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State & Local Tax Policy To Watch In The 2nd Half Of 2019

By **Matthew Nesto**

Law360 (July 19, 2019, 11:32 AM EDT) -- From efforts to expand the sales tax base to new services and industries to proposed taxpayer-funded climate change mitigation plans, the second half of 2019 is expected to see a number of spirited state and local tax policy debates.

Although tax receipts have been strong, fears of an impending economic slowdown have tax writers looking to take action to shore up revenues and reserves before it's too late.

Here, Law360 looks at five key state and local tax policy issues to watch in the second half of the year.

Waves crash against a seawall and homes in Scituate, Massachusetts, in March 2018. Massachusetts' governor and the House speaker have backed competing bills that would commit $1 billion to shore up seawalls and other infrastructure projects to deal with increasing regularity of extreme weather. (AP)

Sales Tax Modernization and Expansion

Although most state legislatures have recessed for the year, those that do meet will receive that much more attention and scrutiny, especially if their work involves a major overhaul of their state sales tax system.

The percentage of personal consumption subject to sales and use tax has fallen from about 50% to 35% in the past 20 years, the Tax Foundation reports, noting that conditions are ripe for reform.

"There's a growing bipartisan consensus that sales tax bases should be 'right-sized' to reflect a 21st century economy, but a belief is one thing and putting it into practice is quite another," said Jared Walczak, senior policy analyst with the conservative-leaning Tax Foundation. "It's only a question of who goes first, and whether the template they create is a good one."

Walczak suggests Utah policymakers could be the ones to watch in the near term, as lawmakers there may use a special session to take up reforms put forth by the governor and a special sales tax task force. Under a bill, the state corporate franchise tax would drop to 4.75% from 4.95% and the state sales

tax would fall to 3.1% from 4.7% by October 2020.

“[Utah lawmakers] have a unique opportunity not only to lead on sales tax modernization, but to make it a well-designed, pro-growth reform,” Walczak said.

Utah is not alone in this endeavor. Last month, Connecticut passed its own sales tax modernization plan within its budget, which left the state’s current 6.35% sales tax rate intact, but expanded the levy to scores of previously untaxed services, including digital downloads, dry cleaning, parking and interior design.

Climate Change Mitigation

Where carbon taxes and plastic bag fees had dominated the environmental policymaking discussion, climate change mitigation efforts — and how to pay for them — have fast become the hottest area of debate, and the second half of 2019 should see continued examples.

Already this year, the Republican governor of Massachusetts and the Democratic House speaker have put forth competing bills that would commit $1 billion to shore up seawalls, bridges and other infrastructure projects deemed at risk due to the increasing regularity of extreme weather.

While Gov. Charlie Baker’s plan would be paid for by a 50% increase in the real estate transfer tax and the alternative version would see the state issuing new debt, either scenario represents a new and costly burden.

According to Joseph Krist, a partner at Court Street Group Research LLC who has analyzed state and local taxation and municipal credit for 50 years, the implications of the budding climate change mitigation costs will be significant and extend well beyond Massachusetts.

“Whether it's raising roads in Florida or resilience projects like the plan to build a seawall on Manhattan's East River, to relocating transit facilities, it impacts every section of the country,” Krist said, highlighting California’s newly created $21 billion fund to help utilities pay for claims arising from future wildfires sparked by their equipment.

Other venues taking action on this front include Orange County, North Carolina, where in June the Board of County Commissioners passed a one-quarter of a cent property tax increase, representing about $500,000, to fund county efforts to combat climate change.

“All sectors will be impacted and it should be clear right now that governments will have to be at the forefront of the mitigation effort,” Krist said, “whether it be costs incurred for their own efforts or financial support for private entities, especially those providing vital public goods.”

Challenging, Complicated and Aggressive Policy

Passage of the federal Tax Cuts and Jobs Act may seem like old news, but for most businesses the second half of 2019 will be when the TCJA’s impact will begin to be felt. That’s because, over the next few months, 2018 federal and state business tax returns will start to be filed, and 2018 is when most of the changes occurred.

“The coming 2018 business tax compliance season will likely be a challenging one, with taxpayers facing

a number of considerations and questions as they translate and apply the federal tax reform changes for multiple state returns," said Scott Smith, the national technical leader of BDO USA LLP's state and local tax practice.

Whether it's new rules surrounding the treatment of foreign income, interest limitation, bonus depreciation, Wayfair repercussions or myriad other tax changes that started in 2018, Smith and others expect the next few months to be costly, complicated and burdensome.

"Midsize companies are paying tens of thousands of dollars to third-party software companies to help administer sales taxes in economic nexus states, and that's just the beginning. Wait for the audit defense costs," said Eric Fader, BDO's state and local tax managing director. "It's incredibly complicated, especially with federal tax reform and GAAP changes running in parallel."

Taken together, it is part of a broader movement that some say reflects a new aggressiveness in that states are pushing the boundaries of taxation into areas that had previously been off-limits, whether by testing the boundaries of Public Law 86-272, or by not fully decoupling from the TCJA's global intangible low-taxed income provision.

"This trend toward boldness will continue as states and cities see results from prior aggressive action and now salivate over constitutionally protected foreign income arising from the Tax Cuts and Jobs Act," said Mitchell Newmark, a state and local tax partner at Morrison & Foerster LLP.

Newmark is preparing for further disputes in the second half of 2019 as states take creative new shots at what he called protected income and transactions.

Tinkering with Texas Property Tax Caps

Beneath its oft-touted economic growth and low-tax status, the state of Texas is also home to one of the nation's most divisive disputes over how best to rein in and limit sharp increases in property taxes, a fight that is expected to continue in the second half of 2019.

Following the governor's signature on a bill that will require cities and counties to get voter approval for any annual revenue increase above 3.5% starting in 2020**,** tax policy watchers say the local response over the next few months could prove very interesting. Some cities and counties have announced plans to adopt rate increases up to the current statewide rate hike cap of 8% to create a cash surplus to cushion against the lower revenue increase limits that start next year, according to Dick Lavine, senior fiscal analyst at the Center for Public Policy Priorities in Austin, Texas.

"The thing to watch is reaction from state officials, who had promised to limit the rate of growth of property taxes, and the public, which may see cutbacks in local public services," Lavine said.

At the same time, a separate fight could emerge within Texas school districts, which will be facing a different and even tighter 2.5% annual cap starting in 2021. This comes as the state has promised to increase aid to public education, while at the same time, is requiring school districts to lower their tax rates by an average of 8% this fall, Lavine said.

When signing the bill in June, Republican Gov. Greg Abbott said the new law would provide additional funding to recruit and retain teachers while also providing lasting property tax relief to homeowners.

Tighter Tax Incentives Scrutiny

Amazon's outsized HQ2 search to locate its second headquarters may be over, but the fallout, increased scrutiny and aftermath within the broader economic incentive arena is pegged to remain in the spotlight for the balance of this year and beyond.

For Nathan Jensen, a professor in the Department of Government at the University of Texas at Austin who researches and writes about economic development strategies, it's the sheer number of states that are rethinking their incentive programs that strikes him.

"Kansas and Missouri are considering a truce on offering incentives for firms moving back and forth across the Kansas City border," Jensen said, adding that large tax incentives for capital intensive investments are about to expire in Texas, while New Jersey finds itself in the midst of a major economic development scandal.

The Garden State will also be home to a second-half showdown over the extension of tax incentives that expired July 1**.** Gov. Phil Murphy has repeatedly promised to veto a bill that would authorize an eight-month extension of the current embattled program, but he has yet to act on that threat.

If Murphy does veto the bill, and his fellow Democrats who control the Legislature override his veto, it would be the first veto override in 20 years.

Meanwhile, the repercussions from Wisconsin's $4.5 billion tax incentive plan that enticed Taiwanese high-tech giant Foxconn to build a plant and bring 13,000 new jobs to the state are expected to remain in focus in the second half of 2019. Foxconn continues to renegotiate to reflect its reduced headcount forecast, and local communities digest the reality of recent credit rating downgrades due to offsetting tax breaks they granted with debt to finance business investments.

"These are all significant developments where incentives, often in the form of tax abatements, are seen as ineffective economic development tools that costs states and local governments [an estimated] $45 to $80 billion range every year," Jensen said.

--Editing by Tim Ruel and Vincent Sherry.