INSIGHT: Between a Pandemic and a Hard Place—State and Local Governments Respond to Coronavirus-Prompted Budget Shortfalls

BY JEFFREY KATZ

State and local governments' finances have begun to see the effects of the Covid-19 pandemic. From decreased consumer spending (and correspondent sales and excise tax revenues) to increased unemployment (and correspondent expenses, as well as decreased income and payroll taxes), tax revenues have dropped precipitously in recent months as expenses have increased—creating a perfect storm for these governments as they look to the next fiscal year. Already, states such as *New Jersey* and *Texas* are facing the crunch, and government-funded institutions are *facing serious downstream impacts*.

The federal government has extended this year's income tax filing deadline to July 15, with most states joining in the extension for their respective filing deadlines. Given that the majority of states' fiscal years end on June 30, the extensions—while well-intentioned—will almost certainly result in budget shortfalls at the end of the current fiscal year, with the Center on Budget and Policy Priorities estimating the shortfalls to reach 15% this fiscal year and over 25% in FY 2021. As *most states retain statutory or constitutional balanced budget requirements*, absent significant federal relief, states will likely scramble to address their near-term financial shortfalls.

While states may receive additional financial support from the federal government in a potential forthcoming relief package, it is unlikely those proceeds alone will suffice to address the pandemic's long-term financial impact. As such, states and localities will likely examine and implement additional independent solutions to fully address their budget woes. These governments have numerous options at their disposal to address their financial problems, and will likely approach the issue with a combination of budget cuts, increases in existing tax rates, and/or the introduction of new sources of tax revenue.

INCREASES ON EXISTING TAXES: ESTATE, PROPERTY, SALES, AND EXCISE TAXES

Estate Taxes

While all individuals are subject to federal estate taxes for assets totaling above *statutorily-defined thresholds*, only *twelve states and the District of Columbia* impose their own estate taxes. Like their federal counterpart, states' estate taxes arise only above statutorily-defined valuation exemption thresholds, ranging from as low as $1 million (in Massachusetts and Oregon) to as high as $11.2 million (in the District of Columbia and Hawaii). Assets above the exemption threshold are subject to tax rates as low as 0.8% (in Illinois, Massachusetts, and Rhode Island) and as high as 20% (Washington).

As a stable form of taxation currently levied only on the wealthiest estates, states that still impose estate taxes are likely to consider either reductions in the exemption threshold valuation or increases in applicable tax rates as means of addressing revenue shortfalls from Covid-19. Those that have abolished it in recent years may even consider its return. Given the inherent political unpopularity of imposing a new tax in dire economic conditions, however, states and localities may simply move to increase their enforcement of applicable taxes through audit and accountability mechanisms to ensure they reap the revenues due.

Similarly, and even perhaps more significantly, the *federal* government's deficit has increased substantially as a result of increased costs attributable to pandemic response and relief packages. This phenomenon increases the likelihood federal legislators will seek alternative opportunities to raise revenue. Beyond changes to estate tax thresholds (which currently sit at $11.58 million for individuals and $23.16 million for married couples) or estate tax rates (which currently max out at 40%), investment income is a likely target and also a potentially significant item for individuals with substantial estates. Such changes may include the federal government *closing the GRAT loophole*, among others; however, like the states, the unpalatable nature of a tax increase may similarly lend to calls for increased enforcement rather than tax hikes or decreases in exemption level.

Property Taxes

All 50 states and the District of Columbia impose property (real estate) taxes, which provide a significant source of local government revenue. For example, in Montgomery County, Maryland, property tax accounted for *46.2%* of the county's total 2019 tax revenue; similarly, in the neighboring District of Columbia, property tax provided *29.8%* of the District's total 2019 tax revenue. In both jurisdictions, property tax rates hover around 1% of the property's assessed value.

As the most *stable tax* in a recession, an increase in property tax rates could provide a reliable source of incremental revenue for states and localities seeking to satisfy shortfalls resulting from the pandemic. Counties in *Kentucky*, *Nevada*, and *Virginia* have already approved such increases for the coming year, while Texas Governor Greg Abbott has *urged* localities to abstain from such increases; *other localitiescontinue to consider* the option.

Some states and localities have considered increasing property tax rates, but have ultimately decided against it. For example, Philadelphia Mayor Jim Kenney sought a 4% property tax increase in his budget for the coming year—but *reneged on the request* after the Pennsylvania General Assembly approved increases in its budget that would provide the needed funds. As states and localities consider the dramatic downstream impacts of budget shortfalls, *particularly as related to education*, property taxes will remain an important sector to watch.

Alternatively, states and localities may consider changes to the methods through which they tax commercial property. Because of a rise in business closures and subsequent real property vacancies due to the economic impact of Covid-19, commercial property valuations (and, thus, property taxes) may decrease. States and localities may thus redefine valuation mechanisms to ensure the stability of their property tax revenues.

Sales and Excise Taxes

States thus far have been hesitant to raise sales taxes on goods and services. Lawmakers have not been shy, however, in ensuring that any increase in the price of goods is taxable under their respective law. The clearest examples appear in the treatment of surcharges added onto take-out and food delivery orders. Utah's State Tax Commission has *required* restaurants to collect sales tax on all deliveries going back to May 1st. Arkansas's Department of Finance and Administration took the same approach in a private letter *ruling* issued May 7. The underlying reasoning seems to be that any surcharge the seller adds onto the customer's bill counts as part of the sales price for the purposes of sales taxes. *Texas* and *Chicago* have reasoned as such, deeming surcharges as part of the price of all food and beverages sold by restaurants, thereby increasing the basis for sales tax on each transaction. State and local jurisdictions have not limited themselves to brick-and-mortar establishments in their quest to make up their budget shortfalls.

Digital taxes have been gaining traction as a potential new source of state tax revenue. Some states have been pondering imposing taxes on websites offering subscriptions, video streaming, or marketplace services. The prospect of *taxing online services* seems alluring, for residents will be consuming online content no matter where they reside, rendering a service provider's move out of the state superfluous. In particular, Maryland's Senate held hearings on a *bill* imposing a tax on digital advertising revenues in late January. Maryland lawmakers are optimistic that this new tax, taxing gross digital advertising revenues at a ceiling of 10%, could raise $250 million in its *first year* if passed. Nebraska is contemplating taxing digital advertising in the same vein, amending their sales and use tax to cover digital advertising revenues. Lawmakers there expect the *bill*, introduced in mid-January, to raise $43 million in the next *fiscal year* should it pass.

And, as much as states have been exploiting new revenue streams in the wake of Covid-19, they have also been exempting excise taxes on commodities and services deemed necessary to contain Covid-19. New Jersey has fashioned exemptions tailored to manufacturers and sellers of alcoholic beverages. Generally, the state is *waiving* excise taxes on the sale and distribution of alcoholic beverages for the duration of New Jersey's state of emergency. In particular, distillers may apply to have the alcohol taxes refunded where the alcohol was used to manufacture hand sanitizer. To facilitate essential commerce in Kansas, Governor Laura Kelly issued Executive Order 20-44. This *order* waived registration and fuel tax permit fees for owners and operators of commercial vehicles contributing to Covid-19 relief.

In sum, states have been making tailored tweaks to their statutory code, and issuing administrative guidance from executive departments to either raise revenue or provide relief to essential infrastructure. Introducing entirely new revenue sources, like digital advertising taxes, through new legislation can be expected to pick up steam as states continue to loosen their stay-at-home orders.

E-Commerce Transaction Tax

In 2018, the U.S. Supreme Court *ruled* that internet retailers can be required to collect sales taxes even in states where they have no physical presence. This decision helped restore the lost revenues as e-commerce replaced brick and mortar sales and to balance the competitive landscape between the two. With the pandemic acting as a further stimulus for online sales and, in turn, an additional irritant to the states' budget problems, states will likely consider increasing the tax rates on e-commerce transactions and/or lowering the thresholds where the taxes are *applicable*.

Retirement Account-Related Legislation May Play Critical Role in Increasing Tax Revenue

The federal government has recently changed the state of play with regards to required minimum distributions (RMDs)—the amount of money that retirement-age individual retirement account (IRA) owners and qualified retirement plan participants must withdraw from certain types of IRAs. The *SECURE Act*, which President Trump signed into law in December 2019, increased the RMD age for qualifying 401ks and IRAs from 70.5 to 72. This change reflected America's increased average life expectancy since the last RMD age determination set in the 1960s (which was based on then-current expectations of labor trends and worker longevity).

Facially, this change benefits retirees; however, other elements of the Act work to the detriment of those inheriting IRAs or 401(k)s. For example, while previous legislation allowed for beneficiaries to receive distributions of inherited IRAs and 401ks over their lifetimes, the SECURE Act requires such beneficiaries to receive these distributions over just 10 years. As with the potential changes to estate and property taxes, attorneys and clients working through the estate planning process should consider these nuances as they make decisions for the future. Although it cannot be said with certainty, revisiting your estate plan in advance of any changes in legislation may serve to mitigate the impact of the same.

Notably, declining American *life expectancies related to the opioid crisis, disparities in the provision of mental health*—and, *potentially, the coronavirus*—may impact the RMD in future legislative reviews and revisions to these provisions. Estate planning attorneys may want to watch Capitol Hill carefully as scientists and public health officials deliver future revisions to the nation's average life expectancy.

UNLIKELY SOURCES PROVIDE NEW OPPORTUNITIES FOR TAX REVENUE

Lawmakers wary of cutting budgets or raising existing taxes will likely look at recent legislative action related to online gambling and recreational marijuana and consider the benefits of introducing new sources of state revenue. Upon legalization of online gambling and recreational marijuana in New Jersey and Illinois, respectively, state lawmakers levied an excise tax, or an excess, legislated tax on all online gambling and marijuana sales. Almost all states currently levy excise taxes on fuel, alcohol, and tobacco sales. Further, consumer spending on online gambling and marijuana has remained steady during the pandemic in New Jersey and Illinois, and the related excise taxes are providing much-needed revenue to the states in a time of financial distress.

While the pandemic has forced actual casinos to shut their doors, online gambling is thriving, and it is not difficult to see why. With millions of people confined to their homes, online entertainment is a go-to remedy to boredom. New Jersey, one of the few states where web-based casino gaming is legal, reported internet gambling tax revenues rose to $65 million in March 2020, a 66% increase from March 2019. Pennsylvania, another state that allows online casino gambling, reported more than $43 million in tax *revenue* from online casinos. *Thomas Allen*, a Morgan Stanley gaming analyst, believes the pandemic's economic impact could motivate more states to legalize online gambling. The taxes associated with the legalization of online gambling in states that currently do not allow it would mitigate the impact of lost revenues resulting from the pandemic.

States may also look to the legalization of marijuana as a new source of tax revenue. For example, even before the pandemic, Illinois legalized the sale of marijuana for recreational use without a public vote as a step towards addressing its financial challenges. In the first four months of legalization, sales of recreational marijuana in Illinois were over *$145 million*. The state tax revenue associated with the sales is between 16.25% and 31.25% of the $145 million. Reflecting on the success of legalized marijuana as a source of revenue, *Governor Lujan Grishman* has voiced regret that New Mexico did not legalize marijuana this year because she believes it could have given the state's economy the help it needs to combat the lost revenue as a result of the pandemic. Likely, New Mexico's governor is not alone in her view of legalizing recreational marijuana as a potential offset to the tax revenue shortfalls resulting from Covid-19.

Conclusion

With state and local budgets under fire as a result of the Covid-19 pandemic, government officials will continue to search for innovative ways to raise revenue without overtly raising taxes or burdening their citizens. Ideas likely to be considered include reallocating resources to enforce current laws, redefining what is taxable, and committing economic sleight of hand by accelerating the distribution of retirement accounts. In addition, states may contemplate new forms of taxation, including online casino gambling, recreational marijuana, and online transactions. States that have traditionally relied on tourism-based excise taxes, such as those on car rentals and hotels, will increasingly look to their domestic population to fill the gaps. There is no one, universal solution to every state and local budget suffering financial distress. As each state and local governments' budgets are unique, so too will their solutions be, pushing the envelope on the flexibility and agility of state governments as Covid-19 continues to disrupt American society.

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