing competitive market for coal.

The second-largest source of West Virginia Severance Tax collections is the natural gas industry, an industry with roughly 50,000 producing wells distributed among roughly 5,000 taxpayers. Some of these wells produce small amounts of oil in addition to natural gas. Due to significant price volatility in recent years, natural gas severance tax collections have ranged from a low of less than \$20 million in 1999 to a high of nearly \$70 million in 2005. At a current well-head price in the neighborhood of \$6 per 1,000 cubic feet, the overall effective rate of tax is roughly 5.5 percent. However, larger producers (i.e., those with annual receipts in excess of \$500,000) tend to have a higher effective tax rate than smaller producers due to the impact of the \$500 tax credit. This tax credit may be a contributing factor to the existence of a relatively large number of taxpayers in this industry.

There are two different timber severance taxes, the regular tax dedicated to funding the Division of Forestry operations, and the special tax dedicated to funding workers' compensation debts. Both taxes are based upon gross receipts associated with the severance of timber in the forest. The regular tax rate is currently set at 3.22 percent, but is scheduled to fall to 1.22 percent on January 1, 2007. The special tax rate is set at 2.78 percent. Safe-harbor calculations are available to taxpayers to remove value-added activities from gross receipts subject to the

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Severance Tax. For example, if the first sale of product occurs beyond the sawmill activity, gross receipts are discounted by 75 percent to arrive at the proper value of receipts subject to the Severance Tax.<sup>177</sup> Wood product manufacturers who also sever timber products in West Virginia may use their Manufacturing Investment Tax Credit to offset up to 50 percent of their Regular Severance Tax liability, but the credit may not be used against the special Severance Tax. Taxpayers may also use the annual \$500 tax credit against their Regular Severance Tax liability, but not against their special Severance Tax liability. As the following chart illustrates, West Virginia imposes the highest timber Severance Tax per 1,000 board feet of production of any state east of the Mississippi River.

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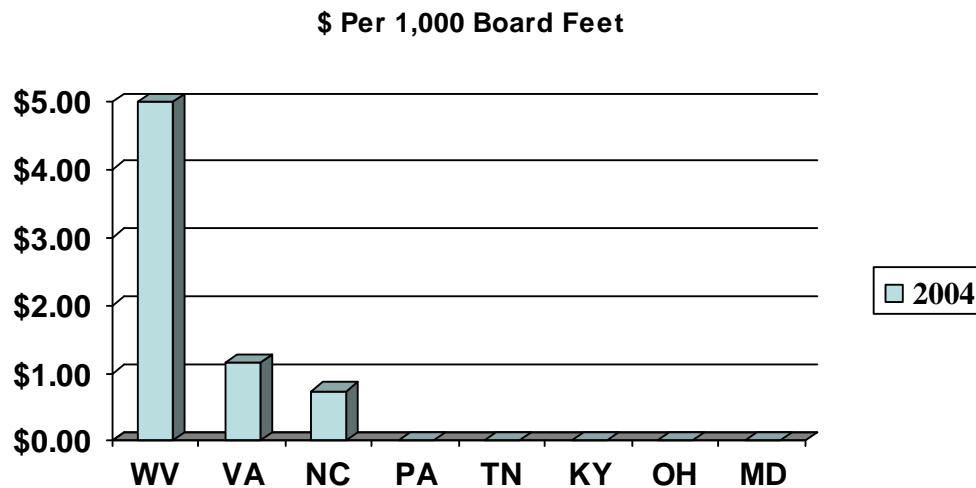
<sup>177</sup> The tax base of the timber severance tax is the gross value of the timber at the point where the production privilege ends. This is an amount equal to the fair market value of the timber at the point where the tree is severed and delimbed. When a sale occurs at that point, taxable value is gross proceeds of sale. In the absence of such a sale, taxable value is that amount which corresponds as nearly as possible to the gross proceeds from the sale of similar products of like quality or character determined under the following uniform and equitable rules.

A person who produces timber and sells logs, and by-products of timber production and bucking operations, on the ground, either where the trees were felled in the forest or at a central collection point, shall report seventy-five percent (75%) of the gross proceeds of sale under the Severance Tax.

A person who produces timber, and sells and delivers timber products, in the same condition as when those products leave the forest, to a saw mill, other manufacturer or consumer, shall report fifty percent (50%) of his gross proceeds of sale under the Severance Tax.

A person who produces timber and further saws, mills or otherwise manufactures the same into lumber, cross ties, timbers, veneer and other products for sale, profit of commercial use shall report twenty-five percent (25%) of his gross proceeds of sale under the Severance Tax. Where no sale is made, the fair market value of lumber, cross ties, timbers, veneer or other products must nevertheless be determined as provided in the severance tax regulations and twenty-five percent (25%) of that amount is reported under the Severance Tax.

**CHART 3**  
**Tax Per 1,000 Board Feet**



Also relevant to Severance Taxes is a discussion of the applicable credits. In the past, taxpayers claimed significant levels of various investment tax credits against the Severance Tax. In the early 1990s, tax credits against the Severance Tax annually approached or slightly exceeded \$75 million. Legislation enacted in 1990 eliminated the future use of Business Investment and Jobs Expansion Tax Credit (Super Credit) against the Severance Tax with grandfather provisions for investment generally made prior to March 10, 1990. Legislation enacted in 1993 eliminated the future use of the Super Credit by the mining industry. Legislation enacted in 2002 eliminated the Super Credit, the Industrial Expansion and Revitalization Tax Credit (except for electric power generators), and the Research and Development Projects Tax Credit. In recent years, the Legislature has annually scaled back the Capital Company Tax Credit from a maximum of \$10 million per year to either \$0 or a maximum closer to \$1-\$2 million per year. As a result of all of these changes, total investment tax credit claims against the Severance Tax are expected to drop below \$10 million in 2006 and to continue a decline toward an annual amount of generally less than \$5 million and possibly closer to \$2 million per year in the near future.

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The Business Tax Subgroup recommends no short-term changes to current policy regarding severance taxes. However, the Project does recommend that the temporary special severance taxes funding workers' compensation debt be allowed to expire as directed in current law. The Project recommends additional study of the following topics:

First, the Project suggests the review of the actual average production cost differential between a conventional coal mine taxed at 5 percent and thin-seam mines taxed at 2 percent or 1 percent under the Regular Severance Tax, to determine whether the tax preference accurately accounts for such differences. Second, the relationship between the \$500 tax credit and taxpayer behavior regarding the structure of new entities in the natural gas industry should be studied to determine whether the tax credit encourages formation of a separate tax entity for each well. Finally, an evaluation of coal-bed methane well taxation policy is warranted.

### *c. Telecommunications Tax*

The current Telecommunications Tax is a 4 percent gross receipts tax imposed upon telecommunications services that are not subject to competition. Services subject to competition as determined annually by the State Public Service Commission are exempt from tax. This exemption was added to the statute effective July 1, 1988, or one year after the Telecommunications Tax was first created. The graph in Appendix G, illustrates annual Telecommunications Tax collections since Fiscal Year 1988.

Collections peaked during the first year at slightly more than \$18 million, even though that year reflected less than 11 full months of tax receipts. The list of competitive services initially included both interstate long distance service and certain in-state long-distance services. However, various other services were gradually added to the list over the years, especially after 2000. The current

exemption applies to virtually all telecommunications services. Therefore, the current annual tax yield is roughly \$0.<sup>178</sup>

Telecommunications services are also excluded from the Consumers Sales and Service Tax by means of a Statute enacted in 1937 that excludes services provided by companies subject to regulation by the Public Service Commission from sales tax. In comparison with other states, West Virginia imposes below-average consumption taxes on telecommunications services.

Even though there is virtually no State consumption tax on telecommunications services in West Virginia, the State Public Service Commission does impose a variety of regulatory fees, including fees to fund local 911 services throughout the State. Also, a number of West Virginia municipalities impose a local two percent municipal excise tax on certain telecommunications services. These miscellaneous fees tend to be rather complex and sometimes awkward to the telecommunications taxpayer. As the industry changes, the complexity and variety of 911 fees also tends to grow.

The Business Tax Subgroup recommends a comprehensive study of telecommunications tax policy in West Virginia. The Project notes that it took the State of Virginia more than three years to reform its telecommunications tax structure. The objective of reform would be to eliminate most of the regulatory fees, the current local tax, and the current State tax and replace this structure with single, equitable broad-based consumption tax that is imposed at a rate roughly approximating the general sales tax rate. The new tax structure could become a local tax collected by the State and generate significant revenue. As a local tax, local government flexibility would be enhanced. In addition, the use of local tax revenues to pay for 911 services may improve the overall efficiency of the various local 911 service centers.

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<sup>178</sup> See Appendix G.



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*d. Health Care Provider Taxes*

More than half of all states impose one or more health care provider taxes to raise funds for their Medicaid programs. Medicaid is the fastest growing component in state budgets and one of the fastest growing components of the federal budget. The federal government pays for more than half of all Medicaid expenditures by matching funds provided by the states. In West Virginia, the current match rate is roughly three federal dollars per every State dollar. Both levels of government are concerned about rising costs. This concern has led to a tug-of-war atmosphere between the federal government and the states. The federal government is concerned that states are gaming the system and artificially raising their match dollars at the expense of the federal treasury. States are concerned that the federal government's mandates and rules are too restrictive, thereby driving up the cost to the states. West Virginia Health Care Provider Taxes meet current federal guidelines as a qualifying source of state funds available for federal matching Medicaid funds.

In West Virginia, the Medicaid budget expanded from approximately \$400 million in Fiscal Year 1989 to about \$2.3 billion in Fiscal Year 2007, an annual increase averaging more than 10 percent. During the past two decades, Medicaid spending grew at more than double the rate of growth in State General Revenues. Despite such growth, a number of groups, including the State Chamber of Commerce are concerned that the State is not spending sufficient funds for the Program and that excess costs are being shifted to the private sector.

Health Care Provider Taxes account for nearly 30 percent of the total current matching State funds for Medicaid in West Virginia, a total of more than \$172 million in Fiscal Year 2006. The General Revenue Fund and the State Lottery Fund provide most of the remaining matching funds. In recent years, the annual growth rate for Health Care Provider Tax collections has been far less than the medical inflation rate and for the State Lottery Fund the growth rate has been flat. The State Lottery Fund is generally capped due to a Legislative change creating the State Excess Lottery

Revenue Fund. Health Care Provider Tax collection growth has been anemic due to the implementation of a 10-year phase out of the tax on services of physicians, chiropractors, dentists, emergency ambulances, nurses, opticians, optometrists, podiatrists, psychologists, and therapists that began on July 1, 2001. These taxes originally accounted for roughly one-third of total Health Care Provider Tax collections. The sixth year of the tax rate phase-out program began on July 1, 2006, when tax rates fell from 50 percent to 40 percent of their original statutory rates. For example, the physician tax rate is now 0.8 percent in comparison to the original rate of 2.0 percent.

The Business Tax Subgroup recommends no changes to current policy with regard to Health Care Provider Taxes, unless policymakers devise alternative tax revenue sources to fully replace the funds associated with these taxes. When the current tax phase-out program is complete, Health Care Provider Taxes will continue for ambulatory surgical centers, independent laboratory or X-ray services, inpatient hospitals, intermediate care facilities for the mentally retarded, nursing homes, outpatient hospitals, and behavioral health facilities.<sup>179</sup>

e. *Excise Tax on Soft Drinks*

West Virginia is one of just six states and the City of Chicago currently imposing a special license tax or consumption tax on soft drinks in addition to the general sales tax. The West Virginia soft drinks excise tax generates nearly \$15 million per year or more than \$8 per capita. The proceeds of the tax are specifically dedicated for the “construction, maintenance and operation of a four-year school of

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<sup>179</sup> Additionally, it is important to note that taxation of insurance entities is an important source of revenue in West Virginia. An Insurance Premium Tax is collected from every insurance company transacting insurance in West Virginia. Moreover, an additional one percent Premium Tax for fire and casualty insurance is dedicated for the Municipal Pensions and Protection Fund. Additionally, every fire and casualty insurance policyholder must pay a surcharge equal to one percent of the gross direct premium paid on the policy to benefit volunteer and part-volunteer fire departments and the Teachers Retirement System. The Tax Modernization Project recommends a long-term review of all insurance taxes.

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medicine, dentistry and nursing of West Virginia University.”<sup>180</sup> Only Arkansas levies a more significant soft drink excise tax for the benefit of that state’s Medicaid Program.<sup>181</sup>

The excise tax on soft drinks, syrups, and dry mixtures is difficult to administer due to requirements related to the indicia markings and definitional issues. The definition of what constitutes a “soft drink” is constantly changing as new products are constantly being created. The current definition includes items such as chocolate flavored milk and any fruit or vegetable juices containing a sweetening additive. Due to definitional issues, some companies are reluctant to introduce new products to the West Virginia market. Finally, unlike most other excise taxes which produce static revenue flow absent periodic tax rate increases, soft drink excise tax revenues tend to rise over time due to an increase in consumer demand.

The Tax Modernization Group recommends that the excise tax on soft drinks, syrups, and mixes be further analyzed as part of a long-term modernization plan. Prior to any reduction in this tax, a source of replacement tax revenues is necessary to eliminate the \$15 million revenue loss that would be associated with repeal of this tax. Within the past year, legislation was enacted to reduce the Consumers Sales and Service Tax rate on food for home consumption, including both soft drink sales and vending machine sales, from 6 percent to 5 percent. Slightly more than 10 percent of the total revenue loss associated with a repeal of the Soft Drink Tax could be made up by increasing the sales tax rate on soft drinks for home consumption and vending machine sales back to the general rate of 6 percent.

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<sup>180</sup> W. Va. Code § 11-19-2.

<sup>181</sup> In the case of bottled drinks, the West Virginia tax equals one cent per every 16.9 fluid ounces or fraction thereof. In the case of dry mixtures, the tax equals one cent per every ounce. In the case of syrup, the tax equals 80 cents per gallon. Soft drink distributors may generally claim a 12.5 percent discount or deduction in tax to account for possible breakage or spoilage of soft drink products. In addition, this discount helps compensate distributors for the cost of placing West Virginia tax-paid indicia markings upon their products. *Id.*

f. *Business Investment Tax Credits*

Policymakers created a number of independent investment tax credit incentives over the years beginning with the creation of the Industrial Expansion Tax Credit in 1969, the Industrial Revitalization Tax Credit in 1981, and the Business Investment and Jobs Expansion Tax Credit (Super Credit) in 1985. The general objectives of each one of these incentive programs was to stimulate the economy, create jobs and promote investment. By 2000, the number of incentive tax credits grew to more than 20 completely separate and sometimes overlapping programs. At the request of former Governor Wise, a cooperative study by both the Tax Department and the Development Office of the various tax credit programs and their effectiveness was conducted in 2001. The results were presented to the Legislature and the Legislature responded by enacting comprehensive legislation in 2002 repealing or eliminating 13 programs and replacing them with three new programs.<sup>182</sup>

Significant scrutiny of tax credit programs began during the late 1980s when total tax collections were in a state of decline at the same time tax credit claims were increasing in magnitude. In response to the *First Report on Super Credit*, Legislation was enacted in 1990 to restrict the availability of the credit to those firms who create new jobs and to eliminate the application of new credits against the Severance Tax. In 1993, legislation was enacted to exclude mining and retail trade from Super Credit application. Legislation was also enacted to provide greater accountability for venture capital funds created under the West Virginia Capital Company Credit Act.

As a result of the Legislation enacted in 1990, 1993, and 2002, business tax credit expenditures gradually declined in ratio to total General Revenue Fund revenues. As illustrated below, Super Credit claims against the Severance Tax declined from a high of \$67 million in 1991 to roughly \$10 million in 2006. Due to periodic Legislation reducing the available annual allotment of the Capital Company

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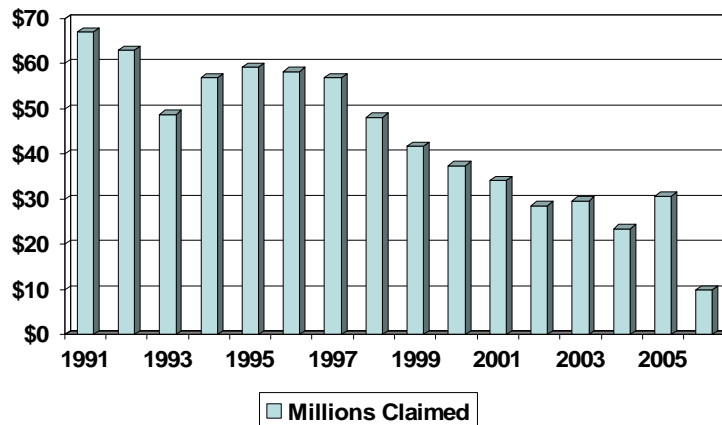
<sup>182</sup> See Appendix H.

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Credit, authorizations of this credit declined from a high of roughly \$10 million per year in the mid 1990s to an average of less than \$3 million per year in recent years.

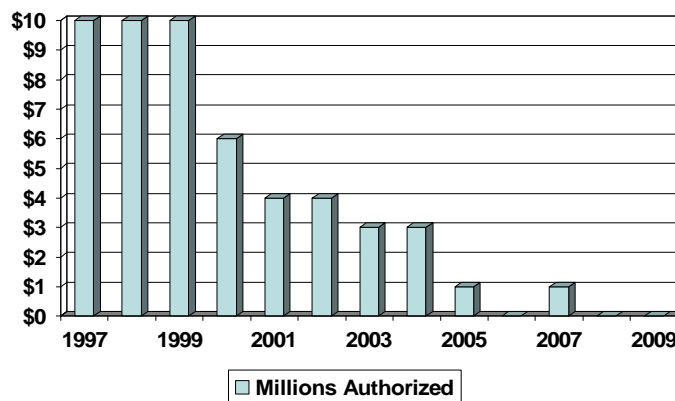
**CHART 4**

**Super Credit Claims Against Severance Tax  
Phase-Out from 1990 Legislation**



**CHART 5**

**Capital Company Tax Credit Allotment  
by Fiscal Year**



A review of the current list of investment tax credits illustrates fewer programs and a trend of declining expenditures. Absent any grandfathered claims associated

with one or more of the various terminated tax credit statutes, total costs of existing programs are generally less than \$25 million. This cost figure does not include credit claims by the electric power and gas storage industries related to their unique tax structures. A discussion of tax credits relating to the electric power and gas storage industries may be found in the State Business and Occupation Tax on Specialized Industries section of this chapter.

The Economic Opportunity Tax Credit was created as a replacement program for the Super Credit, effective January 1, 2003. This credit is available to businesses who generally create at least 20 new jobs and who are engaged in manufacturing, information processing, goods distribution, warehousing, corporate headquarters relocation, or destination oriented recreation and tourism activities within the State. During peak years, the expenditure value of all Economic Opportunity Tax Credits is not expected to exceed \$10 million.

The Manufacturing Investment Tax Credit was created as a replacement program for the Industrial Expansion and Revitalization Tax Credit, effective January 1, 2003. The credit is generally equal to 5 percent of annual qualified investment in manufacturing facilities within the State and may be used to reduce Severance Tax, Business Franchise Tax, and Corporation Net Income Tax liability by up to 50 percent. During peak years, the expenditure value of all Manufacturing Investment Tax Credits is not expected to exceed \$10 to \$15 million. The Business Tax Subgroup recommends retaining this tax credit unless the State is otherwise able to eliminate both the Business Franchise Tax and local personal property taxes on inventory, machinery, and equipment.

The Strategic Research and Development Tax Credit was created as a replacement program for the Research and Development Projects Credit. This credit is generally equal to the greater of 3 percent of total qualified research expenditures or 10 percent of qualified expenditures over a three-year base average. The Legislature recently expanded the scope of tax credits for the support of research and development to also include a credit of 50 percent for capital investments made by individuals in qualified small research and development firms

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and a refundable credit provision for qualified small research and development firms. The Tax Modernization Group recommends a thorough study of the costs and benefits of these programs in the near future.

The Tax Modernization Group also makes the following additional short-term recommendations regarding tax credits:

1. The Capital Company Tax Credit should be repealed in favor of lower Corporation Net Income Tax rates.
2. The High-Growth Business Investment Tax Credit should be allowed to terminate as scheduled on July 1, 2008.
3. The High-Tech Zone provisions of the Economic Opportunity Tax Credit and the Strategic Research and Development Tax Credit should be repealed with appropriate grandfather provisions for existing claims.
4. The Refundable Strategic Research and Development Tax Credit provisions should be allowed to sunset as scheduled on January 1, 2008.
5. The Natural Gas Jobs Industry Retention Tax Credit should be eliminated along with the Business and Occupation Tax on gas storage.

# **Chapter IX**

## ***Consumers Sales and Excise Taxes***





## **IX. Consumers Sales and Excise Taxes**

### **A. Consumers Sales and Service Tax and Use Tax**

The Consumers Sales and Service Tax and Use Tax is a significant source of revenue for the General Revenue Fund. Collections for the Consumers Sales and Service Tax last year were over \$1.1 billion, and accounted for over 27 percent of collections for the General Revenue Fund. The Tax Modernization Project has not as of yet undertaken an analysis of the entire Consumers Sales and Service Tax structure. The members of the Project have, however, identified three particular areas of the Consumers Sales and Service Tax that warrant consideration.

#### **1. Sales Tax on Food and Food Ingredients Intended for Home Consumption**

The State of West Virginia has a detailed history with respect to exempting food for home consumption from sales taxation. When the West Virginia Consumers Sales and Service Tax was originally enacted in 1934, no specific exemption for food was provided. On July 1, 1941, an exemption was made for certain food items including bread, butter, flour, eggs, and milk. This partial food exemption lasted only ten years, and was repealed in 1951. The Consumers Sales and Service Tax on food and food intended for home consumption (hereafter, sales tax on food for home consumption) remained until 1979, when the State provided a three-year phase out of sales tax on food for home consumption, with complete elimination in 1981. To replace revenues lost by the food for home consumption exemption, the State's overall Consumers Sales and Service Tax was increased to 5 percent. In March 1989, the exemption for food for home consumption was once again removed. The 6 percent tax rate on food for home consumption was applied. Effective January 1, 2006, the rate on food for home consumption was reduced to 5 percent.<sup>183</sup> Thus, West Virginia has a history of providing an exemption, then either increasing the general Consumers Sales and Service Tax rate or repealing the exemption, or both.

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<sup>183</sup> See W. Va. Code §§ 11-15-3a; 11-15B-2 (Supp. 2006).

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Taxpayer appetite for the general sales tax and the sales tax on food for home consumption varies across the country. States with high sales tax on food for home consumption (e.g., Alabama and Arkansas) tend to impose significantly below average residential property taxes. States with no sales tax on food for home consumption tend to impose some combination of a higher than average overall sales tax rate, higher than average personal income taxes or higher than average residential property taxes. Residents in South Dakota recently voted against a referendum to eliminate the sales tax on food for home consumption out of concern that other taxes would rise to fill the gap. Virginia recently reduced its sales tax on food for home consumption from 4.5 percent to 2.5 percent, and raised its overall tax rate to 5 percent at roughly the same time. New Mexico recently raised its overall state and local sales tax rate by 0.5 percent at the same time it eliminated its sales tax on food for home consumption. The Idaho Legislature recently enacted an increase in its general sales tax rate, including taxes on food for home consumption, to finance a property tax relief program. A group of legislators in Pennsylvania recently advocated the extension of that state's sales tax to food for home consumption in exchange for residential property tax relief.

The sales tax on food for home consumption is currently imposed by state government and/or local government units, or both, in 20 states, including West Virginia. In a number of states, the sales tax on food for home consumption is either levied at a lower rate than the general sales tax rate (e.g., West Virginia) or the tax is imposed only by local governments (e.g., Alaska). The following table contains more details.

TABLE 1

<b>Sales Tax On Food For Home Consumption</b> <sup>184</sup>				
<b>Maximum</b>			<b>Maximum</b>	<b>Maximum</b>
<b>Rate Rank</b>	<b>State</b>	<b>State Rate</b>	<b>Local Rate</b>	<b>Total Rate</b>
1	Arkansas	6.000%	5.500%	11.500%
2	Alabama	4.000%	7.000%	11.000%
3	Oklahoma	4.500%	6.000%	10.500%
4	Idaho <sup>(b)</sup>	6.000%	3.000%	9.000%
5	Tennessee <sup>(c)</sup>	6.000%	2.750%	8.750%
6	Kansas <sup>(b)</sup>	5.300%	3.000%	8.300%
7	Mississippi	7.000%	0.250%	7.250%
8	Alaska <sup>(a)</sup>	No Tax	7.000%	7.000%
8	Utah	4.750%	2.250%	7.000%
10	Louisiana <sup>(a)</sup>	0.000%	6.250%	6.250%
11	South Dakota <sup>(b)</sup>	4.000%	2.000%	6.000%
11	Wyoming <sup>(b,e)</sup>	4.000%	2.000%	6.000%
13	Missouri <sup>(c)</sup>	1.225%	4.500%	5.725%
14	South Carolina <sup>(c)</sup>	3.000%	2.000%	5.000%
14	West Virginia <sup>(c)</sup>	5.000%	0.000%	5.000%
16	Hawaii <sup>(b)</sup>	4.000%	0.000%	4.000%
17	North Carolina <sup>(a)</sup>	0.000%	3.000%	3.000%
17	Georgia <sup>(a)</sup>	0.000%	3.000%	3.000%
19	Virginia <sup>(c,d)</sup>	1.500%	1.000%	2.500%
20	Illinois <sup>(c)</sup>	1.000%	0.000%	1.000%

a - No State Sales Tax Rate Applies, But Local Taxes Do Apply.

b - These States Provide an Income Related Tax Credit to Offset Food Tax to Compensate Poor Households.

c - These States Tax Food for Home Consumption at a Lower Tax Rate Than Other Taxable Purchases.

d - Virginia reduced its tax rate on groceries after raising the overall tax rate by 0.5 percentage points.

e - Wyoming enacted a temporary exemption from July 1, 2006 to June 30, 2008 for both the State and local rate.

Additional Notes: New Mexico recently eliminated its tax on groceries and partially offset the loss by increasing the sales tax rate by 0.5 percentage points.

<sup>184</sup> Sources: Federation of Tax Administrators -- January 2006 Survey. State Revenue Department Web Pages.

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The remaining 26 states that impose the general sales tax totally exempt food for home consumption from their sales tax base.

The concept of an exemption for sales tax on food for home consumption grew out of criticism that such a sales tax is regressive, because lower-income households spend a higher share of their income on food for home consumption than do those in higher-income households. This problem, however, has been mitigated to some extent. The sales tax on food for home consumption became less regressive in 1987 when federal law effectively created a State and local sales tax exemption for purchases of food made with food stamps or Women, Infants and Children (“WIC”) program vouchers.

The 1999 Commission on Fair Taxation studied the sales tax on food for home consumption in an in-depth fashion and concluded that reductions in the sales tax on food for home consumption may not benefit low-income individuals as much as some had alleged.<sup>185</sup> As the 1999 Commission stated:

It was the opinion of the Commission that equity could better be served by a more progressive personal income tax than by exempting groceries from the State sales tax, as had been suggested by some. . . . In addition, low-income families that receive food stamps or women’s, infants and children’s programs (WIC) payments do not pay sales tax on food purchased with food stamps or with WIC coupons. Almost 70 percent of food expenditures by low-income West Virginian families are covered by some assistance program. As a result, they would benefit little, if at all, from the repeal of the sales tax on food.

While it is true that lower income individuals and families spend a higher percentage of their incomes on food than do higher income individuals and families, the persons who would derive the greatest benefit from repeal of the food tax would be the higher income individuals and families because they spend more dollars

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<sup>185</sup> 1999 Commission on Fair Taxation, Supplement D, Current Proposed Sales Tax Systems: Their Effects on West Virginia’s Economically Disadvantaged Citizens, August 1998.

on groceries even though those dollars represent a smaller percentage of their budgets. While lower income individuals would see their total sales tax bill decline by less than \$20, higher income individuals would see reductions of over \$200.<sup>186</sup>

A recent study confirmed that the sales tax on food for home consumption is not as regressive as often thought because of food stamps and consumption patterns that vary with income.<sup>187</sup> In fact, a decrease in the sales tax on food for home consumption may benefit low income earners no more than high or middle income earners. Because sales taxes are fully shifted to consumers, a tax exemption on the sales tax on food for home consumption lowers the tax burden on consumers, but it entails some hidden costs.<sup>188</sup> Such actions, however, narrow the tax base and are often balanced by new taxes that might be more unfair or inefficient than those being repealed.

In recent years, the equity argument for exempting food for home consumption from the Consumers Sales and Service Tax has been supplemented by an additional argument that exempting food for home consumption would enhance sales within the State by reducing incentives for consumer shopping in border states. A recent study analyzed the effect on cross-border shopping from a 6 percent increase in West Virginia's food tax in 1989.<sup>189</sup> That study concluded that the higher tax rate in West Virginia led to a loss of an estimated \$6 million in sales in border counties. The statewide impact was significantly less than one percent of the

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<sup>186</sup> 1999 Commission on Fair Taxation at 3-930.

<sup>187</sup> Tosun, Mehmet, and Pavel Yakovlev, "West Virginia Sales Tax on Food for Home Consumption," *West Virginia Business and Economic Review* 12: 8-15, March 2006.

<sup>188</sup> Besley, Timothy J., and Harvey S. Rosen. "Sales Taxes and Prices: An Empirical Analysis," *National Tax Journal* 52 (2): 157-178, June 1999; Poterba, James. "Retail Price Reactions to Changes in State and Local Sales Tax," *National Tax Journal* 52 (1): 79-90, March 1999.

<sup>189</sup> Tosun, Mehmet, and Mark Skidmore, *Cross Border Shopping and the Sales Tax: A Reexamination of Food Purchases in West Virginia*, September 2005.

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total sales tax on food for home consumption. Although some may argue that the sales tax on food for home consumption should be eliminated to reduce this \$6 million loss in border county sales, the members of the Tax Modernization Project disagree. The repeal of the sales tax on food for home consumption would equate to a \$125 million reduction in State revenues.

From a business development standpoint, an exemption sales tax on food for home consumption would be far less robust than alternative policies designed to reduce business activity taxes (e.g., Business Franchise Tax). Moreover, the typical long-term tradeoff for a sales tax exemption on food for home consumption is a 1.0 percentage point increase in the general sales tax rate. For many businesses and low income consumers that do not pay a sales tax on food for home consumption, a 7 percent sales tax with the food for home consumption exemption results in greater tax liability than a 6 percent sales tax without the food for home consumption exemption. Other commentators have asserted that the sales tax's excess burden (i.e., efficiency loss) increases with the narrowing of the tax base.<sup>190</sup> Other studies show that states combining a broad-based consumption tax with elimination of a tax on business inputs are better off.<sup>191</sup> These findings support the idea that a larger tax base allows for a smaller tax rate, which reduces the incentives to shop online or across state borders.

Based on the aforementioned studies, the ability of the State to provide meaningful relief to low-income individuals through a Family Tax Credit, and the great need to reduce certain business taxes, the Tax Modernization Committee recommends caution with regard to policies promoting additional reductions in the sales tax rate on food for home consumption. As the 1999 Commission on Fair Taxation stated: **“[w]hile repeal of the sales tax on groceries has a strong**

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<sup>190</sup> Baum, Donald N. “Economic Effects of Eliminating the Sales Tax Exemption for Food: An Applied General Equilibrium Analysis,” *Journal of Economics* 24 (1): 125-148, 1998.

<sup>191</sup> Russo, B. An efficiency analysis of proposed state and local sales tax reforms, *Southern Economic Journal* 72 (2): 443-462, October 2005.

**emotional appeal, it does not represent a significant improvement in tax equity.**<sup>192</sup> The 1999 Commission concluded that focusing on the improvement of other areas of the tax system, such as the Personal Income Tax, would better serve the citizens of the State. Experience in other states and past experience in West Virginia indicate that an exemption from the sales tax on food for home consumption generally corresponds with a tax increase elsewhere. The alternative tax increase could easily result in greater taxation of capital formation and of lower income individuals.

Thus, the members of the Tax Modernization Project are opposed to eliminating the sales tax on food for home consumption. If, however, an additional reduction is the objective, we recommend a phased-down approach as opposed to the outright elimination of this tax. Moreover, we do not believe that the sales tax on food for home consumption should be phased out in its entirety. A repeal or significant reductions of the sales tax on food for home consumption are not viable given that many alternative tax revisions would provide greater economic stimulus.

## **2. Prescription Drugs**

Under the West Virginia Code, “sales of drugs, durable medical goods, mobility-enhancing equipment and prosthetic devices dispensed upon prescription and sales of insulin to consumers for medical purposes” are exempt from the Consumers Sales and Service Tax.<sup>193</sup> This exemption, however, does not generally apply to drugs sold to hospitals (or to other providers of medical services). Instead, such drugs have been deemed taxable because hospitals generally use drugs in providing professional services. In essence, the professional service provider is treated as the taxable “consumer” of the tangible personal property purchased by

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<sup>192</sup> 1999 Commission on Fair Taxation at 3-930.

<sup>193</sup> W. Va. Code § 11-15-9(a)(11) (2005).



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the professional service provider for use, consumption or distribution in the activity of providing the professional service.<sup>194</sup>

In 2001, the Supreme Court of Appeals of West Virginia concluded that certain sales in a hospital were entitled to an exemption as “prescription sales.” Specifically, the Supreme Court of Appeals of West Virginia ruled that the sale of a radiopharmaceutical drug to a medical service provider is exempt from the West Virginia Consumers Sales and Service Tax where the drug is purchased and dispensed pursuant to a physician's prescription that was prepared prior to the sale for a particular, individual patient.<sup>195</sup> Under the court’s holding, if a drug (or other prescription item) is sold to a hospital or other medical service provider in circumstances where the purchase of the drug is made pursuant to a prescription prepared for a particular, individual patient, and if that prescription was written prior to the sale, by a person licensed to prescribe (e.g., a physician), then the exemption for sales of prescription drugs applies.

The members of the Tax Modernization Project believe that the current exemption should be expanded to exempt all purchases of drugs and prosthetic devices by hospitals, physicians, and other health care providers if such items are ultimately to be dispensed upon prescription. The cost of this proposal is approximately \$10 million.

### **3. Tax Exemption for Direct Use Manufacturing**

Most states, including West Virginia, provide a direct use sales tax exemption to manufacturers.<sup>196</sup> Purchases of machinery, equipment, tools, and raw materials by manufacturers for direct use in a manufacturing activity are exempt from sales tax. This type of exemption for business inputs limits any potential pyramiding impact of the sales tax and is generally viewed as good tax policy. Purchases of

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<sup>194</sup> See, e.g., W. Va. C.S.R. §§ 110-15-36.4 and 37.2.

<sup>195</sup> *Syncor Int'l Corp. v. Palmer*, 208 W. Va. 658; 542 S.E.2d 479 (W. Va. 2001). W. Va. Code § 11-15-9(a)(11) (the exemption for purchases of prescription drugs and insulin).

<sup>196</sup> W. Va. Code § 11-15-9(b)(2) (2005).

indirect use items, such as office furniture for the plant manager or food for an office party, are subject to sales tax.

Manufacturers often employ contractors to construct or refurbish their facilities. For purposes of compliance, contractors are subject to taxation on all of their purchases even if the resulting purchase is used in a project involving an entity that is otherwise exempt from sales tax. Under current law, manufacturers avoid the indirect imposition of sales tax by directly purchasing the machinery, equipment, and materials that the contractor will install at the manufacturing facility. However, certain types of specialized equipment cannot be easily purchased separately by the manufacturer due to the lack of expertise necessary to make such purchases. In addition, some warranties may be voided unless the contractor controls the purchase and installation. As a result, some manufacturers face an embedded sales tax cost that may be significant in size. In some cases, the extra cost may dissuade the manufacturer from making the investment in West Virginia. The Tax Modernization Group recommends legislation granting a pass-through exemption to contractors for purchases of equipment, machinery, and materials made for direct use in a manufacturing facility. The exemption would apply to any item that would be exempt if purchased directly by the manufacturer, as long as that item is properly used in the manufacturing facility and will cost in excess of \$3 million. This proposed change should stimulate additional capital investment in West Virginia manufacturing facilities.

#### **B. Cigarette and Other Tobacco Product Excise Taxes**

Throughout this Report the Tax Modernization Project has identified several taxes that may represent a drag on West Virginia's economy, including the Business Franchise Tax, the Corporation Net Income Tax, and certain aspects of the Personal Income Tax. Additionally, this Report makes several recommendations which seek to address those problems. Although those recommendations would dramatically improve West Virginia's system of taxation, implementing those recommendations will cause a decrease to the State's General Revenue Fund. Unlike the United

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States Government, the State of West Virginia must balance its budget every year. Reductions in tax, therefore, must be cautiously enacted to ensure the State will have a balanced budget.

If the State needs revenue to offset losses, one potential source of revenue that warrants attention is an increase in the excise tax rate on cigarettes. West Virginia's current excise tax rate is the 35th lowest in the country. Moreover, since West Virginia last increased its excise tax on tobacco in 2003, 20 states have increased their respective excise taxes on cigarettes. Of our border states, Pennsylvania, Maryland, and Ohio each have excise taxes that are significantly higher than West Virginia's excise tax on cigarettes. Significantly, two of our border states have engaged in tax reform to reduce, overhaul, or eliminate inefficient taxes, and those states have passed an increase in the excise tax rate on cigarettes to offset lost revenues. Ohio, for example, increased its tax by \$0.70 – from \$0.55 to \$1.25 per pack.

Accordingly, if additional revenues are needed for the State, an increase in the excise tax rate on cigarettes would be warranted. An increase in the excise tax from \$0.55 to \$1.00, for example, could generate as much as \$60 million. Such an increase would leave West Virginia's rate on cigarettes below those in Ohio and Pennsylvania and equal with Maryland's excise tax on cigarettes.

Moreover, the State should also consider reviewing the tax on other tobacco products. West Virginia currently charges a 7 percent tax based on the wholesale price of other tobacco products. This rate is lower than comparable taxes in our surrounding states. Ohio, for example, charges a 17 percent wholesale tax; Maryland charges a 15 percent wholesale tax; Kentucky charges a 7.5 percent wholesale tax; and Virginia charges a 10 percent wholesale tax. If additional revenues are needed, West Virginia could increase its tax rate on the wholesale price of other tobacco products and still remain competitive with our border states.

# **Chapter X**

## ***Property Taxes and Local Government Finances***



## X. Property Taxes and Local Government Finance

### A. Introduction

Another aspect of the Tax Modernization Project was a review of property taxes and local government finance. The Property Taxes and Local Government Finance Subgroup was charged with the responsibility to review and present proposals regarding property taxes and local government finance which would:

- (1) Improve the assessment and collection of the property tax and municipal fees and taxes; and
- (2) Provide greater flexibility and fiscal capacity for local governments.

Over 20 individuals participated in the deliberations of the Property Taxes and Local Government Finance Subgroup. The Subgroup included a wide variety of local government officials including various municipal and county officials and organizations. The Subgroup also included officials of the West Virginia Department of Education and Department of Revenue.<sup>197</sup>

The Property Taxes and Local Government Finance Subgroup is well aware that West Virginia provides fewer fiscal options to its local governing bodies (counties, municipalities, and school boards) than any other state in the nation. As has been thoroughly discussed, the Tax Limitation Amendment of 1932 had a dramatic effect on the ability of local governments to raise revenues. Real property taxes on owner-occupied homes are low in West Virginia, as can be seen from the following table.

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<sup>197</sup> Although there was consensus on these recommendations, they should not be considered the official positions of the organizations and offices of those who participated in the deliberations of the Subgroup.

**TABLE 1**  
**AVERAGE REAL PROPERTY TAX DEDUCTION CLAIMED ON FEDERAL INCOME TAX RETURNS**

SOURCE: IRS-STATISTICS OF INCOME DIVISION

2003 Tax Returns

<u>STATE</u>	<u>All Tax Returns</u> Average Property Tax Deduction	<u>Family Income</u> \$39,000 Average Property Tax Deduction	<u>Family Income</u> \$61,000 Average Property Tax Deduction	<u>Family Income</u> \$86,000 Average Property Tax Deduction	<u>Family Income</u> \$132,000 Average Property Tax Deduction
NEW JERSEY	\$6,005	\$4,401	\$4,835	\$5,443	\$6,892
NEW HAMPSHIRE	4,830	3,686	4,113	4,690	5,899
PENNSYLVANIA	3,361	2,435	2,691	3,177	4,306
MARYLAND	2,686	1,915	2,176	2,523	3,320
OHIO	2,418	1,668	2,023	2,447	3,435
VIRGINIA	2,495	1,568	1,860	2,297	3,338
KENTUCKY	1,415	1,022	1,165	1,406	2,018
WEST VIRGINIA	1,059	738	842	966	1,410
<b>AVERAGE - ALL STATES</b>	<b>\$3,094</b>	<b>\$2,089</b>	<b>\$2,383</b>	<b>\$2,866</b>	<b>\$4,028</b>

Property taxes on business real property are double those on owner-occupied homes. Business inventories, machinery, equipment, and fixtures are taxed as well. Business property taxes are well above those of the median state, as reflected in the following chart.

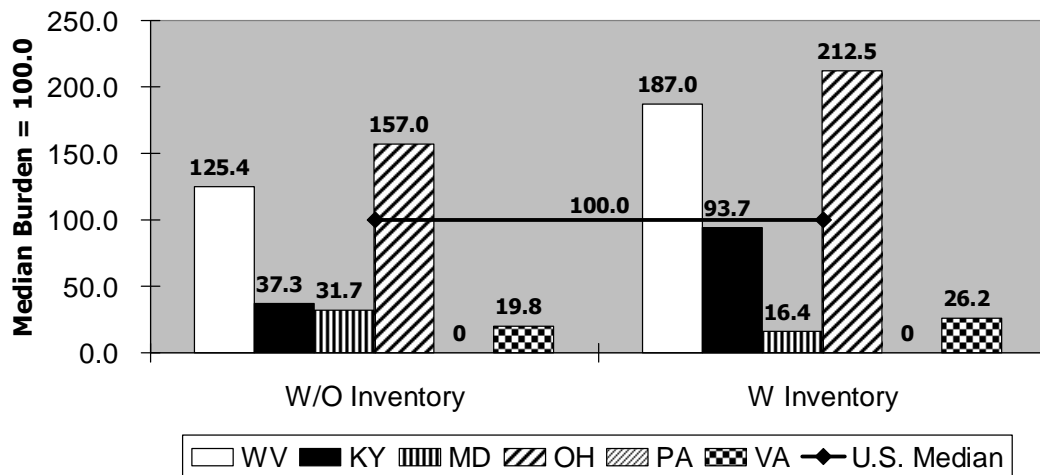
**CHART 1**

## Industrial Personal Property Taxes

### Example: 40% of Total Personal Property is Inventory

Source: Minnesota Taxpayer's Association: Payable Year 2002

Tax Year 2002: Average Class III Rate in WV



As is indicated by the chart, West Virginia's industrial personal property taxes are significantly higher than any of our border states with the exception of Ohio. Ohio, however, is currently in the process of phasing out their personal property taxes. When that phase out is completed, West Virginia's personal property taxes on business will be the highest in the region.

Because of Constitutional limitations dating from the 1930s, the Property Tax is not a productive source of local government revenue. Under current law, West Virginia municipalities derive revenue from the following sources: a Business and Occupation Tax, Property Tax, an excise tax on utilities, and licenses and other fees and charges. The Municipal Business and Occupation Tax generates a significant



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portion of revenue for municipalities. In West Virginia, the Property Tax collections for Fiscal Year 2006 accounted for 28 percent of total municipal tax revenues, and the local Business & Occupation Tax accounted for more than 60 percent of total municipal tax revenues.

The Subgroup firmly believes that the State should allow local governments to choose from a mix of local revenue sources to meet the needs of their individual situations. County and municipal governments have different problems and revenue potentials. Local government should be allowed to design their own revenue structures. The problems faced by small towns and counties differ from those of larger entities, as do the problems of border cities and counties when contrasted with interior municipalities and counties. As one participant stated, "Do not trade one mandate for another mandate."

The Subgroup also believes it significant to point out the fear expressed by opponents of local flexibility that local governments would, upon receiving such flexibility, increase real property taxes was unfounded due to the check of the local ballot box and the State Constitution. Local governments do not need more State mandates. Instead, the Subgroup believed that local governments need the ability to plan and finance their futures with as much flexibility as possible.

The recommendations fall into three categories: (1) recommendations aimed at increasing the ability of local governments (county and city) to collect taxes and fees currently in effect; (2) recommendations to provide local governments with greater flexibility in managing their fiscal affairs; and (3) recommendations to overhaul and update antiquated provisions of the West Virginia Code relating to local taxation.

### **1. Proposals for Immediate Modernization**

With respect to increasing compliance and enhancing the ability of local governments to collect fees and taxes, the Property Taxes and Local Government Finance Subgroup recommends that additional statutory provisions be enacted to allow more extensive sharing of information for Property Tax collection and

enforcement. Under the West Virginia Code, Property Tax return information is confidential, except that it may be “open to inspection by or disclosure to officers, members and employees of the state tax department, county assessors, county commissions and to members of the board of public works whose official duties require such inspection or disclosures for property tax administration purposes.”<sup>198</sup>

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<sup>198</sup> W. Va. Code § 11-1A-23 (2003) provides as follows:

(a) *Secrecy of returns and return information.* -- Property tax returns and return information filed or supplied pursuant to this article and articles three, four, five and six of this chapter and information obtained by subpoena or subpoena duces tecum issued under the provisions of this article shall be confidential and except as authorized in this section, no officer or employee of the state tax department, county assessors, county commissions and the board of public works shall disclose any return or return information obtained by him, including such return information obtained by subpoena, in any manner in connection with his service as such an officer, member or employee: *Provided*, That nothing herein shall make confidential the itemized description of the property listed, in order to ascertain that all property subject to assessment has been subjected to appraisal: *Provided, however*, That the commissioner and the assessors shall withhold from public disclosure the specific description of burglar alarms and other similar security systems held by any person, stocks, bonds and other personal property held by a natural person, except motor vehicles and other tangible property utilized publicly, and shall withhold from public disclosure information claimed by any taxpayer to constitute a trade secret or confidential patent information: *Provided further*, That such property descriptions withheld from public disclosure shall be subject to production and inspection in connection with any review, protest or intervention in the appraisal or assessment process, under such reasonable limitations as the board of review, board of equalization and review or court shall require. The term officer or employee includes a former officer, member or employee.

(b) *Disclosure.* -- (1) Information made confidential by subsection (a) of this section shall be open to inspection by or disclosure to officers, members and employees of the state tax department, county assessors, county commissions and to members of the board of public works whose official duties require such inspection or disclosures for property tax administration purposes. Disclosure may be made to persons, or officers or employees thereof, who are employed by the state tax commissioner by contract or otherwise, provided such person, or officer or employee thereof, shall be subject to the provisions of this section as fully as if he was an officer or employee of the state tax department. Information made confidential by subsection (a) of this section shall be open to inspection by the property owner providing such information and to his duly authorized representative. (2) Information made confidential by subsection (a) of this section may be disclosed in a judicial or administrative proceeding to collect or ascertain the amount of tax due, but only if (i) the taxpayer is a party to the proceedings or (ii) such return information directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer which directly affects the resolution of an issue in the proceeding.

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The Subgroup also recommends amending the Code to include county sheriffs and city financial officers in the group of officials entitled to inspect such information. It would be beneficial to both county and city collections if this information was available to aid in enforcement and collection of delinquent taxes and fees, as county sheriffs and city financial officers have the responsibility for collection of this levy.

The West Virginia Code currently permits the State Tax Department to exchange certain tax information with municipalities.<sup>199</sup> Additionally, the State Tax Department is authorized to coordinate with certain state agencies with respect to a single point of registration system.<sup>200</sup> The authority with respect to each of these provisions, however, does not provide sufficient flexibility for information sharing to allow local officials to properly monitor and seek delinquent taxpayers. Accordingly, the Property Taxes and Local Government Finance Subgroup recommends that the West Virginia Code be amended to allow the State Tax Department to enter into an agreement with the assessors, sheriffs, and municipalities for the exchange of tax information, including but not limited to the Federal Employer Identification Numbers contained in business franchise registration certificates. The authority to share such information should be specifically limited to the purpose of exchanging information

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<sup>199</sup> W. Va. Code § 11-10-5d(1)(j) (2003) reads in part: “The tax commissioner shall, upon the written request of the mayor or governing body of any West Virginia municipality, allow the duly authorized agent of the municipality to inspect and make copies of the state business and occupation tax return filed by taxpayers of the municipality and any other state tax returns (including, but not limited to, consumers sales and services tax return information and health care provider tax return information) as may be reasonably requested by the municipality. Such inspection or copying shall include disclosure to the authorized agent of the municipality for tax administration purposes of all available return information from files of the tax department relating to taxpayers who transact business within the municipality.” The tax commissioner shall be permitted to inspect or make copies of any tax return and any return information or other information related thereto in the possession of any municipality or its employees, officers, agents or representatives that has been submitted to or filed with the municipality by any person for any tax including, but not limited to, the municipal business and occupation tax, public utility tax, municipal license tax, tax on purchases of intoxicating liquors, license tax on horse racing or dog racing and municipal amusement tax.

<sup>200</sup> W. Va. Code § 11-12-7 (2003).

relating to the enforcement and collection of taxes and fees. Without such information, local officials are unable to correlate names on the property tax roles with the Federal Employer Identification Numbers. This inhibits the ability of local government officials to identify businesses with delinquent personal property taxes.

The Property Taxes and Local Government Finance Subgroup also believes that local government should have the ability to share collection costs. It is recommended that statutory authority be provided for all local governments (counties, school boards, and municipalities) to share in and pay the costs of collection of delinquent property taxes in proportion to the amount to be received from the collection. If the county bears the initial cost of the collection, it shall be reimbursed prior to any distribution to municipalities or school boards. At times there is little incentive for the county to pursue delinquent taxes, particularly if this involves the expense of legal action. The school boards receive on average 70 percent of whatever delinquency is collected, yet there is no legal authorization for them to participate in funding of the county's action to collect delinquent property taxes. In some cases, the legal action would cost the county more than the county would receive from the collection.

The Property Taxes and Local Government Finance Subgroup also recommends that the State Tax Department assume a greater role in the preparation of the Real Property Sales-Ratio Study. The Real Property Sales-Ratio Study is used to determine whether assessors are properly assessing real property at the required 60 percent of market value. Currently, the State Tax Department prepares a Real Property Sales-Ratio for each county, but the county assessors are responsible for supplying the sales from each county which are to be included in the Study.<sup>201</sup> Reliance on 55 different assessors to select the sales to be considered in the ratio has led to inconsistencies between counties and creates a potential for

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<sup>201</sup> See W. Va. Code § 7-7-6a (2003) (relating to duty of assessors to submit information); W. Va. Code 11-1C-9 (2003) (relating to periodic valuations by the State Tax Department); W. Va. Code § 11-1C-5 (2003) (relating to authority of State Tax Commissioner); and W. Va. Code § 11-1a-21(d) (2003) (relating to authority of State Tax Commissioner).

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manipulating the sales reported to produce a more satisfactory ratio. As is done in other states, such as Kansas and South Dakota, the county assessors should submit all sales to the State Tax Department, and the State Tax Department, using objective measures for all sales, would then determine what sales should be included in the study and whether sales from adjoining counties should be used to accurately portray the assessment of property. The Subgroup notes that this recommendation, if implemented, will require sufficient additional funding to the State Tax Department to properly undertake the real property sales ratio study each year.

The Property Taxes and Local Government Finance Subgroup also recommends that statutory authority be provided to allow municipal governments to put liens on property for failure to pay municipal fees. West Virginia law currently permits liens to be filed only for unpaid Municipal Business and Occupation Taxes. Not having this capacity makes it difficult, if not impossible, for municipalities to collect these fees if the owner transfers the property or lives outside the State.

The Property Taxes and Local Government Finance Subgroup also recommends that several definitions be “modernized.” Specifically the Subgroup recommends the definition of “charitable” – as that term relates to the Municipal Business and Occupation Tax – be clarified. Under current law, “corporations, associations and societies organized and operated exclusively for religious or charitable purposes” are exempt from the Municipal Business and Occupation Tax.<sup>202</sup> They recommend the rule be clarified by making it explicit that any income covered by the Unrelated Business Income Tax (UBIT) of the Internal Revenue Service Code be clearly taxable under the Municipal Business and Occupation Tax. The Subgroup concluded that there appears to be some inconsistency between and among counties as to what property is considered to be “charitable” as the West Virginia Code does not define the term. The Subgroup concluded that a single

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<sup>202</sup> W. Va. C.S.R. § 110-26-3.

definition tied to the UBIT would best serve the interests of county and city governments in the assessment and collection of fees and taxes.<sup>203</sup>

There was full agreement that the definition of what constitutes a farm should be revisited. Under rules promulgated by the State Tax Department, in order to qualify as a farm, the farm “must produce for sale, consumption or use agricultural products . . . having a fair market value to the producer of at least one thousand dollars (\$1,000), including any government subsidies or payments for farm products which may be given away.” Or, if “the farm has a total area of less than five (5) acres, then it must produce and sell at least five hundred dollars (\$500.00) worth of agricultural products.”<sup>204</sup>

The Property Taxes and Local Government Finance Subgroup believes that the current threshold of more than five (5) acres and one thousand dollar (\$1,000) and the less than five (5) acres, five hundred dollar (\$500) threshold, is too easily met and encourages the holding of vacant property until it can be sold for development. The initial income thresholds were established in 1984 and have not been adjusted since that time. The Subgroup does not have an alternate definition of farms. The Subgroup notes that most farms in West Virginia are generational or are legitimately used as farms. Therefore, the members realize that great caution must be taken in this area. Indeed, much further investigation and analysis is necessary and will focus on how other states have defined farms for property tax purposes as well as reviewing the Corporation Net Income Tax definitions for farms from the Internal Revenue Service.

The Property Taxes and Local Government Finance Subgroup also proposes eliminating the property tax growth formula and levy rate rollback. As part of the

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<sup>203</sup> The Subgroup was also concerned about the taxation of non-profit entities, and particularly for those who engage in business related activities. The group noted that this issue affects the most important state and local taxes: income, sales, and property. The Subgroup suggests additional study to derive a clear delineation of who is taxable and who is exempt and what activities give rise to tax liabilities which is consistently applied.

<sup>204</sup> W. Va. C.S.R. § 110-1A-2.6.3.4.

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reassessment of property in the early 1990s, the Legislature enacted the following provisions:

Notwithstanding any other provision of law, where any annual appraisal, triennial appraisal or general valuation of property would produce a statewide aggregate assessment that would cause an increase of one percent or more in the total property tax revenues that would be realized were the then current regular levy rates of the county boards of education to be imposed, the rate of levy for county boards of education shall be reduced uniformly statewide and proportionately for all classes of property for the forthcoming tax year so as to cause the rate of levy to produce no more than one hundred one percent of the previous year's projected statewide aggregate property tax revenues from extending the county board of education levy rate....<sup>205</sup>

These provisions are essentially a one percent property tax growth limitation requiring a levy rate rollback. The Subgroup concludes that the limitation is unfair to both the growth counties and the counties showing little, if any, growth in real property values. First, because the measurement is a statewide average limitation, those county school boards with the highest growth are not able to expand their taxes to meet the requirements of that growth. Second, the lower or no growth county school boards of education see their levy rates reduced even though they had little or no expansion of the tax base to justify the rollback. This provision further suppresses local revenues and places further stress on the State school aid formula. Finally, these provisions were enacted in the context of a statewide reappraisal in the 1980s and should not apply outside the context of a statewide reappraisal.

Related to the elimination of the one-percent rollback, the Property Taxes and Local Government Finance Subgroup also recommends that the exemption of new property from the tax base in the context of the rollback should be eliminated.<sup>206</sup> All agree that determining what was and what was not “new” personal property is, at

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<sup>205</sup> W. Va. Code § 11-8-6f(a) (2003).

<sup>206</sup> See W. Va. Code §§ 11-8-6e (2003) and 11-8-6f (2003).



best, problematic and an administrative burden. In the case of personal property, the calculation is made merely by comparing the previous year's assessed values with the current year and using the difference as "new property." The new property exemption also limits the taxing ability of local governments. It was noted that the recommendation to eliminate the exemption of new property must go forward with the elimination of the growth formula to avoid windfalls.

Under current law, municipalities have the ability to impose a tax equal to six percent of the consideration paid for the use or occupancy of a hotel room.<sup>207</sup> Counties, however, are limited to three percent of such consideration paid. County governments believe that greater flexibility would enhance the counties' ability to raise revenue to support economic development and recreation. The Property Taxes and Local Government Finance Subgroup believes that an increase for counties is warranted and would have little impact, if any, on hotel and motel occupancy rates or the ability of the county to attract visitors.

## **2. Proposals for Further Study and Intermediate-Term Implementation**

The Property Taxes and Local Government Finance Subgroup also has recommendations which will require more investigation prior to submission for legislative action. The themes are: to identify additional compliance mechanisms for local governments to collect taxes and fees; to provide additional flexibility for local governments in terms of revenue; and to update and modernize outdated provisions of the West Virginia Code.

Continuing on the theme of compliance, the Subgroup believes that legislation should be enacted to require businesses to register in municipalities. In addition to helping with municipal fee collection, registration would allow enhanced

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<sup>207</sup> W. Va. Code § 7-18-2 (2003) ("The rate of tax imposed shall be three percent of the consideration paid for the use or occupancy of a hotel room: *Provided:* That on and after the first day of July, two thousand five, a municipality may by ordinance increase the rate of tax imposed in this section to not more than six percent of the consideration paid for the use or occupancy of a hotel room.").



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enforcement of other ordinances as well as State law. The Subgroup recommends that this business registration procedure be tailored after the State business registration process.

The Property Taxes and Local Government Finance Subgroup also believes that the taxation of royalty interests in certain property needs further study. The Subgroup recognized that when mineral rights are severed from the land, it is difficult for the county to identify the royalty interests for taxation purposes particularly for out-of-state owners. One solution to this problem would be to continue having the royalty interest owner responsible for the taxes, but requiring the payer of the royalty to be responsible for withholding and remission of the taxes to the county. In that scenario, the county would be in a much better position to ensure that property taxes levied on royalties are paid.

The Subgroup also thought it would be prudent for landlords to be responsible for municipal fees. Specific authority in statute needs to be included to make landlords responsible for unpaid municipal fees if their tenants fail to pay them. When tenants leave, they often leave behind unpaid garbage and other local fees. This proposal would make the landlord responsible for the collection of these fees if the tenant has not paid them.

The Property Taxes and Local Government Finance Subgroup also recommends that the Legislature overhaul the existing reporting deadlines and requirements for assessment of all real and personal property. Under current law, assessors must meet a variety of dates and deadlines associated with property tax certification which have no logical reason. For example, the State Tax Commissioner must submit to the Legislature, by February 15th of each year, a preliminary statewide aggregate tax revenue projection to assist the Legislature in its deliberations regarding county board of education levy rates.<sup>208</sup> This is required to determine the appropriation needed for the State School Aid Formula. In order for the State Tax Commissioner to prepare the report by February 15, counties must

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<sup>208</sup> W. Va. Code § 11-1C-5(a)(4).

provide the necessary assessment information on February 1. As explained below, however, the values supplied by the counties to the State Tax Commissioner are incomplete as of February 1 and may not accurately reflect the tax base of the county.

Under current law, the assessor submits values to the County Commission sitting as a Board of Equalization and Review, on February 1. The Board meets and then has until February 28 to review the work of the assessor. Moreover, the assessor is then required to provide to the State Tax Commissioner and all levying bodies by no later than March 3rd the final aggregate values within the county of all property.<sup>209</sup> Thus, the values supplied by the assessor to the State Tax Commissioner and the Board on February 1 may be substantially different from those final values submitted to the State Tax Commissioner and levying bodies on March 3rd.

The Property Taxes and Local Government Finance Subgroup, therefore, recommends uniform dates be established for filing of all property tax returns and assessments. This will allow for better communications with the Legislature so that accurate determinations may be made with respect to local share under the school aid formula. Because there are so many dates and requirements associated with property tax assessment and certification, this is an issue which will need further work to make sure every related date and activity is included.

Under West Virginia law, the Legislature needs to revisit the provisions relating to which entities are regulated by the Public Service Commission and thus not subject to certain local taxation in defining which utilities are taxable.<sup>210</sup> As the scope of “utilities” which are not regulated by the Public Service Commission grows, this restriction creates an increasing problem in determining taxable status. The development of non-utility electric generators and internet companies has complicated this issue.

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<sup>209</sup> W. Va. Code § 11-3-6 (2003).

<sup>210</sup> W. Va. Code § 11-6-1 (2003).

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The Property Taxes and Local Government Finance Subgroup has one additional proposal that could be accomplished in the next year if the Legislature so desired. Under our current Constitutional structure, 60 percent of voters must approve an excess levy for counties and cities. A few years ago the requirement for schools to pass bond or excess levies was reduced from 60 to 50 percent. Changing this limitation to provide the same authority for local governments would have a significant impact on improving local government fiscal flexibility. This proposal would require a Constitutional amendment to be approved by the voters.

### **3. Issues for Further Study and Analysis**

Finally, the Property Taxes and Local Government Finance Subgroup developed proposals that present complex issues which will require additional research and noted that the continued research necessary on these issues may span more than a year. Most of these involve fundamental and substantial changes in the structure and administration of property taxes and local government finances.

As a long-term study, the Subgroup proposes streamlining collection and enforcement efforts for unpaid local fees and taxes. Specifically, the Subgroup will be reviewing whether a “clearinghouse” of all unpaid taxes and fees would be possible. Currently, local governments (and State agencies) are not aware of unpaid taxes and fees which may be due other entities. Such a clearinghouse would allow joint collection efforts. In cases where amounts due one entity may be so small that it is not worth the effort to pursue collection, aggregated efforts to collect may become economical.

The Subgroup also considered giving local officials the authority to report delinquent taxes and fees to credit agencies to provide an additional incentive for taxpayers to pay local taxes and fees in a timely manner. This tool could be key to local governments. When liens are recorded, they go on credit reports. In tandem with the proposal to give municipalities the authority to file liens for taxes other than the Municipal Business and Occupation tax, this proposal would help with collections. Significant research is required to ensure that any new program

established for reporting complies with all other state and federal requirements, including steps to ensure that all appropriate notices are given to avoid litigation. The Subgroup believes this legislation would complement the state clearinghouse program referred to above.

The Property Taxes and Local Government Finance Subgroup also believes that the State should review and consider a “One Stop Shop” for payment of property taxes and licensing. This proposal for payment of personal property taxes on vehicles, along with vehicle, truck, trailer, and boat license renewal would increase compliance, allow for the additional registration of vehicles, and promote ease for the taxpayer. The Subgroup believes that further analysis is necessary to investigate the best manner to implement such a streamlined process for payment of property taxes and licensing. Also, the Subgroup believes that some all terrain vehicles and manufactured homes are escaping property taxation. Discussions were held suggesting the registration of these items, and the Subgroup believes further analysis and study in resolving this issue is needed.

The Subgroup believes that future consideration with respect to the taxation of “Voice Over Internet Protocol” is warranted. Under current law, certain communications are subject to the Municipal Business and Occupation Tax while others are not. As Voice Over Internet Protocol grows quickly, this expansion will create not only tax problems for cities, but competitive inequalities for different types of providers.

The Subgroup also believes that local governments should be given greater flexibility in enacting local sales and use taxes. Effective in 2008, municipalities will have the option of enacting a local sales and service tax and a local use tax, but only if the Municipal Business & Occupation Tax is repealed.<sup>211</sup> The Subgroup believes

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<sup>211</sup> W. Va. Code § 8-13C-4 provides that, effective the first day of July, 2008, “any municipality that does not impose, or ceases to impose, the business and occupation or privilege tax authorized by section five, article thirteen of this chapter has the plenary power and authority to impose, by ordinance, an alternative municipal sales and service tax at a rate not to exceed one percent, subject to the provisions of this article: *Provided, That:* (1) The tax does not apply to any purchase of tangible personal property, custom software or

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that very few cities, if any, have a sufficient retail base to offset the loss of the Municipal Business and Occupation Tax with a local sales and use tax. The Subgroup recommends the local sales tax should be optional allowing counties and cites the opportunity to enact one. To ensure local flexibility, either the city or the county should be allowed to separately enact the tax or to have a county-wide tax that is shared between the entities.

The Subgroup also believes that the State should seriously consider whether local governments should have the ability to impose income, occupational, and payroll taxes. The Subgroup noted that several surrounding states (Kentucky, Maryland, Ohio, and Pennsylvania) give this option to local governments. It has proven successful as a source of revenue allowing not only additional funds, but also the reduction or elimination of other taxes such as those on personal property.

The Subgroup also believes that further analysis is needed to determine whether a property tax recapture provision should be implemented. Specifically, if land is classified as managed timberland or as a farm but later is developed, the difference in the property taxes which had been foregone due to the property classification should be recaptured for the previous three to five years. The current system, without such recapture provisions, rewards speculation and reduces local government revenue.

The Subgroup also suggests long-term studies of potential replacements for the tax on personal property and the Municipal Business and Occupation Tax. There was general agreement that these two taxes were difficult to determine fairly, were costly to administer, and were major impediments to economic growth and job creation. Of particular concern was the tax on business inventory. Only 12 states, including West Virginia, tax business inventory. It was recognized that repeal of

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the results of taxable services in a transaction completed within the corporate limits of the municipality before the first day of July, two thousand eight, or before such later date specified in the ordinance of the municipality imposing the tax; and (2) the effective date of the tax, or of a change in the rate of the tax, shall be no earlier than the first day of a calendar quarter that at a minimum begins one hundred eighty days after notice of the tax, or of a change in the rate of tax, is provided to the Tax Commissioner as provided in section six of this article.” See also W. Va. Code § 8-13C-5 (same concerning use taxes).

these taxes would require a substantial alternate source of revenue be found for use by local governments which would be under local control. Due to the significant revenue losses that would occur due to the elimination of all or part of personal property taxes or the municipal business and occupation tax, the Subgroup concluded that without a viable alternative source of revenue under local control it would be imprudent to repeal either form of taxation. The Subgroup also recommended that the State review property and sales tax exemptions to determine whether sufficient justification exists to justify their value.

Finally, the Property Taxes and Local Government Finance Subgroup believes that the appraisal and administrative process with respect to the valuation and appraisal of mineral interests should be subject to additional review. Specifically, the Property Taxes and Local Government Finance Subgroup believes that an evaluation of coal, gas, oil, other minerals and coal bed methane is warranted, including review of practices and other states.

Also, the Subgroup noted that after the State Tax Department evaluates minerals and industrial property, the values assigned to those properties are provided to county assessors. Following the assessment, an appeal may be taken to the County Commission sitting as a Board of Equalization and Review. The Subgroup identified three problems with this procedure. First, because the State Tax Department sets the values, county commissioners and the local assessor have little if any knowledge of how the values were established. Appraisal of these properties requires specialized training. This limits the ability of such officials to accurately handle appeals. Second, the State Tax Department must attend multiple meetings in all 55 counties throughout this process. It was felt at times, taxpayers are manipulating the current system. Taxpayers will often appear late in the appeal process with significant amounts of technical data and questions when it is difficult for the State Tax Department representative to be present. To solve these problems, the Subgroup recommends that a further study be initiated to determine if it is advisable to establish a State Board of Review for industrial and mineral property that is subject to State appraisal. As an alternative this could be

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accomplished by using regional boards rather than one review panel for the entire State.

# **Chapter XI**

## ***State Road Fund***





## XI. The State Road Fund

### A. Introduction

The State Road Fund Subgroup was organized to review the taxes and fees associated with the State Road Fund, keeping in mind the following objective:

*To provide sufficient revenues in the State Road Fund to ensure the continuation of the Department of Transportation programs, including those of the Division of Highways and the Division of Motor Vehicles.*

A number of comments and suggestions were provided by the Department of Transportation, the Tax Summit participants, and the Informational Questionnaires.

Two studies that specifically focused on the State Road Fund were especially beneficial. First, the West Virginia Tax Study Commission issued a report in 1984 that analyzed issues relating to the adequacy of the State Road Fund.<sup>212</sup> Then, in 2004, the Bureau of Business and Economic Research at the College of Business and Economics, West Virginia University, updated the 1984 report.<sup>213</sup> Both documents provide detailed analysis of the State Road Fund and should be reviewed before making significant policy decisions. Having no intention to reinvent the wheel, members of the Project set out to supplement the previous studies and add a fresh perspective from the group members as well as public feedback to the current debate. The ultimate goal of this endeavor was to provide potential options to solve the revenue problems currently associated with the State Road Fund.

It is important to note that the Tax Modernization Project is not the only entity currently analyzing the State Road Fund. The Department of Transportation and the Legislature are reviewing the fund to develop a policy that establishes the specific funding levels and programs desirable for the State's transportation

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<sup>212</sup> West Virginia Tax Study Commission, Issue #6: The Adequacy of the Road Fund.

<sup>213</sup> Patrick C. Mann, Mehmet S. Tosun, and Tom S. Witt, Future of West Virginia's Highways System: A Comparative Analysis of the West Virginia State Road Fund and Policy Options (August 2004) (the "2004 Road Fund Report").

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infrastructure. Once the decision has been made as to the specific level of funding needed for the Fund, the State will be in a better position to determine how to obtain those revenues.

Therefore, no specific funding or program levels were designated by the State Road Fund Subgroup. Instead, the recommendations represent several potential additions to (or deletions from) the current funding levels, and they also present solutions to tax and fee problems identified by the Subgroup. These recommendations include ways to improve collection methods, simplify tax collection, and streamline State expenditure methods. The State Road Fund Subgroup does not, however, address the question of the overall adequacy for different program and funding levels. Instead, at this point the State Road Fund Subgroup has highlighted issues to be addressed.

The State Road Fund Subgroup established the following goals:

1. Review all taxes and fees currently allocated to the State Road Fund and their adequacy in funding highway construction and maintenance;<sup>214</sup>

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<sup>214</sup> The 2004 Road Fund Report, at page 53, concluded that several criteria can be employed in evaluating highway revenue sources:

1. Economic efficiency, which focuses on taxes varying positively with mileage driven as well as vehicle weight and taxes varying inversely with the number of axles on vehicles. This criterion focuses on an efficient allocation of resources or, in this particular case, the efficient use and financing of the highway system.
2. Equity (fairness) or distributional effects, which can incorporate concepts of ability-to-pay (taxes should be levied in accordance with income and/or wealth), benefits received (taxes should be levied in accordance with the benefits that users receive from the highway system), and cost causation (taxes should be levied in accordance with the highway expenditures caused by users).
3. Stability, which focuses on revenue stability over time and financing potential.
4. Administration feasibility (or cost efficiency), which focuses on administrative, enforcement and compliance costs. This criterion focuses on cost minimization in the provision of the highway system.

2. Identify issues associated with the current financing system;
3. Improve equity of treatment by increasing compliance for highway users as increased compliance will enhance the State Road Fund and increase real property tax revenues for county governments and school boards; and
4. Improve efficiency in collection of various taxes and fees.

Before delving into the issues identified by the State Road Fund Subgroup, and its recommendations, a short background of the State Road Fund is warranted. As mentioned previously, the State Road Fund was created in 1921 following the ratification of the Good Roads Amendment of 1920, and the State Road Fund was elevated to a constitutional fund in 1942. The Constitution now specifically provides that the:

[r]evenue from gasoline and other motor fuel excise and license taxation, motor vehicle registration and license taxes, and all other revenue derived from motor vehicles or motor fuels shall, after the deduction of statutory refunds and cost of administration and collection authorized by legislative appropriation, be appropriated and used solely for construction, reconstruction, repair and maintenance of public highways, and also the payment of the interest and principal on all road bonds heretofore issued or which may be hereafter issued for the construction, reconstruction or improvement of public highways, and the payment of obligations incurred in the construction, reconstruction, repair and maintenance of public highways.<sup>215</sup>

The Legislature has implemented the mandates of Section 52. The West Virginia Code provides that “all state license taxes imposed upon automobiles or

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5. Practicality, which includes practical attributes such as tax simplicity, public acceptability and understanding, the minimization of rate (tax) shock, and state budget implications.

<sup>215</sup> West Virginia Constitution, Article VI, Section 52.

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other motor or stream driven vehicles; registration fees imposed upon all owners, chauffeurs, operators, and dealers in automobiles or other motor vehicles” are to be deposited into the State Road Fund. As a result, the following principal taxes and fees are deposited into the State Road Fund: Motor Fuel Excise Tax;<sup>216</sup> Motor Vehicles Privilege Tax;<sup>217</sup> and registration fees, including motor vehicle registration fees and drivers license and permit fees.<sup>218</sup> West Virginia Code § 17-3-1 also calls for the deposits of, among other things, federal funds and proceeds of constitutionally authorized issuances of bonds. The Legislature has also stated that “[w]hen any money is collected from any of the aforesaid sources, it shall be paid into the state treasury by the officer whose duty it is to collect and account for the same, and credited to the State Road Fund, and shall be used only for the purposes named in this chapter.” Those purposes are:

- (a) To pay the principal and interest due on all State bonds issued for the benefit of said fund, and set aside and appropriated for that purpose;
- (b) To pay the expenses of the administration of the road department; and
- (c) To pay the cost of maintenance, construction, reconstruction, and improvement of all State roads.<sup>219</sup>

The State Road Fund Subgroup members recognized several issues affecting revenues under the current State Road Fund structure. First, costs have escalated. This escalation of construction costs has eroded the real value of revenue deposits, which has in turn caused declines in the construction and maintenance of highways

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<sup>216</sup> W. Va. Code §§ 11-14C-1 through 47.

<sup>217</sup> W. Va. Code § 17A-3-4 (“A tax is imposed upon the privilege of effecting the certification of title of each vehicle in the amount equal to five percent of the value of the motor vehicle at the time of the certification.”).

<sup>218</sup> W. Va. Code § 17B-2-8 (relating to driver’s license fees).

<sup>219</sup> W. Va. Code § 17-3-1.

and bridges. Second, revenue sources for the State Road Fund either have been declining or are unstable. Third, and most importantly, motor fuel prices have escalated, resulting in a reduction of fuel consumption, thereby reducing the “real” contribution of motor fuel excise taxes. The increase of motor fuel prices has also encouraged consumers to purchase alternative fuel vehicles and more fuel-efficient vehicles, the use of which further reduces revenues and undermines the user fee basis of the State’s transportation system.

Furthermore, the motor fuel taxes and the registration fee revenues are based upon the volume of fuel consumed and the number of vehicles registered, both of which have stagnated in recent years. The resulting devaluation of these revenues after adjustment for inflation has compounded the problems facing the State Road Fund. Also, although the Motor Vehicle Privilege Tax revenues have increased over time due to inflation and changes in the new vehicle market, structural changes in new and used vehicle markets in the future signal little real growth. Finally, an issue potentially affecting the revenues for the State Road Fund is the fact that a portion (five cents) of the Motor Fuel Excise Tax is set to expire on August 1, 2007.

Several other issues impact State Road Fund overall revenues. First, in contrast to many states, West Virginia has few options for counties to generate additional tax revenues for the construction and maintenance of roads and bridges within their domains. Second, the shift from conventional to alternative fuel vehicles threatens user revenue sources that fund improvements in the State transportation system. Third, West Virginia is only one of four states with total responsibility (excluding municipalities) for all highway construction and maintenance.<sup>220</sup> These problems significantly constrain the State Road Fund, and the discussion and recommendations to follow propose solutions to these problems.

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<sup>220</sup> “West Virginia is only one of four states (the other states are Delaware, North Carolina, and Virginia) having jurisdiction over both state and county roads. The State is responsible for 92.4 percent of the 38,900 miles of public highways in West Virginia while municipalities are responsible for only 5.5 percent.” 2004 Report at 19. Federal agencies are responsible for the remaining 2.1 percent.

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### **B. Recommendations**

The recommendations of the State Road Fund Subgroup can be partitioned into the following areas. First, the State Road Fund Subgroup has stressed the importance of revenue stability for the State Road Fund. Second, the Subgroup proposes recommendations to make taxes and fees dedicated to the Fund more consumer friendly. Third, the Subgroup has presented recommendations to improve the State's ability to increase compliance. Fourth, the Subgroup considers the relationship between the State Road Fund and the General Revenue Fund, and makes recommendations for improving current budgetary and administrative issues. Fifth, the Subgroup believes that local governments should be given more flexibility and more options to assist in providing roads. Finally, the members of the State Road Fund Subgroup identified several issues needing significant further study and development.

#### **1. Revenue Stability**

The State Road Fund Subgroup has concluded that the State Road Fund does not have sufficient levels of revenue to meet its current requirements.<sup>221</sup> Because the current level of revenue is insufficient to finance the State Transportation System plan, the State Road Fund Subgroup does not believe that current revenue levels should be reduced.

The Motor Fuel Excise Tax is an excise tax "composed of a flat rate equal to twenty and one-half cents per invoiced gallon plus a variable component". The flat rate is scheduled for a five-cent reduction effective August 1, 2007.<sup>222</sup> The Subgroup strongly believes that at a minimum the current flat rate of twenty and one-half cents per gallon should be extended. Ideally, the base flat rate would be permanently established at that rate. This recommendation does not represent an

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<sup>221</sup> 2004 Report at 68 ("One obvious conclusion is that an increase in one or more West Virginia State Road Fund revenue sources is necessary for West Virginia to maintain its present system properly.").

<sup>222</sup> W. Va. Code § 11-14C-5 (2003).

increase in tax collections and would equate to no projected change in revenues, but a failure to continue the current flat rate of twenty and one-half cents would cause a significant reduction in revenue for the State Road Fund. The failure to simply retain the current rate would cost the State Road Fund approximately \$55 million on an annual basis.

As mentioned above, the Motor Fuel Excise Tax also has a variable component. This variable component is equal to five percent of the average wholesale price of the motor fuel. The West Virginia Code provides, however, that the “average wholesale price shall be no less than ninety-seven cents per invoiced gallon.”<sup>223</sup> The State Road Fund Subgroup has two recommendations with respect to the variable rate of the Motor Fuel Tax. First, the State Tax Department should be permitted to calculate the average wholesale price based on current prices, thus allowing the variable component to be recalculated for a period beginning January 1, 2007.

Second, the State Road Fund Subgroup recommends that the floor established for the average wholesale price of the variable component be increased from its current rate of ninety-seven cents to one dollar and thirty cents. This change would not cause an immediate increase in revenues as the average wholesale price for 2004 was \$1.30 and for 2005 the average wholesale price was \$2.01. This increase in the floor would help to stabilize a major funding source for the State Road Fund in the future.

Another potential source of revenue for the State Road Fund would be to increase the minimum Privilege Tax levied by the Division of Motor Vehicles to more than the current charge of \$25 (based on a book value of \$500 or less). An increase to \$37.50 (based on a minimum book value of \$750 or less) is estimated to increase revenues by approximately \$300,000.

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<sup>223</sup> W. Va. Code § 11-14C-5 (2003).



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**2. Consumer Friendly Recommendations**

The State Road Fund Subgroup has developed several recommendations designed to make West Virginia more consumer and business friendly by waiving inspection fees for new vehicles, reducing the fee for registration of vehicles titled in other states, and providing for the collection of the Consumers Sales and Service Tax at the time of sale.

The Subgroup believes that the State should change the Privilege Tax cost associated with licensing vehicles titled in other states. Under current West Virginia law, no credit is provided for sales, use, or privilege taxes on vehicles paid elsewhere. Thus, when residents of a state other than West Virginia decide to move into our State, the individual must pay a five percent Privilege Tax based on the value of each vehicle owned and brought into West Virginia even though the individual paid a sales or privilege tax in another state. Of our surrounding states, only Maryland imposes such a tax without a corresponding credit. The absence of a credit creates several problems. First, there is a significant disincentive for those moving to West Virginia to title their vehicles in West Virginia. Because fewer cars are titled in the State, fewer West Virginia residents pay personal property taxes on their vehicles, and less revenue is collected. Officials and citizens from our border counties consistently have asserted that this is a significant problem in West Virginia. Questions of fairness are also raised as West Virginia residents lawfully pay the tax yet others escape taxation. The absence of a credit also creates ill will: The tax has been sarcastically dubbed the “Welcome to West Virginia Tax.”

The State Road Fund Subgroup has developed two potential solutions to this problem. The first option is to offer a credit for taxes paid in other states at the time of the initial registration and title application. Such a change would necessitate additional administrative duties by the Division of Motor Vehicles to ensure that taxes had, in fact, been paid. Although the State could see a decline in gross revenues of approximately \$4.8 million, the revenue loss would be significantly mitigated through increased compliance. If more individuals title their vehicles in

West Virginia, vehicle registration fees and local property tax revenues will increase, thereby offsetting projected revenue losses. If State policymakers disfavor a full credit for taxes paid in other states, the second option is to offer a tiered credit that considers among other items the age of the vehicle, the value of the vehicle, the difference in the tax rate between West Virginia and the state of former residence, and a minimum tax could be formulated.

In addition to providing a credit for such sales, the State should reconsider the annual inspection requirement for all vehicles two years old or newer. Because most new vehicles are not yet substantially affected by use and wear and are covered by warranties extending for at least two years, such initial inspections may be unnecessary. Under this plan, inspection stickers issued at the time of purchase of new vehicles would be good for up to two years, while one-year old vehicles would be good for one year. In both cases, there would be no charge for the inspection sticker so long as the vehicle is covered by the manufacturer's warranty. The State Tax Department believes that the loss of revenue due to such a pro-consumer policy would not be significant.

### 3. Compliance

In addition to providing a credit for privilege and sales taxes paid on vehicles in states other than West Virginia, the State Road Fund Subgroup recommends that the Privilege Tax should be changed to a special Consumers Sales and Service Tax at the same rate of five percent. Such a change would have several positive effects. First, federal income tax law permits filers to deduct sales taxes paid on vehicles on their federal tax form.<sup>224</sup> Second, because the Consumers Sales and Service Tax must be paid on a sale and remitted by the seller, such a move would increase compliance, particularly for all-terrain vehicle sales and subsequent registration.

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<sup>224</sup> 26 U.S.C. § 164. "Sales taxes on motor vehicles are also deductible as a general sales tax . . . up to the amount of tax that would have been imposed at the general sales tax rate." Internal Revenue Service, 2005 Instructions for Schedules A & B (Form 1040), available at <http://www.irs.gov/pub/irs-pdf/i1040sa.pdf>.

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The State should also impose a late fee on expired registrations. Under current law, the State does not do so. Subgroup members recommend a \$10 per month late fee, beginning 30 days after expiration. This would also enhance the fairness of the system. This change should be coupled with a provision indicating that all new registrations commence from the expiration date, and not from the date that registration fees and any penalties are ultimately paid. The estimated additional State Road Fund revenue would be approximately \$800,000.

### **4. General Revenue Fund and Administrative Funding**

Since Fiscal Year 1984, the State of West Virginia has not transferred any moneys from the General Revenue Fund to the State Road Fund.<sup>225</sup> Such transfers, however, did occur in the early 1980s. For example, in Fiscal Year 1981, transfers from the General Revenue Fund to the State Road Fund exceeded \$22 million, and Fiscal Year 1983 transfers from the General Revenue Fund totaled \$52 million. The members of the State Road Fund Subgroup believe that State policy leaders should re-examine whether any current General Revenue Fund moneys should be used for the construction and maintenance of roads. Re-examination of the role of General Revenue Funds in support of a public good, such as a modern highways system, is warranted. Other states provide such support. In calendar year 2005, 35 states allocated general revenue funds in support of state highway construction and maintenance, with amounts reaching upwards of \$1.2 billion in Massachusetts.

Moreover, the State Road Fund Subgroup also believes that the State should examine and consider whether it should shift specified expenses from the State Road Fund to the General Revenue Fund, and reallocate specified General Revenue Fund sales tax collections to the State Road Fund. It is important to note that such transfers would require Legislative commitment to make available sufficient moneys in the General Revenue Fund to provide for the annual payment of required expenditures.

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<sup>225</sup> 2004 Report at 29. It should be noted that in Fiscal Year 2007 the West Virginia Legislature appropriated \$11 million from the proceeds of the State Excess Lottery Revenue Fund to support the State Road Fund.

The members of the Project would also like to point out the significant concerns to be considered in transferring General Revenue Funds to the State Road Fund. First, West Virginia's General Revenue Fund has not, historically, seen, on an annual basis, surplus revenues that could be dedicated to the State Road Fund. Thus, a significant and constant transfer would likely necessitate program reductions or revenue enhancements elsewhere. Second, much of the revenues in the General Revenue Fund are currently distributed for debt service and other programs. Providing additional restrictions on the use of the moneys in the General Revenue Fund would only further complicate the matter. The key point is that the State Road Fund needs significant analysis and discussion. The funding of the State Road Fund needs particular attention.

If the State decides to use General Revenue Fund money for the State Road Fund, the following are potential options to measure the amount of transfer. First, approximately \$5.4 million from the State Road Fund are used every fiscal year to assist in funding the West Virginia State Police with respect to the monitoring of highways, and another \$4.6 million is dedicated to weight enforcement on the highways through the Public Service Commission. Although these expenditures are appropriate for the State Road Fund, they could be financed from the General Revenue Fund. Additionally, under current law, funding for roads and bridges for new schools is provided by the State Road Fund at an approximate annual cost of \$2.4 million. The State Road Fund Subgroup believes that new school funding should include all necessary public infrastructure necessary for students to access the school. By requiring the School Building Authority or local entities to provide for such infrastructure, additional moneys would be available for the State Road Fund. The State may consider elimination of the Industrial Access Road Program.<sup>226</sup> While

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<sup>226</sup> Each year \$3 million in State Road Fund revenues are transferred to the Industrial Access Roads Fund. "The moneys in the fund shall be expended by the division of highways for constructing and maintaining industrial access roads within counties and municipalities to industrial sites on which manufacturing, distribution, processing or other economic development activities, including publicly owned airports, are already constructed or are under firm contract to be constructed." W. Va. Code § 17-3A-1.

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the program has funded many projects since its inception, the State Road Fund Subgroup believes that authorization of local option taxes at the county level will permit counties to finance industrial roads directly, thereby enhancing the general construction and maintenance program funded by the State Road Fund. The current program costs approximately \$3 million in State Road Fund revenues.

In addition to transferring funding for programs from the State Road Fund, the Legislature may also consider transferring an amount approximating certain sales tax collections relating to vehicles or road construction to the State Road Fund. The State could estimate the amount of Consumers Sales and Service Tax paid for purchases by contractors for specific use in Department of Transportation projects within the State and allocate these funds from the State General Revenue Fund to the State Road Fund. This proposed change would provide additional funds for highway construction and maintenance by offsetting the sales tax costs on such projects, and it could result in an annual transfer of roughly \$3.7 million (estimated for Fiscal Year 2007) from the General Revenue Fund to the State Road Fund. The State may also desire to transfer amounts equal to Consumers Sales and Service Tax receipts on the sales of tires and batteries, estimated at \$30.5 million annually, to the State Road Fund or the amount of transfer could be the value of Consumers Sales and Service Tax receipts for vehicle repairs, estimated at \$19.3 million annually. Again, all of these potential modifications would have a significant impact on the General Revenue Fund and involve serious policy considerations.

The State should solicit paid advertising on West Virginia Courtesy Patrol Vehicles to defray cost of annual operation. Although it would be difficult to predict the amount of revenue that such a program could generate, any money collected from such a program would offset State Road Fund financing of the Courtesy Patrol.

Another potential modification for the State Road Fund involves streamlining Department of Transportation accounts and funds. This would not reduce revenues, but instead would provide greater administrative flexibility for the State Road Fund. The following funds could be eliminated and revenues placed in the State Road Fund:

- (a) Fund 8208, Special Registration Plates: § 17A-3-14. However, W. Va. Code § 17A-3-14(c)(15)(B), providing that a portion of the revenue from the special bird and deer plates is deposited directly into a Department of Natural Resources fund at the time of collection, must be retained;
- (b) Fund 8210, Inspection of Reconstructed Vehicles: § 17A-4-10(f);
- (c) Fund 8215, Insurance Certificates: § 17A-3-3(g);
- (d) Fund 8216, Motorboat Licenses: § 20-7-12. However, W. Va. Code § 20-7-12(a)(4), providing that a portion of the revenue from the motorboat license is deposited directly into a Department of Natural Resources fund at the time of collection, must be retained;
- (e) Fund 8217, Returned Checks: The second paragraph of W. Va. Code § 17A-2-23 should be struck.

Additionally, the State should consolidate all Division of Motor Vehicles special revenue accounts into four fund accounts, with unallocated balances reverting to State Road Fund. Special Revenue Funds to be consolidated into a “Super” Special Revenue Fund:

- (1) Super Special Revenue Fund:
  - (a) Fund 8202, Hearing Fees: § 17C-5A-2a;
  - (b) Fund 8209, CDL: § 17E-1-23(a);
  - (c) Fund 8213, Driver License Reinstatement: § 17A-9-7. However, the third paragraph providing that a portion of the revenue is deposited directly into a Department of Motor Vehicles fund at the time of collection, must be retained.
  - (d) Fund 8214, Driver Rehabilitation: §§ 17C-5A-3(b)(1) and 17C-5A-3a(a);
  - (e) Fund 8219, Motorcycle License Examination: § 17B-2-7c; and

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- (f) Fund 8221, Motor Vehicle Salesperson License: § 17A-6E-14.
- (2) Funds that MUST continue to exist separately:
  - (a) Fund 8220, Dealer Recovery: § 17A-6-2a; and
  - (b) Fund 8212, Motorcycle Safety: § 17A-10-3b.

Many of the above-mentioned funds have been created over the years to provide for specific services and allow for a specific fee to cover the cost of that service. In many cases, the specific fee collected is not sufficient to cover the actual cost of providing that specific service.

Through computerization, electronic funds transfer, and consolidation, many services that once were provided by separate offices may now be provided by a single office. Since all of these functions constitute the core responsibilities of the State Road Fund and specifically the Division of Motor Vehicles, it only makes sense to consolidate the funding as well. The benefit to the State would result in a simplified accounting system, easier administration of the funds available, and sufficient total dollars available to fund all required services without the need for separate accounting requirements for individual services.

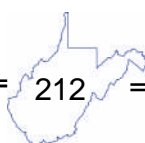
Finally, the State Road Fund Subgroup recommends that the State shift the reporting date for Motor Fuel Excise Tax payments from the last day of the month to the 25th day of the month.<sup>227</sup> This change would decrease State revenue volatility from month to month.

**5. Local Flexibility**

The State should also permit local option taxes, allowing counties to levy additional funds supporting highway construction and maintenance within the county. Such options could include: income taxes; local option property transfer taxes; and wage taxes capable of generating sufficient revenue to address highway

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<sup>227</sup> Under current law, the motor fuel excise tax must be paid by each taxpayer on or before the last day of the calendar month to the State Tax Commissioner for the amount of tax due, if any, for the preceding month. W. Va. Code § 11-14C-19.



construction and maintenance priorities identified by either metropolitan planning organizations or county comprehensive land use plans. The funds requested could be approved by either local option election or authorization of a county commission. Revenues generated would be used by the Division of Highways to supplement the State Road Fund for use in those jurisdictions, but it is not the intent to create individual county highway construction and maintenance units. Estimated revenues are dependent upon the action of the individual counties; however, implementation of the new integrated State Tax Department computer system will allow collection of these revenues on a county-by-county basis.

## **6. Issues for Long-Term Study and Consideration**

In addition to the above proposals, which could be implemented over the next several months, the members of the State Road Fund Subgroup have identified other areas of concern for further study. First, the State should examine alternative funding options for treatment of hybrid and alternative fuel vehicles. Any proposals related to these funding options would require estimates of the avoided annual fuel taxes, and a carefully crafted administrative regime. A survey of the states by the Division of Motor Vehicles indicates that few states have addressed this issue, and further and significant research is warranted in this context. Second, the State should consider indexing registration and other fees to the Consumer Price Index, with the total fee rounded to the nearest dollar. Such a change could coincide with an increase in registration fees. Additionally, if the State determines that additional revenue is needed for the State Road Fund, the State could increase the Motor Vehicle Privilege Tax (or sales tax on vehicles, if the State so desires) to six percent, placing vehicle taxation on par with other taxed goods.

The State should also examine its ability to integrate the licensing of vehicles with registration of personal property at the county level. If registration compliance is increased and the State is provided mechanisms to ensure that all licensed vehicles are registered at the county level, the State could increase revenues to support county government and boards of education without raising taxes.



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Finally, the State of West Virginia should explore privatization of the West Virginia Turnpike. Faced with declining user fee revenues, many states, including Texas, New Jersey, Maryland, Florida, and Pennsylvania are re-examining the assets associated with public turnpikes. In some cases, turnpikes are either leased or sold to private sector consortiums, and the proceeds are used to construct and maintain other state highways and bridges.

# ***Appendices***



## APPENDIX A



### *The West Virginia Tax Modernization Project* Informational Questionnaire

Our Mission Statement: Systematic research and analysis of state and local taxation resulting in creation of a more equitable and improved tax structure which encourages economic growth.

We are asking that you review and provide input regarding the following broad questions concerning a variety of tax topics. Should you have any questions, please direct them to [tmp@tax.state.wv.us](mailto:tmp@tax.state.wv.us) the Tax Modernization Group.

- Are you representing?       An Individual  
     A Professional Association  
     A Non-Profit Organization  
     A Business  
     A Governmental Entity

What broad Industry Code best describes you, your firm or your organization? \_\_\_\_\_  
 (Please see the code list below)

NAICS	Description	NAICS	Description
11	Forestry, fishing, hunting, and agriculture	53	Real estate & rental & leasing
21	Mining	54	Professional, scientific & technical services
22	Utilities	55	Management of companies & enterprises
23	Construction	56	Admin, support, waste mgt, remediation services
31-33	Manufacturing	61	Educational services
42	Wholesale trade	62	Health care and social assistance
44-45	Retail trade	71	Arts, entertainment & recreation
48	Transportation & warehousing	72	Accommodation & food services
51	Information	81	Other services (except public admin)
52	Finance & insurance	99	Unclassified establishments

Please provide your Zip Code. \_\_\_\_\_

	Quite Unfamiliar	Unfamiliar	Neither Familiar/ Unfamiliar	Familiar	Quite Familiar
How familiar are you with the current WV State and local tax structure?	1	2	3	4	5

- In what ways does the current WV State and local tax structure affect you or the operation and investment decisions of your organization?

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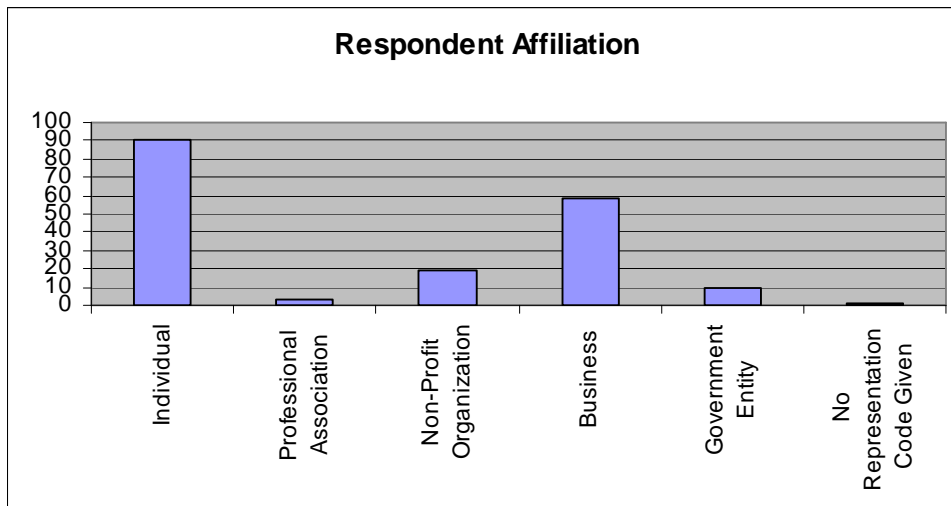
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(Continued)

- 1A. Please provide the positive aspects.
- 1B. Please provide the negative aspects.
- 2A. What suggestions for WV State and local tax structure would you make?
- 2B. What suggestions would you make under the requirement that any tax reduction(s) be offset by equal revenue enhancement(s)?
3. What do you feel are the current strengths and weaknesses of local, school, municipal and county government revenue systems?
  - 3A. Please provide any positive issues.
  - 3B. Please provide any negative issues.
  - 3C. How could these problems be addressed?
4. What are the top three tax issues in our state?
5. By altering the types and/or rates of taxes, fees and exemptions, how might the state foster business retention, expansion and/or job creation? What one change would be most likely to cause our firm or other businesses to expand their West Virginia operations?
6. Please provide any other comments you may have regarding the current WV state and local tax structure that were not addressed in the previous questions.

Please remit to:  
Research Division  
PO Box 2389  
Charleston, WV 25328

## APPENDIX B

The first demographic item on the survey asked about the association of the respondent. As shown in the chart below, nearly one-half (90 of the 182) of the tabulated surveys came from individuals. Respondents indicating that they represented a business accounted for 59 surveys, or roughly one-third of the total. Surveys were also filed by persons representing non-profit organizations (19), government entities (10) and professional associations (3). One survey was filed without this item having been completed.



Survey respondents were also asked to describe themselves, their firm or their organization using a broad industry code. The industry codes were selected from the two-digit North American Industry Classification System (NAICS) codes used by the United States Bureau of Census. The table below shows the industry codes reported, in descending order by the number of respondents.

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**APPENDIX B  
(Continued)**

**TABLE 1**

<b>NAICS Code (2-digit) and Description</b>	<b>Number</b>
54 – Professional, Scientific & Technical Services	31
– No Industry Code Indicated	25
52 – Finance & Insurance	19
62 – Health Care and Social Assistance	16
53 – Real Estate & Rental & Leasing	16
11 – Forestry, Fishing, Hunting, and Agriculture	14
61 – Educational Services	12
99 – Unclassified Establishments	11
81 – Other Services (Except Public Administration)	10
42 – Wholesale Trade	7
44 – Retail Trade (NAICS Code 44)	5
51 – Information	5
23 – Construction	4
32 – Manufacturing (NAICS Code 32)	3
33 – Manufacturing (NAICS Code 33)	2
55 – Management of Companies & Enterprises	2
22 – Utilities	1
31 – Manufacturing (NAICS Code 31)	1
48 – Transportation & Warehousing	1
71 – Arts, Entertainment & Recreation	1

For the nine most used industry codes (i.e., those with 10 or more surveys), a cross-tabulation by association type and industry code was reviewed. As expected, respondents identifying themselves as individuals submitted a large number of surveys without providing an industry code. Individuals were also represented in a high percentage of overall responses (i.e., they filed more surveys, based on percentage terms, than the overall individual percentage of 49.5 percent of all surveys) for the following industry classes:

**TABLE 2**

<b>NAICS Code (2-digit) and Description</b>	<b>Percentage</b>
11 – Forestry, Fishing, Hunting, and Agriculture	75.0%
81 – Other Services (Except Public Administration)	70.0%
61 – Educational Services	66.7%

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**TABLE 2**  
(Continued)

<b>NAICS Code (2-digit) and Description</b>	<b>Percentage</b>
54 – Professional, Scientific & Technical Services	58.1%
52 – Finance & Insurance	52.6%

Businesses (32.4 percent of all surveys) were represented in a high percentage of overall responses in the following industry classes:

**TABLE 3**

<b>NAICS Code (2-digit) and Description</b>	<b>Percentage</b>
53 – Real Estate & Rental & Leasing	57.1%
52 – Finance & Insurance	47.4%

Non-profit organizations (10.4 percent of all surveys) were represented in a high percentage of overall responses in the following industry classes:

**TABLE 4**

<b>NAICS Code (2-digit) and Description</b>	<b>Percentage</b>
62 – Health Care and Social Assistance	62.5%
99 – Unclassified Establishments	18.2%

The third demographic item asked the respondent to provide the respondent's zip code. A frequency count of the surveys indicates that 79 different zip codes, including three from outside West Virginia, were reported. Also, eleven respondents did not provide a zip code. The zip codes reported five or more times were as follows:

**TABLE 5**

<b>Zip Code and City</b>	<b>Number</b>
25301 Charleston	11
25701 Huntington	10
25311 Charleston	7
25404 Martinsburg	7
25314 Charleston	6



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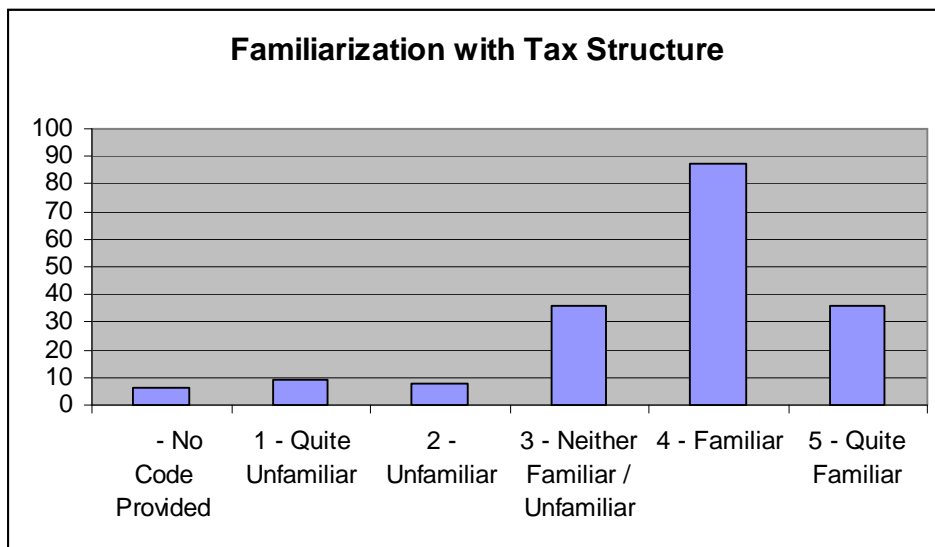
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**TABLE 5**  
(Continued)

<b>Zip Code and City</b>	<b>Number</b>
26505 Morgantown	6
26301 Clarksburg	5
26554 Fairmont	5
26623 Frametown	5

The final demographic item on the questionnaire asked the respondent to indicate, “How familiar are you with the current WV State and local tax structure?” As shown in the chart below, most respondents indicated that they were “familiar” (87) or “quite familiar” (36) with the tax structure.

**CHART 2**



**Tax Structure**

The first question on the survey was, “In what ways does the current WV State and local tax structure affect you or the operation and investment decisions of

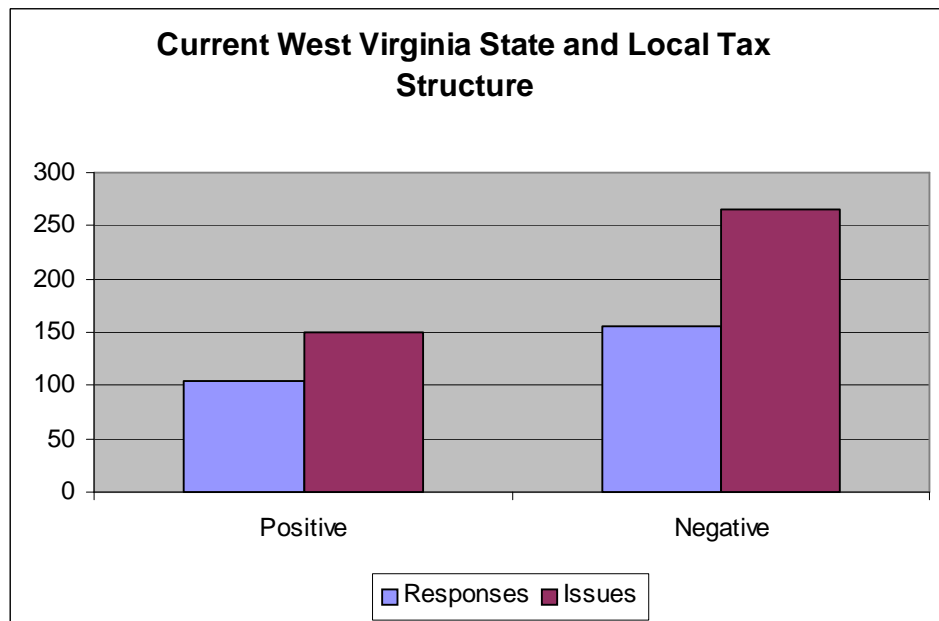
**APPENDIX B**  
(Continued)

your organization?” Respondents were asked to provide both positive aspects and negative aspects.

The “free-form” response to this question and the responses to all of the other major questions were reviewed to extract the salient points into a smaller field that could be tabulated. Often one reply contained multiple comments and each comment was extracted.

As shown in the chart below, more respondents (155) provided comments on the negative aspects of the tax structure compared to respondents providing comments on the positive aspects (105). The individual responses for both parts of Question 1 were reviewed to extract the separate issues addressed in the response. The respondents commenting on the negative aspects cited a total of 265 issues (or an average of roughly 1.7 issues per respondent), while the respondents commenting on the positive aspects included a total of 150 issues (or an average of roughly 1.4 per respondent).

**CHART 3**



**APPENDIX B**  
(Continued)

Tax Structure – Positive Aspects

The issues identified from the review of the responses to the positive aspects of the tax structure were further grouped by topic. The Property Tax (26 comments) and Personal Income Tax (16) generated the most common specific tax comments. However, comments about taxes in general (71) comprised over one-half of the total.

The largest single group of positive comments (13) about the Property Tax referred to the tax as “low.” The next largest grouping of comments (5) cited the farm exemption, including statements such as “farm exemption means survival as a business.” Other comments mentioned the tax was fair, if uniformly applied, and efficient. Also, two specific Property Tax provisions, the Freeport Exemption and the managed timberland program, were cited as positive aspects of the current tax structure.

For the Personal Income Tax, the largest group of comments (5) concerned tax rates. The rate-related responses appeared to cover the entire spectrum. Two responses cited the progressive rate structure as a positive, one response indicated the rates were fair, another indicated the tax was more fair than flat taxes, and one indicated that the graduated rates offset regressive taxes. Similar to the Property Tax, three responses indicated the Personal Income Tax was “low.” Another group of three responses used the question asking for positive aspects of the current tax structure to offer suggested law revisions related to retirees. Another suggestion was offered to have “some wage tax go to the road fund.” Other responses cited the low-income exclusion and a deduction for the Smart 529 plan.

Several other comments mentioned specific taxes or referenced incentives. One person commented that it is a positive aspect of the Tax Code that the Consumers Sales and Service Tax was only imposed at the State level. Also, a respondent indicated the current structure was fine. The other Consumers Sales and Service Tax comments cited exemptions for manufacturing and research and

## APPENDIX B

(Continued)

development equipment. References to the Corporation Net Income Tax and Business Franchise Tax mentioned the consolidated filing election, foreign source income treatment and that the Corporation Net Income Tax was equitable. Responses mentioned that West Virginia has lower rates on cigarettes and gas than Ohio and Pennsylvania and that rented vehicles were not subject to the Motor Vehicle Title Privilege Tax. Also, the Severance Tax on coal and timber was mentioned.<sup>228</sup> Positive comments related to incentives noted that the “tax credits were the best in the USA.” Also, it was mentioned that the incentives were beneficial and helped the State favorably compete with other states. One comment indicated that “incentives do not help the State.”

Comments not referencing a specific tax included a large number stating that taxes support many other functions including education, infrastructure projects, police, fire, Medicaid, teacher pay and the quality of life. Also, there were a group of comments mentioning that the tax forms were easy to understand and complete.

### Tax Structure – Negative Aspects

The Property Tax and the Personal Income Tax also received a large amount of negative comments. However, for the negatives, Personal Income Tax citations (43) outnumbered the Property Tax references (38).

The largest subcategory of Personal Income Tax negative aspects actually related to suggestions for revising the tax. The suggestions included: reducing the rates, fixing the “marriage penalty,” raising the low-income exclusion, repealing the tax completely, changing to a flat rate, adjusting the rates for inflation, allowing itemized deductions, and deferring capital gains taxes for investment. Additionally, some suggestions were offered that the withholding tax tables should be updated or the rates evaluated. The next largest subcategory of responses indicated that the tax was unfair to low and middle-income taxpayers or that the tax favored high-

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<sup>228</sup> The comment referencing the Business and Occupation Tax (i.e., “tax should be instituted by municipalities”) appeared to be more of a suggestion.

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(Continued)

income taxpayers. Another comment indicated that the tax was unfair, especially for flood victims. Other groupings cited the treatment of senior citizens/retirees, indicating the tax was too high or regressive. Also, there was a comment that too many taxpayers owe tax rather than receive a refund.

The most negative aspects of the Property Tax related to the tax on personal property. General references to the unfairness of the tax on personal property were matched by a nearly equal number of comments specifically citing the tax on vehicles. The taxes on inventory and equipment were also cited as negatives. In addition, respondents cited a number of policy items as negative, including the treatment of landowners/loggers, the assessment date coinciding with business' peak season, and the treatment of second residences. Also, one respondent cited his experience of purchasing a structure to use as a home and then learning that their first taxes paid on the home were based upon the prior use as a non-owner occupied house. Other comments cited real estate appraisal issues, stating valuations were too low and the Homestead Exemption was too low. Respondents took the opportunity to offer suggestions, including repealing the Property Tax on vehicles, levying the Property Tax on vehicles once only, reducing the Property Tax on tenant-occupied housing, eliminating Property Tax exemptions, and reducing the Property Tax on equipment and inventory.

The Corporation Net Income Tax and Business Franchise Tax were also among the specific tax types cited as negative. Nine responses indicated the rates were too high or should be reduced. Also, there were four references that taxpayers should pay either the Corporation Net Income Tax or the Business Franchise Tax, but not both. Other comments mentioned that the Business Franchise Tax penalized businesses or was a high burden on capital-intensive businesses. Another response cited the "throw out rule" as a negative aspect.

Eighteen comments were made concerning the Business and Occupation Tax. Because the State Business and Occupation Tax affects only a relatively small

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(Continued)

number of taxpayers, it was assumed that the comments were directed at the local Business and Occupation Tax levied by many West Virginia municipalities. The comments included references that the tax was a disincentive to business, limited expansion, and was inefficient and difficult to administer.

The Consumers Sales and Service Tax was cited 18 times as a negative aspect of the tax structure. Ten of the references were to the tax on food, including one to leave the tax rate on food at six percent. Two comments cited the tax on hospitals and two others mentioned the tax on medicine and supplies provided to patients. Also, the tax on clothing was mentioned. One other comment indicated the tax structure was complex and there were too many exemptions.

Several responses referenced the Health Care Provider Tax indicating the tax was unfair and uncompetitive with other states, reimbursement was unfair, and the tax needed to be examined. Comments on the Severance Tax covered both sides, indicating on one end that the tax was too low or inadequate and on the other end that the tax was excessive and discouraged investment. Other comments referencing specific taxes included suggestions to repeal the sales tax portion of the tax on fuel, raise the tax rate on tobacco, repeal the Motor Vehicle Title Privilege Tax on out-of-state vehicles, and repeal the Privilege Tax entirely.

Responses not referencing a specific tax included comments that there were too many taxes, taxes were unfair, taxes were complicated, and the payment of taxes left fewer funds for other purposes.

### **Suggestions for Tax Structure**

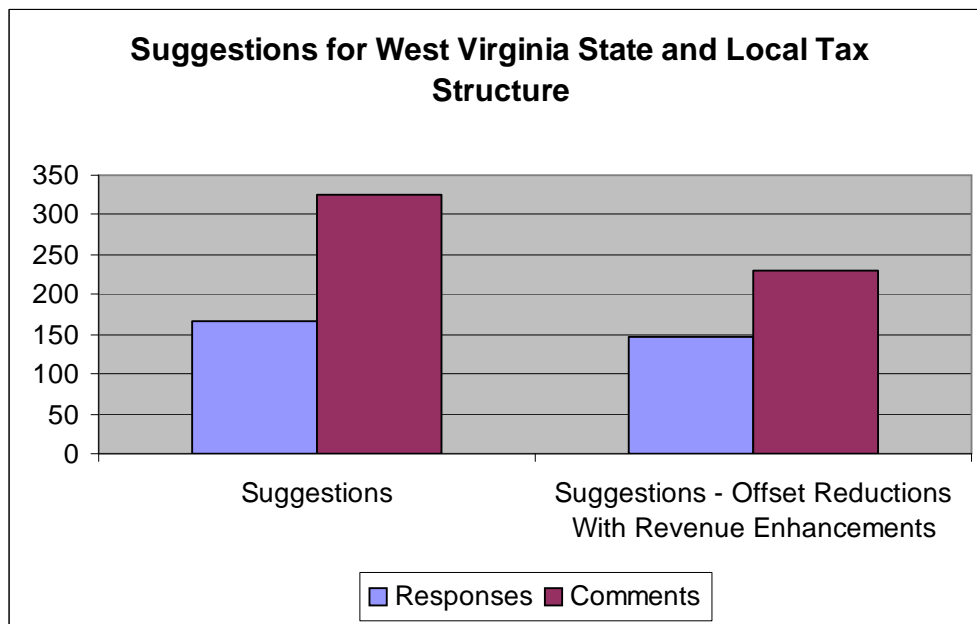
The next item on the survey sought suggestions for the tax structure from respondents. Specifically, the survey asked, "What suggestions for West Virginia State and local tax structure would you make?" and, "What suggestions would you make under the requirement that any tax reduction(s) be offset by equal revenue enhancements(s)?" The first part of this question was completed by more

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(Continued)

respondents (167) than any other question on the survey. (The negative aspects on Question 1 elicited the next highest total of 155.) As indicated below, respondents did not provide as many suggestions to the second part of the question.

**CHART 4**



More suggestions (53) were offered for the Personal Income Tax than for any other specific tax type. Grouping of the suggestions by subcategories resulted in several nearly equal-sized groups. Suggestions related to itemized deductions and retirement income comprised the largest subcategories. The itemized deduction suggestions included three suggestions related to general itemized deductions, along with a suggestion to provide a deduction for Property Taxes and a suggestion for a casualty loss deduction. The retirement income suggestions included proposals to exclude all retirement annuities, to treat federal and State retirees like police and fire retirees, and to provide senior citizens with a cost-of-living adjustment. However, there was also a suggestion to remove the senior citizen exemption. Four suggestions were offered concerning raising the low-income threshold. Other repeated suggestions concerned creating an earned income credit,

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reducing or eliminating the tax, modifying the exemptions, and modifying the rate structure.

Ten of the 45 Property Tax suggestions proposed eliminating or reducing the tax on personal property, two proposed eliminating the tax on vehicles, and two made recommendations for eliminating the tax on equipment and inventory. However, one suggestion was made to increase the tax on personal property and three suggested increasing the entire Property Tax. Also, three responses indicated that the tax should be left as is. Two suggestions were made to increase the Homestead Exemption, and one was offered to make the determination of the exemption based upon a percentage and not a set dollar amount. Other suggestions included proposals to direct more of the tax to the county of origin, to provide more oversight of assessors, to eliminate Class IV, and to move the assessment date to January 1.

Thirteen of the 32 Consumers Sales and Service Tax suggestions addressed the tax on food, calling for the elimination or reduction of the tax. Exemptions or tax reductions were also suggested for clothing, non-profit hospitals, services, medical supplies, and prescription drugs (an existing exemption). Three suggestions to increase the tax were made, and one was offered stating that the six percent rate should not be reduced if other taxes would be increased. Other suggested increases included the removal of the professional services exemption and levying a tax on nonfood luxury items. Also, suggestions were made to dedicate the sales tax revenue to Medicaid matching.

The most common suggestion relating to the 28 Corporation Net Income Tax and Business Franchise Tax references was for the elimination of one or both of the taxes. Also, suggestions were made to replace the Corporation Net Income Tax with a value-added tax and to replace the Business Franchise Tax with a commercial activity tax. Other offerings included closing loopholes, apportioning by sales only, eliminating credits, and taxing only income from West Virginia operations.



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Other common suggestions related to specific taxes included the elimination or reduction of the Business and Occupation Tax; eliminating the Estate/Inheritance Tax; increase of taxes on cigarettes, alcohol and soda; increase of the hotel tax; elimination of the Health Care Provider Tax; and increase of the Severance Tax.

Comments that did not reference a specific tax type included: adopting the 1998 "Fair Tax Plan"; leaving the current tax structure as is; dropping one of the three major taxes (i.e., income, sales and property); imposing a luxury tax; and minimizing exemptions and preferences.

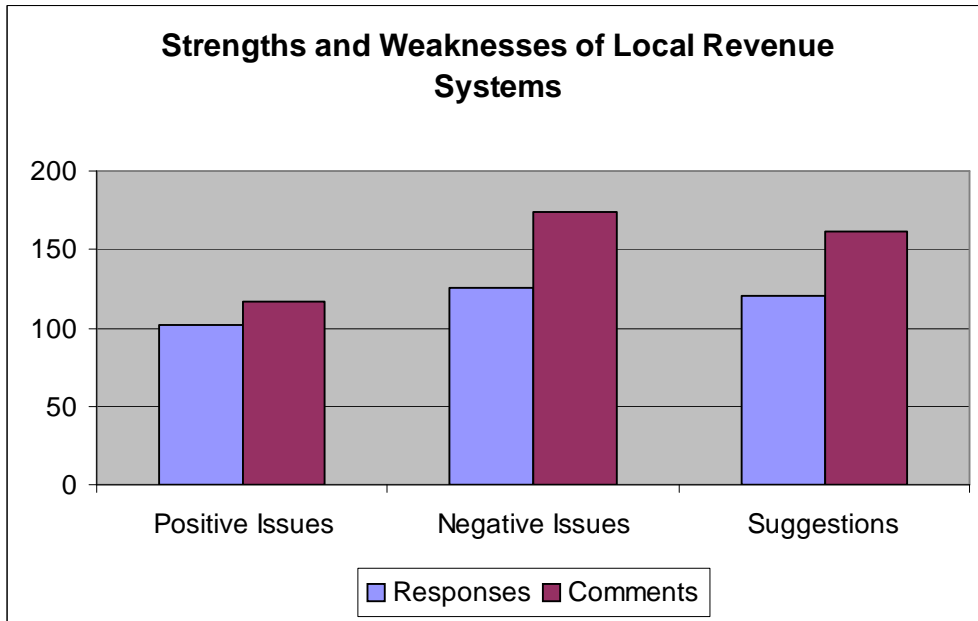
**Local, School, Municipal and County Government Revenue System**

The third major question on the survey was, "What do you feel are the current strengths and weaknesses of local, school, municipal and county government revenue systems?" Respondents were asked to provide the positive aspects, the negative aspects and to provide information on how the problems could be addressed.

A response to the positive aspect of the question was made on 102 surveys and yielded 117 separate comments. As with the initial question on the tax structure, there were more negative replies (125) than positive replies. The negative replies produced 174 separate comments. Possible suggestions to address the issues were submitted on 120 surveys and contained 162 separate comments.

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**CHART 5**



Many of the comments on the positive aspects of a local government revenue system cited the funding of education and schools. Other comments mentioned that the revenue system was stable and cited the low Property Tax. Also, a positive aspect mentioned that levies must be approved locally.

The Property Tax was cited as a negative aspect 29 times. The issues with the tax covered a wide range. Although the concern that the tax was unfair was repeated four times, other comments concerned the allocation of the tax, the assessment of the tax, the officials involved in the process (both local and State), the belief that excess levies support other jurisdictions, and that the tax was not a good way to fund government. Also, mentioned were out-of-date assessments, the proliferation of exemptions and preferences, and the lack of review of abatements.

Enforcement of the Municipal Business and Occupation Tax was cited as a negative on three surveys and the regressive nature of the tax was cited twice. While these two items accounted for one-half of the Municipal Business and

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Occupation Tax references, other comments indicated the tax drives business away and is an inefficient method of funding.

Other negative responses included references to redundant services, mishandled funds, the need for consolidation of services, the lack of accountability of funds, poor administrators, State control of revenue, State collections of local money, State mandated teacher pay, and the lack of home rule.

Suggestions to address the local government revenue system mentioning the Property Tax included changes that would both decrease and increase revenue. Suggestions that would likely result in a decline in revenue included eliminating the entire tax, dropping the personal property tax, eliminating the inventory tax, reducing levy rates, capping the tax at a percentage of income, instituting a fixed rate for taxpayers on a fixed income, and raising the Homestead Exemption. The suggestions that would likely increase revenue included removing many exemptions and preferences, passing a Statewide excess levy, and retaining a larger percentage of the revenue for local use. Other Property Tax related suggestions included filing abatements and payment in lieu of tax agreements with the Secretary of State, appraising property once every three years, better education of State appraisers, providing State guidance to assessors, changing the State mandated assessment form, establishing a Property Tax Appeals Board, and utilizing third-party assessments and assessors.

Finally, other suggestions for this survey item included replacing or eliminating the Municipal Business and Occupation Tax and implementing State enforcement and central auditing of the Municipal Business and Occupation Tax. Additionally, implementing home rule, consolidating government, decentralizing government, simplifying State education funding, permitting local government to collect sales taxes, implementing the "Fair Tax Plan," implementing a commuter tax, implementing a rent tax, and taxing "those without property who do not pay their fair share" were suggested.

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**Top Three Tax Issues**

The next item on the survey asked “What are the top three issues in our state?” The item was completed on 141 surveys from which 376 comments (or roughly 2.7 comments per survey) were extracted.

Comments referencing specific tax types cited the Property Tax most often (56 times). A general reference to the Property Tax occurred 9 times while there were 22 references to the tax on personal property (including three specific references to vehicles and two to inventory). Taxation of minerals was cited 4 times (twice suggesting the tax was unfair or too high and twice that the tax was underpaid or undervalued). Also, multiple references were made that there were too many exemptions or preferences.

The Consumers Sales and Service Tax was mentioned 37 times on this part of the survey. Twenty-two of the references were to the tax on food.

Other specific tax types listed in this part of the survey included the following:

1. Corporation Net Income Tax and Business Franchise Tax (33 times, but no predominant theme),
2. Personal Income Tax (21 times, with tax rates cited most often),
3. Municipal Business and Occupation Tax (18 times, but no predominant theme),
4. Incentives (11 times, with accountability cited most often),
5. Severance Tax (10 times, but no predominant theme),
6. Excise Taxes (8 times, with the gasoline tax listed most often),
7. Corporation License Tax (2 times),
8. Health Care Provider Tax (2 times),
9. Motor Vehicle Title Privilege Tax (2 times).

Respondents provided many other comments that could not be assigned to a specific tax type. Some of the references that occurred more than once included

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comments that there are too many taxes, the rates are too high, and the tax system is too regressive. Additionally, workers' compensation issues were listed 12 times.

**Suggestions for Altering Types or Rates of Taxes, Fees and Exemptions**

The fifth question on the survey was "By altering the types and/or rates of taxes, fees and exemptions, how might the State foster business retention, expansion and/or job creation? What one change would be most likely to cause your firm or other businesses to expand their West Virginia operations?" From the 135 responses to this question, 193 separate suggestions were extracted.

Unlike the prior questions, suggestions related to incentives were greater than the number of suggestions related to a specific tax type. Incentives for existing West Virginia businesses were suggested more often than any other subcategory. The suggestions referencing existing business were characterized as follows:

1. Reward long-time employers,
2. Provide grants/tax credits for new equipment,
3. Eliminate discrimination for in-state businesses,
4. Provide incentives based on years present in West Virginia,
5. Give existing businesses the same incentives as new businesses, and
6. Provide incentives to develop local businesses.

The second most popular subcategory for incentives appeared to be targeted incentives. In addition to a general statement to "target incentives," the suggestions included the following:

1. Provide incentives for alternative energy use,
2. Provide incentives for individual farmers, and
3. Provide incentives for locating in needy areas.

Incentives referencing new business comprised the third largest subcategory and included the following:

1. Provide entrepreneurs with a start-up exemption,

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2. Provide incentives for new businesses, but not excessive,
3. Provide incentives for new businesses, but not forever, and
4. Provide tax breaks for “start-up.”

Other comments concerning incentives included references to jobs (2), accountability (2), lowering the qualifying criteria (2), the abolishment of credits (2) and several singular suggestions.

Suggestions concerning the Corporation Net Income Tax and the Business Franchise Tax comprised the largest group addressing a specific tax. Seven comments suggested the elimination or phase out of the Business Franchise Tax, while one comment called for a reduction in the tax. Conversely, six responses suggested lowering the Corporation Net Income Tax, while elimination of the tax was suggested once. Also, four respondents suggested “making the large and small corporation tax equal.”

Survey respondents offered 17 suggestions related to the Property Tax. All but four of the suggestions were directed to the tax on personal property. Exemptions for raw materials, intermediate products, equipment and inventory were suggested. Related responses suggested an exemption and a change in the way daily rental vehicles are treated. The other personal property exemptions called for a reduction and complete elimination. The general Property Tax response included suggestions for a reduction and for a “tax break from escalating taxes.”

Suggestions referencing other specific tax types included eliminating or reforming the Municipal Business and Occupation Tax, removing the sales tax on food, removing the sales tax on clothing, eliminating the sales tax on non-profit hospitals, increasing the Cigarette Tax to the national average, reducing Personal Income Tax rates, indexing the Personal Income Tax to 1988, increasing the Severance Tax on timber, and reducing the Severance Tax on coal.

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Other suggestions not specific to a particular tax type included continue workers' compensation reform, upgrading the tax computer system, taxing income not ownership, moving from income taxes to consumption, reducing all taxes, simplifying the tax system, incorporating the "Fair Tax Plan," establishing metro governments, and improving the infrastructure.

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**RECOMMENDATIONS BY...**  
**Participants of the Tax Summit Meetings**  
**Held July 6, 2006**

Transcript of Recommendations for Tax Modernization before Karon L. Vorholt, a Certified Court Reporter and Notary Public in and for the State of West Virginia, on the 6th day of July 2006, commencing at 3:25 p.m., held at the Charleston Civil Center, 200 Civic Center Drive, Charleston, West Virginia.

**APPEARANCES:**

**JOHN C. MUSGRAVE**, Cabinet Secretary,  
Department of Revenue

**VIRGIL T. HELTON**, Tax Commissioner,  
State Tax Department

**CHRIS MORRIS**, Assistant Tax  
Commissioner, State Tax Department

**MR. MUSGRAVE:** What we're going to do is take about five minutes. We have the 14 moderators up here.

I'm going to ask that each of them come to the podium, introduce themselves. Indicate what tax they -- the tax and fees, administrative issues they considered, whether it was business or personal, property, or road fund, or local. And try to take about five minutes each or four minutes each and tell us what they found

out. Give us a report. Please introduce yourself as you go to the podium too. Thanks.

**MS. BOGCESS:** Good afternoon everyone. My name is Samantha Boggess. And I'm with the Offices of the Insurance Commissioner. I served as a moderator for business tax in Room 208.

I would also like to thank each member of my work group and my team. Your participation and contribution was sincerely appreciated. I would also like to say please be assured that all information that was gathered today will be considered by the Tax Modernization Work Group.

With that being said, I would like to give you our four issues. Number one was government spending. So we have to tie that into taxes somehow. Improve the Tax Department.

Third is high corporate net income rate. And number four was to close the loopholes on tax shelters.

The following solutions were identified. For government spending we recommend the review and implementation of the Governor's Study to review how to save money. In part to address too many State employees. Also to ensure that those employees are in appropriate jobs.



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Another solution was to consolidate city and county governments.

We also recommend review higher education to eliminate duplication of services in the pollinization of funding process. Basically we recommend that we do not spend more than we take in.

The second issue was to improve the Tax Department. Our solution is to hire and train qualified audit staff to do out-of-state audits.

We want more aggressive enforcement. And we want to identify the areas in which revenue is lost. And then address those areas.

We also ask that we implement the mediation at the Tax Department level.

Our third issue was high corporate net income rate. We asked that it be lowered through legislation.

We believe that if there's more aggressive enforcement, then we can collect the funding from those who legitimately owe.

We also ask for better enforcement on multi-state businesses.

Our last issue that we identified in the top four was to close the loopholes on tax shelters.

One solution is to implement the anti-PIC. Next was aggressive nexus. We recommend a separate Tax Department to focus on foreign businesses.

This concludes our group's report and recommendations. Thank you very much.

**MS. BENSON:** Hi. I'm Lova Benson. And I work for West Virginia Conservation Agency. And I was moderator in Room No. 207 for business taxes also.

The top four issues that we had were tax structure simplicity, the review of business franchise and corporate net income taxes, long-term effects of tax changed impacts. And a better way to lower taxes is to lower government costs.

No. 1, tax structure simplicity. Suggested ways to overcome this is electronic filing, reporting and paying taxes. Consolidating taxes. And effectively funded Tax Department to make the tax system easy to understand and provide a competitive structure with other states.

The second item was the review of business franchise and corporate net taxes, trying to lower corporate net taxes to be competitive with other states. And to try to phase out the business franchise tax over time.

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The third issue was long-term effects of tax changed impacts. Tax changes should be incremental. Accurate estimates must reflect future behavior after tax reform changes.

Reform should be durable, lasting and stable. Genuine concern over ability to lower taxes.

The fourth item is a better way to lower taxes is to lower government cost. And in order to do that, we would provide efficiency and administration in the examination of services provided and the adequacy of charges.

And to sum it all up, the group felt that -- mostly they felt apprehension to the changes. They were concerned about the long-term effects the changes would provide.

**MS. CARDER:** Good afternoon. My name is Lara Carder. I'm from the West Virginia Department of Administration, the Division of Personnel.

And I was moderator for Room 209. And we focused on business taxes.

And the following are the top four issues that we identified as problems or concerns that need to be addressed.<sup>229</sup>

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<sup>229</sup> During the morning breakout session in Room 209, the issue of the tax on soft drinks was raised. Based on the

Our first issue was that we believe that the State lacks a clear policy that outlines the entire tax structure.

Our second issue was that we felt that the current tax system stifles business and limits our competitiveness with other states and with businesses here within the state.

And our third issue that we identified was that we believe that there's a lack of fairness between providing incentives to establish West Virginia businesses and to the newer businesses that are locating here.

And fourthly, the last issue that we identified was that the burden of supporting the tax system within the state falls more heavily on businesses than on other areas of payers of taxes within the state. So we came up with four solutions for how we could correct -- or what we thought would be great recommendations to correct some of these issues.

No. 1, draft a policy that would be clear. And that we could consolidate the tax code. It would include provisions of a good tax system that were outlined in some

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interest shown by the participants in this room, the proposal to repeal the tax on soft drinks should have been included on the afternoon agenda.

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of the presentations made today. It would also include a dynamic tax model.

We believe it should be drafted by a committee. Most likely the Tax Modernization Committee. And that it should clearly outline the percentages of taxpayers, and according to which segments of society of those who will have to pay taxes should pay.

For example, that whether 50 percent of the taxes should be paid by businesses, 50 percent by personal, et cetera.

No. 2, our issue was the stifling of business. We believe that that could be remedied by repealing the franchise tax.

We believe that economic growth will occur, and can be stimulated by repealing that tax.

Our third issue was the incentives for new businesses in the fairness of applying those towards new businesses versus established businesses.

We feel that it would be best if we look at reducing or eliminating the corporate net income tax.

And this would bring us more in line with surrounding states. And would help us to be a little more competitive.

And fourth and lastly, in regard to those incentives, we believe that the tax incentives need to be evaluated. And it needs to be fair for all business in West Virginia. Not just those businesses that are coming in. But also for those businesses that are already located here and who have been providing for our communities over time.

And those are the recommendations that our group discussed. And thank you for your time.

**MS. DADISMAN:** Hello. I'm Marsha Dadisman. I work for the Department of Health & Human Resources.

Today I served as moderator for business tax. And we were in the Lounge.

We identified four areas where problems exist. The first one, out-of-state competition. The second one deals with franchise tax. The third one, inventory tax. And the fourth one, baseline jobs.

The first problem related to out-of-state competition. The problem statement is, out-of-state businesses conducting business in West Virginia may have an unfair competitive advantage.

The solution is to create a uniform sales tax. Another solution that the group discussed was that on purchases from

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outside the state into West Virginia by a business, we should tax the retailer, not the wholesaler. The second problem deals with franchise tax. Franchise tax is regressive. And when combined with corporate income tax is a double penalty against businesses.

The solution, abolish the franchise tax. And decrease corporate income tax over time to mirror the personal income tax rate.

The third area, inventory tax. The problem is that inventory and all other personal property is not taxed properly.

Tax on inventory hinders businesses – or business expansion. I'm sorry. Currently inventory is taxed twice - property and sales tax.

The solution is to repeal the inventory tax. Repeal it on all tangible personal property and increase or shift it to real property.

And the fourth problem, baseline jobs. The problem is there's a lack of growth in baseline jobs that create -- well those jobs that create wealth.

The solution is to provide infrastructure development, such as roads, water, sewer, instead of tax credit.

Include incentives for existing businesses. And target incentives to

specific democrat -- demographic areas -- that's an intended pun -- such as on aging

And I also want to thank the members of the group that I facilitated. They are very knowledgeable and very passionate about the topics that they discussed today.

**MS. McNEMAR:** Good afternoon. My name is Kelly Jo McNemar with the Department of Administration.

And this afternoon -- or today I served as moderator with a great team from the Tax Department regarding local taxation fees and administration. Our session was held in Parlor Room A.

While we discussed a lot of things today with our participants, we were able to identify four issues.

The first, alternatives to property tax to fund education. Trying to keep local property taxes at home.

The second, inequity and inconsistency between city, county and school regarding bond issues and taxes.

The third, less state control regarding local authority. We want a more flexible local government. And the fourth was stronger authority for collections.

In regard to alternatives to property tax to fund education, and trying to keep those property taxes at home, the group

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discussed accountability for the budget digest.

Tax, and the opportunity to tax professionals, advertisers and bottled water. And to reexamine all exemptions.

In regard to inequity and inconsistency between city, county and school regarding bond issues and taxes, the group discussed having the same rules apply to all entities. Having the same ability to tax.

For example the hotel/motel tax being consistent, and then allowing for flexible usage. And also having a simple majority for passing levies.

In regards to less state control regarding local authority, allowing a more flexible local government, the group discussed eliminating rollback provisions and caps, restructuring the B & O classification and rate.

That would allow for a piggyback on State taxes, like general sales. And also could potentially allow a local economic growth tax.

We also discussed changing the time line for setting the tax and levy rates.

In regard to less -- or in regard to stronger authority for State collections, our fourth issue, the group discussed

implementing statutory authority and penalties and tax liens.

And they also discussed a local enforcement authority to collect.

The group did a great job today. Thank you for your information and for your time and input.

**MS. PAUER:** Hello. My name is Jennifer Pauer. And I'm with the Department of Environmental Protection. And I spent the day moderating the property tax group in Room 206.

The four issues that we identified were that there is a competitive disadvantage of the property tax on manufacturing in West Virginia versus other states.

Property tax dispute resolution is an issue. And there's no consistent valuation on minerals across the state.

And our fourth issue was inconsistency across the state of what qualifies as a farm.

So when we talked -- brought those issues back this afternoon and discussed solutions, what we came up with is for the first one, competitive disadvantage of the property tax on manufacturers versus other states.

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The first solution that we had was to adopt legislation to exempt manufacturers' inventory from property taxation.

And we were told that there is Senate Bill 59 out there. That's an opportunity for that to happen.

The second solution was to show the public benefit of being competitive to manufacturers within the state.

The third solution was to eliminate the equipment tax. And if we could not eliminate equipment tax, we could give credit for the property tax for some other state tax. And include a carry forward credit for future tax, or a refundable credit.

Our fourth solution on our first issue was to eliminate personal property tax and recoup the income by changing the levy rate on real property.

And in conjunction with that, we could shrink local government by eliminating the cost of collection -- the people who have to collect those personal property taxes.

Our second issue was property tax dispute resolution. And we had two solutions to that one.

The first one was to increase the time period to conduct property tax hearings. It only happens during the month

of February. And we thought an increase in that time would help.

The last solution to that one was to create a Board of Property Tax Appeals which will be qualified, fair and independent.

Our third issue was that there is no consistent valuation of minerals across the state. And we had two solutions to that one also.

The first solution was to evaluate the regulation and simplify the formula.

The second solution was make valuations more available to the public, and to simplify them.

The fourth issue was inconsistency across the state with what qualifies to be a farm. And our solution to that one was to change the law to provide a clearer definition of a farm.

And within that definition we should consider sale of farm products to exceed a specific value. And also to define the Farmland Protection Act.

Those were the issues that we worked on today, and the solutions that we came up with. We did have a very good group. And I thank everyone for their time.

**MS. BOROWSKI:** Good afternoon. My name is Jan Borowski. I work for the Solid Waste Management Board. I was

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moderator today for property tax. We were in Room 205.

We were to identify four issues, which we did. And we came up with solutions. But we did not come to consensus. Someone wanted me to mention that.

Our first issue was to protect and preserve our culture through taxation. Specifically they mentioned agriculture, tourism and forestry.

The second issue was that we need a two-rate tax system. That's land and improvements.

Our third issue was to preserve property tax as it is. And four was the school funding as it relates to property tax.

So going back to our first issue, to protect and preserve our culture through taxation.

One of the solutions was to relate the tax to use. Another solution was to implement a rollback provision when land has changes.

And the third solution was to maintain the evaluation system used today.

Regarding the two-rate tax system, it was suggested to change the law to permit a two-rate system, to increase the

tax on land and to lower the tax on buildings.

Our third issue, preserve tax as it is. The comment there was if you eliminate property tax, the staple replacement would be to develop and maintain the funding.

And the last one, the school funding as it relates to property tax. The solution was to decouple school funding from property tax, to change the school aid formula.

The solution was that we need alternative funding source, possibly have a land value tax only to support education. Thank you.

**MS. WHITE:** Hello. My name is Libby White. And I work for the West Virginia Lottery.

And today I was moderator of a group for the road fund tax, fees and administration in Room 103.

I had a wonderful group. I'd like to thank you all who participated.

Actually we came up with at least 15 issues of concern. And fortunately were able to consolidate that to one primary issue.

Regarding the road tax -- road fund tax, fees and administration, the primary issue is that funding sources as far as

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State highway system, current maintenance and future development, the resources are limited, restricted, and they are diminishing.

Our solution -- or possible solutions to look at for this issue are perhaps researching and exploring the use of toll as a possible revenue source on our highways.

We could explore the impact of using a vehicle mileage fee as a way to fund highway maintenance.

We could entertain concepts of private/public ventures for maintenance. And even for possible construction of new systems.

We also thought about diverting the consumers sales tax from tires, cars, other instruments used by vehicles to the Highway Fund. That was a good concept.

And we thought about exploring the fiscal impact of using general revenue funds to supplement the Highway Fund.

Finally, we thought we had to look to the future. Today the Highway Fund is based on a petroleum- based tax fee.

In the future there will be alternative energy. We're already seeing hybrids now. We'll have many different things on our highway system.

How are we going to tax or assess fees upon elements such as ethanol, hydrogen or solar power.

I'd like to thank you all, and thank the members of the group.

**MS. OAKES:** Good afternoon. My name is Tonja Oakes. And I'm from the Tax Department. And like Libby, I also moderated in the road fund tax in Room 104.

And we identified four issues. The first being vehicle privilege tax for businesses or individuals when they move to West Virginia from another state – and perhaps they've already paid that privilege tax in another state.

Alternative fuel production. Revenue from areas that could be dedicated to highways. And uniformity of all taxes.

The first solution was the privilege taxes -- of course to simply remove the tax. And to give credit for West Virginia residents when they have paid that to another state.

The solution for the second issue was future development, the resources are limited, restricted, and they are diminishing.

Our solution – or possible solutions to look at for this issue are perhaps researching and exploring the use of toll as



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And we thought about exploring the fiscal impact of using general revenue funds to supplement the Highway Fund.

Finally, we thought we had to look to the future. Today the Highway Fund is based on a petroleum-based tax fee.

In the future there will be alternative fuel production, was that in order to initiate that alternative fuel production they would need State government support for them to initiate that production.

The revenue from the highways -- I mean revenue that could be generated for highways, was revenue for motor vehicles, related maintenance and disposals, fee on vehicle violations, like tickets that you receive. Part of those fees goes to the jail.

They recommended that maybe the fees be incorporated to a new fee so that it could be generated for highways. Allow the local governments to impose an excise tax on vehicles for repairs to local roads.

And the uniformity of all taxes, the recommendation was review of competitive taxes in the bordering states. And perhaps a review of converting the motor vehicle tax to variable rates. Thank you for a good time.

**MS. KOON:** Good afternoon. My name is Teresa Koon. And I'm with the West Virginia Department of Environmental Protection.

I moderated the personal income tax fees and administration session in Room 203.

Our four issues, we combined three that were very similar.

So the first issue was the threshold for low-wage workers, which incorporates them -- some discussion on standard exemption. As well as the low income earned exclusion that the Governor mentioned in his presentation.

The second issue is the inheritance tax. The third issue, excise taxes. And the fourth issue is indexing the rate brackets for income tax for inflation.

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The first issue, the threshold for taxing low-wage workers, we discussed solutions such as credits for different income brackets. Which the state of Kentucky does credit, similar to what the federal government does. And there are 18 states that do that, that we could look to for advice.

We discussed also a straight 25,000 or a 12,500 exemption, standard exemption for everyone. Which includes a flat tax for higher incomes, that would be tacked onto that.

And we discussed some ways to maybe address any revenue differences that may result from some of those.

And we talked about looking at other taxes aside from personal income to make up for revenue shortfalls, such as property tax and giving more control to local governments to levy property taxes and use those funds.

And to reduce government -- to reduce government in general. But to also look at reducing government where the majority of the expenditures are going. And maybe some -- a call for some additional oversight on government expenditures.

The second issue was the inheritance tax. This -- there was definitely

no consensus on this in our group. And each solution kind of counteracts the other.

So we had a solution of reinstating the inheritance tax on estates over five million. We had a solution of eliminating the inheritance tax altogether.

A suggestion that we might decouple it with the federal estate tax and have our own West Virginia inheritance tax or a state tax.

And it was also mentioned that this is an easy tax to collect if the federal government is collecting it.

But in West Virginia it may not amount to a significant revenue source. So it would be wise to do that only if it was tacked on to the federal estate tax, to make it easier to administer.

The third issue was the discussion on excise taxes. There was a general feeling to increase and index cigarette taxes and smokeless tobacco. And one suggestion was to provide the revenue from that to Medicaid.

The suggestion to consider that if we do look at excise taxes we need to consider the effect on the retail competition with border states who are able to charge less for products, and folks going across the border to purchase those products.

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So we need to be careful to consider that as we look at excise taxes.

The discussion -- the group also discussed targeting excise taxes based on the negative impact.

Again tobacco would be an example that there's medical data to support that there are a number of costs -- health-related cost from the use of tobacco. And we may want to look at targeting our excise taxes based on some of those negative impacts.

And finally, there was some discussion about the excise tax on alcohol, and the fact that the Governor concurrently increased that now. And that may be something that The Summit should consider.

And the final issue was indexing the rate brackets for income tax for inflation. And that was kind of a problem and a solution together. So there are no sort of follow-up issues with that.

So this concludes our group's recommendations. And it was a pleasure to work with all of you. And thank you.

**MS. LION:** Hello. I'm Linda Lion. I'm with the Public Service Commission. And I was personal tax, as well. And we were in Room 204.

We had four issues come up. The first one was tax form revision. The second was to decrease the tax burden on low-income persons.

The third was to decrease personal property tax for our senior population. And the last one was to keep West Virginia from modeling after unsuccessful states.

So the first one on the tax form revision was to make a standardized exemption a personal income tax. The same as the federal.

The next one was low income exclusion. That that tax be tiered based on your family size.

And the third was to have a transition tax between a buyer and a seller above transaction amounts of \$250 or .03 percent rate.

And West Virginia, if we did this, we would be the first state to enact it.

The second was to decrease the tax burden for low income. And some of the solutions were the transition tax would generate more revenue.

And the tier low-income exclusion tax, which I just talked about. And to exempt Social Security income from personal income on our taxes.

## APPENDIX C

(Continued)

Eliminate the grocery tax and eliminate the privilege tax on automobiles.

Our third problem was to decrease personal property tax for our seniors.

And some of the solutions were to tier it by the ability to pay based on their income. And to attract people who have the ability to pay personal property taxes to West Virginia by advertising.

Maybe a one-year tax incentive for those people moving into the state. And then the transition tax came up as well.

The last one we had was for West Virginia to model after successful states. And the main thing was where do we want to go in West Virginia. So we want to look at successful models of tax reformation.

We'd like to maybe advertise to affluent baby boomers and children of baby boomers to come to West Virginia to live here.

And maybe another solution was intergenerational centers. And the third one was to target successful industry initiatives.

And the last one was to look at how our government spends our money, and make sure that we're getting the best banking for our buck.

I want to thank my team. They did a great job. Thank you very much.

**MS. HOLSTEIN:** Good afternoon. I'm Robin Holstein. I'm with the State Conservation Agency.

I moderated one of the personal taxes, fees and administration breakouts in Room 202.

We managed to compile a large number of things. I think we had 24 altogether. And we were able to whittle those down to our top four.

And the top four items that we identified, one was excise taxes on soft drinks. Sin taxes, and ATF's are too low.

Two, the collection of and administration of *ad valorem* and personal property taxes are not standardized. In 55 counties you may have 55 different ways to administer those.

Three, personal income tax exemption is too narrowly defined. And four, sales and provider taxes are inconsistent.

In our afternoon session as we identified some solutions to these issues, we noted one, to increase the excise taxes. If you put five cents on a half liter of soft drinks, double the sin taxes, and put \$100 for ATF.

Two, standardize and centralize the collection administration of *ad valorem* and personal property taxes into a State office.

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**APPENDIX C**  
(Continued)

Three, redefine personal income tax exemption to include everyone. And raise that exemption to \$20,000.

Four, eliminate exemptions on personal transactions such as on sales taxes. They are inconsistent, and too poorly defined.

I want to thank everyone who worked with me. And I had a wonderful group as I said.

I want to thank you for inviting me to do this. It's been a wonderful educational day me. Thank you.

**MS. FITZWATER:** Good afternoon. I'm Ginny Fitzwater. And I'm with the Department of Health & Human Resources.

I served as moderator also in personal tax work group. And we were located in Room 201.

The following top four issues were identified by our group.

The first issue was the working poor and how they are taxed. Our second issue was personal property tax on vehicles.

Our third issue was taxes on pensions and annuities. And our fourth issue was percent of taxes paid should be equal for high and low income.

In the afternoon our work group identified the following solutions to address the issues.

In regard to issue one, the group defined working poor as low income earners. And suggested raising personal exemptions to the federal poverty level, and making personal income tax more progressive to offset and increase in the income tax threshold.

In regard to Issue 2, personal property tax on vehicles, the group suggested repealing the privilege tax imposing sales tax on vehicles and giving credit on vehicles purchased out of state when relocating back to West Virginia.

In regard to Issue 3, taxes on pensions and annuities, the group suggested increasing low income exemption to \$20,000.

In regard to Issue 4, percentage of taxes paid overall should be more equitable for high and low income, the group has suggested a more progressive income tax structure be established.

This concludes our group's report and recommendations. And also concludes the moderators' reports.

**APPENDIX C**  
(Continued)

On behalf of all the moderators, I would like to thank you for your time and your attention today.

## APPENDIX D

### STATE INDIVIDUAL INCOME TAXES

(Tax rates for tax year 2006 -- as of January 1, 2006)

State	--- Tax Rates ---			# of Brackets	--- Income Brackets ---				--- Personal Exemption ---				Federal Tax			
	Low	High			Low		High		Single	Married	Child	Ded.				
ALABAMA	2.0	-	5.0	3	500	(b)	-	3,000	(b)	1,500	3,000	300	*			
ALASKA	No State Income Tax															
ARIZONA	2.87	-	5.04	5	10,000	(b)	-	150,000	(b)	2,100	4,200	2,300				
ARKANSAS (a)	1.0	-	7.0	(e)	6	3,399	-	28,500		20	(c)	40	(c)	20	(c)	
CALIFORNIA (a)	1.0	-	9.3	(x)	6	6,319	(b)	-	41,477	(b)	87	(c)	174	(c)	272	(c)
COLORADO	4.63			1	-----Flat rate-----				-----None-----							
CONNECTICUT	3.0	-	5.0	2	10,000	(b)	-	10,000	(b)	12,750	(f)	24,500	(f)	0		
DELAWARE	2.2	-	5.95	6	5,000		-	60,000		110	(c)	220	(c)	110	(c)	
FLORIDA	No State Income Tax															
GEORGIA	1.0	-	6.0	6	750	(g)	-	7,000	(g)	2,700	5,400	3,000				
HAWAII	1.4	-	8.25	9	2,000	(b)	-	40,000	(b)	1,040	2,080	1,040				
IDAHO(a)	1.6	-	7.8	8	1,159	(h)	-	23,000	(h)	3,300	(d)	6,600	(d)	3,300	(d)	
ILLINOIS	3.0			1	-----Flat rate-----				2,000		4,000		2,000			
INDIANA	3.4			1	-----Flat rate-----				1,000		2,000		1,000			
IOWA (a)	.036	-	8.98	9	1,269		-	57,106		40	(c)	80	(c)	40	(c)	*
KANSAS	3.5	-	6.45	3	15,000	(b)	-	30,000	(b)	2,250	4,500	2,250				
KENTUCKY	2.0	-	6.0	6	3,000		-	75,000		20	(c)	40	(c)	20	(c)	
LOUISIANA	2.0	-	6.0	3	12,500	(b)	-	25,000	(b)	4,500	(i)	9,000	(i)	1,000	(i)	*

**APPENDIX D**  
(Continued)

State	--- Tax Rates ---		# of Brackets	--- Income Brackets ---				--- Personal Exemption ---				Federal Tax
	Low	High		Low		High	Single	Married	Child	Ded.		
MAINE (a)	2.0	- 8.5	4	4,550	(b) -	18,250	(b)	2,850	5,700	2,850		
MARYLAND	2.0	- 4.75	4	1,000	-	3,000		2,400	4,800	2,400		
MASSACHUSETTS (a)	5.3		1	-----Flat rate-----				3,575	7,150	1,000		
MICHIGAN (a)	3.9		1	-----Flat rate-----				3,100	6,200	3,100		
MINNESOTA (a)	5.35	- 7.85	3	20,510	(j) -	67,360	(j)	3,300	(d) 6,600	(d) 3,300	(d)	
MISSISSIPPI	3.0	- 5.0	3	5,000	-	10,000		6,000	12,000	1,500		
MISSOURI	1.5	- 6.0	10	1,000	-	9,000		2,100	4,200	1,200	*(s)	
MONTANA (a)	1.0	- 6.9	7	2,300	-	13,900		1,900	3,800	1,900	*(s)	
NEBRASKA (a)	2.56	- 6.84	4	2,400	(k) -	26,500	(k)	103	(c) 206	(c) 103	(c)	
NEVADA	No State Income Tax											
NEW HAMPSHIRE	State Income Tax is Limited to Dividends and Interest Income Only.											
NEW JERSEY	1.4	- 8.97	6	20,000	(l) -	500,000	(l)	1,000	2,000	1,500		
NEW MEXICO	1.7	- 5.3	4	5,500	(m) -	16,000	(m)	3,300	(d) 6,600	(d) 3,300	(d)	
NEW YORK	4.0	- 6.85	5	8,000	(n) -	500,000	(n)	0	0	1,000		
NORTH CAROLINA (o)	6.0	- 8.25	4	12,750	(o) -	120,000	(o)	3,300	(d) 6,600	(d) 3,300	(d)	
NORTH DAKOTA	2.1	- 5.54	(p)	5	29,700	(p) -	326,450	(p)	3,300	(d) 6,600	(d) 3,300	(d)
OHIO (a)	0.712	- 7.185	9	5,000	-	200,000		1,300	(q) 2,600	(q) 1,300	(q)	
OKLAHOMA	0.5	- 6.25	(r)	8	1,000	(b) -	10,000	(b)	1,000	2,000	1,000	*(r)
OREGON (a)	5.0	- 9.0	3	2,650	(b) -	6,550	(b)	159	(c) 318	(c) 159	(c)	*(s)
PENNSYLVANIA	3.07		1	-----Flat rate-----				-----None-----				
RHODE ISLAND	25.0%	Federal Tax Liability (t)										



**APPENDIX D**  
(Continued)

State	--- Tax Rates ---			# of Brackets	--- Income Brackets ---				--- Personal Exemption ---				Federal Tax Ded.			
	Low		High		Low		High	Single	Married	Child						
SOUTH CAROLINA (a)	2.5	-	7.0	6	2,570	-	12,850	3,300	(d)	6,600	(d)	3,300	(d)			
SOUTH DAKOTA	No State Income Tax															
TENNESSEE	State Income Tax is Limited to Dividends and Interest Income Only.															
TEXAS	No State Income Tax															
UTAH	2.30	-	7.0	6	863	(b)	-	4,313	(b)	2,475	(d)	4,950	(d)	2,475	(d)	*(u)
VERMONT (a)	3.6	-	9.5	5	29,900	(v)	-	326,450	(v)	3,300	(d)	6,600	(d)	3,300	(d)	
VIRGINIA	2.0	-	5.75	4	3,000		-	17,000		900		1,800		900		
WASHINGTON	No State Income Tax															
WEST VIRGINIA	3.0	-	6.5	5	10,000		-	60,000		2,000		4,000		2,000		
WISCONSIN	4.6	-	6.75	4	8,840	(w)	-	132,580	(w)	700		1,400		400		
WYOMING	No State Income Tax															
DISTRICT OF COLUMBIA	4.5	-	9.0	3	10,000		-	30,000		1,370		2,740		1,370		

## APPENDIX D

(Continued)

### Source: The Federation of Tax Administrators from various sources.

- (a) 15 states have statutory provision for automatic adjustment of tax brackets, personal exemption or standard deductions to the rate of inflation. Massachusetts, Michigan, Nebraska and Ohio indexes the personal exemption amounts only.
- (b) For joint returns, the taxes are twice the tax imposed on half the income.
- (c) tax credits.
- (d) These states allow personal exemption or standard deductions as provided in the IRC. Utah allows a personal exemption equal to three-fourths the federal exemptions.
- (e) A special tax table is available for low income taxpayers reducing their tax payments.
- (f) Combined personal exemptions and standard deduction. An additional tax credit is allowed ranging from 75% to 0% based on state adjusted gross income. Exemption amounts are phased out for higher income taxpayers until they are eliminated for households earning over \$56,500.
- (g) The tax brackets reported are for single individuals. For married households filing separately, the same rates apply to income brackets ranging from \$500 to \$5,000; and the income brackets range from \$1,000 to \$10,000 for joint filers.
- (h) For joint returns, the tax is twice the tax imposed on half the income. A \$10 filing tax is charge for each return and a \$15 credit is allowed for each exemption.
- (i) Combined personal exemption and standard deduction.
- (j) The tax brackets reported are for single individual. For married couples filing jointly, the same rates apply for income under \$29,980 to over \$119,100.
- (k) The tax brackets reported are for single individual. For married couples filing jointly, the same rates apply for income under \$4,000 to over \$46,750.
- (l) The tax brackets reported are for single individuals. For married couples filing jointly, the tax rates range from 1.4% to 8.97% (with 7 income brackets) applying to income brackets from \$20,000 to over \$500,000.
- (m) The tax brackets reported are for single individuals. For married couples filing jointly, the same rates apply for income under \$8,000 to over \$24,000. Married households filing separately pay the tax imposed on half the income.

**APPENDIX D**  
(Continued)

- (n) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from \$16,000 to \$20,000.
- (o) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from \$21,250 to \$200,000. Lower exemption amounts allowed for high income taxpayers. Tax rate scheduled to decrease after tax year 2007.
- (p) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from \$49,600 to \$326,450. An additional \$300 personal exemption is allowed for joint returns or unmarried head of households.
- (q) Plus an additional \$20 per exemption tax credit.
- (r) The rate range reported is for single persons not deducting federal income tax. For married persons filing jointly, the same rates apply to income brackets that are twice the dollar amounts. Separate schedules, with rates ranging from 0.5% to 10%, apply to taxpayers deducting federal income taxes.
- (s) Deduction is limited to \$10,000 for joint returns and \$5,000 for individuals in Missouri and Montana, and to \$5,000 in Oregon.
- (t) Federal Tax Liability prior to the enactment of Economic Growth and Tax Relief Act of 2001.
- (u) One half of the federal income taxes are deductible.
- (v) The tax brackets reported are for single individuals. For married couples filing jointly, the same rates apply for income under \$49,650 to over \$326,450.
- (w) The tax brackets reported are for single individuals. For married taxpayers, the same rates apply to income brackets ranging from \$11,780 to \$176,770. An additional \$250 exemption is provided for each taxpayer or spouse age 65 or over.
- (x) An additional 1% tax is imposed on taxable income over \$1 million.

## APPENDIX E

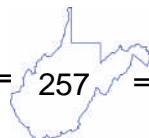
TABLE 1

### State Corporate Tax as % of Private Industry GSP

Source: U.S. Census Bureau, State Government Tax Collections 2005 and Bureau of Economic Analysis GSP 2004

\* States with Minimum Taxes or Additional Franchise Taxes

<u>State</u>	<u>Private GSP Share</u>	<u>Top Rate</u>	<u>Rank</u>
Alaska	2.15%	9.4%	1
New Hampshire*	1.01%	8.5%	3
<i>West Virginia*</i>	<i>0.68%</i>	<i>9.0%</i>	<i>5</i>
Pennsylvania*	0.60%	9.99%	7
North Carolina*	0.58%	6.9%	9
Kentucky*	0.53%	7.0%	11
Maryland	0.43%	7.0%	18
Ohio*	0.36%	8.5%	29
Virginia	0.22%	6.0%	41
<i>Average State</i>	<i><u>0.40%</u></i>	<i>Median</i>	<i><u>7.0%</u></i>



## APPENDIX F

### Minimum Corporate Taxes By State<sup>230</sup>

<u>State</u>	<u>Traditional Income Tax</u>	<u>Additional Franchise Tax</u>	<u>Minimum Fee</u>	<u>AMT Provisions</u>
Alabama	Yes	Yes	\$100	No
Alaska	Yes	No	No	18% of Fed AMT
Arizona	Yes	No	\$50	No
Arkansas	Yes	Yes	\$150	No
California	Yes	No	\$800	6.65% AMT
Colorado	Yes	No	No	No
Connecticut	Yes	No	\$250	0.31% Franchise
Delaware	Yes	Yes	\$35	No
District of Columbia	Yes	No	No	No
Florida	Yes	No	No	3.3% AMT
Georgia	Yes	No	No	No
Hawaii	Yes	No	No	No
Idaho	Yes	No	\$20	No
Illinois	Yes	No	No	No
Indiana	Yes	No	No	No
Iowa	Yes	No	No	7.2% AMT
Kansas	Yes	Yes	\$55	No
Kentucky	Yes	No	\$175	Various AMT
Louisiana	Yes	Yes	\$10	No
Maine	Yes	No	No	27% of Fed AMT
Maryland	Yes	No	No	No
Massachusetts	Yes	Yes	\$456	No
Michigan	No	Yes - SBT	No	No
Minnesota	Yes	No	No	5.8% State AMT
Mississippi	Yes	Yes	No	No
Missouri	Yes	No	No	No
Montana	Yes	No	\$50	No
Nebraska	Yes	Yes	\$26	No

<sup>230</sup>

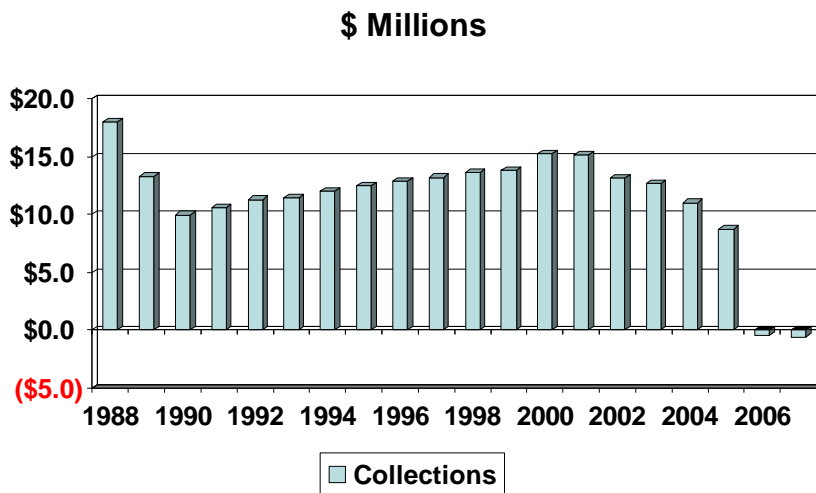
Source: Commerce Clearing House, *2005 State Tax Handbook*

**APPENDIX F**  
(Continued)

<u>State</u>	<u>Traditional Income Tax</u>	<u>Additional Franchise Tax</u>	<u>Minimum Fee</u>	<u>AMT Provisions</u>
Nevada	No	Yes-Wage Tax	No	No
New Hampshire	Yes	Yes-BET	No	No
New Jersey	Yes	No	\$500	Various AMT
New Mexico	Yes	No	No	No
New York	Yes	No	\$100	Various AMT
North Carolina	Yes	Yes	\$35	No
North Dakota	Yes	No	No	No
Ohio	Yes – Phase Out	Yes - CAT	\$50	No
Oklahoma	Yes	Yes	\$10	No
Oregon	Yes	No	\$10	No
Pennsylvania	Yes	Yes	\$75	No
Rhode Island	Yes	No	\$500	Capital Stock AMT
South Carolina	Yes	Yes	\$25	No
South Dakota	No	No	No	No
Tennessee	Yes	Yes	\$100	No
Texas	No	Yes - GMT	No	No
Utah	Yes	No	\$100	No
Vermont	Yes	No	\$250	No
Virginia	Yes	No	No	No
Washington	No	Yes - B&O	No	No
West Virginia	Yes	Yes	\$50	No
Wisconsin	Yes	No	No	No
Wyoming	No	Yes-Franchise	No	No
Note: SBT - Single Business Tax, BET - Business Enterprise Tax, CAT - Commercial Activity Tax				
GMT - Gross Margins Tax, and B&O - Business and Occupation Tax				

## APPENDIX G

### Telecommunications Tax Collection History



## APPENDIX H

### 2002 TAX CREDIT REFORMS

- (a) Termination or elimination of ineffective credits -
- (i) **Coal Based Synthetic Fuels Credit** - Terminated 11-13D-3d, effective 12/31/02.
  - (ii) **Aerospace Industrial Facility Credit** - Terminated 11-13D-3f and grandfathered existing credits, effective 12/31/02.
  - (iii) **Value-Added Wood Manufacturing Operations Credit** (11-13M) – Allowed to expire 7/1/02.
  - (iv) **Value-Added Agricultural Products Credit** - Amend 11-23-24a and 11-24-22a to grandfather existing credits and terminate the credit as of 7/1/02
  - (v) **Value-Added Steel Manufacturing Operations Credit** - Amend 11-13N-4 to change the expiration date of the credit from 7/1/05 to 7/1/02. Expired 7/1/02
  - (vi) **Value-Added Aluminum or Polymer Manufacturing Operations Credit** (11-13O) – Allowed to expire 7/1/02.
  - (vii) **Housing Development Projects Credit (11-13D-5a)** - Terminated with existing entitlements grandfathered, effective 12/31/02.
  - (viii) **Convenience Food Store Security Tax Credit** - Terminated section 21-13-5, effective 3/9/02.
  - (ix) **Increased Generation of Electricity Tax Credit** - Current provision (11-13H) was allowed to go inoperative, because it provides a credit against 11-13-2m tax, and the provisions of West Virginia Code §11-13-2m are no longer operative, so the credit is no longer operative.
  - (x) **Coal Coking Facilities Credit** - Terminated 11-23-24 and 11-24-22, effective 7/1/02.



**APPENDIX H**  
(Continued)

(b) Replacement or refinement of tax credits.

- (i)(A) Terminated the **Super Credit** (business investment and jobs expansion tax credit) (11-13C-1 *et seq.*), and grandfathered existing credit entitlements, effective 12/31/02.
- (i)(B) Enacted the **Economic Opportunity Credit** (11-13Q-1 *et seq.*) for investments made on and after 1/1/03, as a replacement for the super credit -- The change from super credit to economic opportunity tax credit was a realignment of State tax credit policy to cause a more effective and more targeted credit structure, with greater accountability, and it also represents a tax simplification measure.
- (ii)(A) Terminated the **Industrial Expansion and Revitalization Tax Credit** (11-13D-1 *et seq.*) for all businesses except electricity generation businesses, and grandfathered existing entitlements, effective 12/31/02.
- (ii)(B) Enacted the **Manufacturing Investment Tax Credit** 11-13R-1 *et seq.* for investments made on and after 1/1/03, as a replacement for the industrial expansion and revitalization tax credit for all manufacturing businesses other than electricity generators. The change from industrial expansion and revitalization tax credit to manufacturing investment tax credit was a realignment of State tax credit policy to cause a more effective and more targeted credit structure, with greater accountability, and it also represents a tax simplification measure.
- (iii)(A) Terminated former **Research and Development Projects Tax Credit** 11-13D-5, with existing entitlements grandfathered, effective 12/31/02.
- (iii)(B) Enacted the **Strategic Research and Development Tax Credit** (11-13R-1 *et seq.*) for investments made on and after 1/1/03, to replace the 11-13D-5, Research & Development Projects tax credit. The change from 11-13D-5 research & development projects tax credit to 11-13R-1 strategic research and development tax credit was a realignment of State tax credit policy to cause a more effective and more targeted credit structure, with greater accountability, and it also represents a tax simplification measure.