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Insights: Alerts

COVID-19's Impact on State and Local Taxes

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Please note: The below information may require updating, including additional clarification, as the COVID-19 pandemic is dynamic and continues to develop. Please monitor this site and/or your email for updates.

COVID-19 has been described as a virus that may be as contagious economically as it is medically.[1] It has already caused the stock market to plummet. The sensible steps being taken to prevent it from spreading, such as curtailing travel and public gatherings, are causing the economy to grind to a halt. At this time, it is difficult to know if this is a short-term blip and everything will soon return to normal or if instead the present "new normal" will continue throughout 2020 and beyond. Either way, there will be a negative impact on 2020 state tax collections, which may cause states to consider various measures to protect the fisc. This alert summarizes COVID-19's potential state tax revenue impact, anticipates ways states could respond, and suggests a course of action for business taxpayers.

Revising State Tax Revenue Estimates Downward

Economists have been revising state tax revenue forecasts for 2020 downward. This is not surprising. States generally receive most of their tax revenue from sales taxes, excise taxes, and personal income taxes. All of these will be negatively impacted by COVID-19. With respect to sales taxes, large retailers are increasingly closing their stores, and many states and cities have already mandated the closure of restaurants and other businesses; as a result, consumers are expected to make fewer taxable purchases, putting downward pressure on sales tax revenues. In connection with excise taxes, with most professionals working from home and almost all large events cancelled, it is expected that citizens will decrease their driving, meaning that they will buy less gasoline for their cars, resulting in the states receiving less gasoline excise tax than projected. Additionally, reduced travel will mean a decrease in hotel stays, causing states to receive considerably less hotel excise tax than forecasted. With respect to personal income tax, lower overall employee payouts in 2020 will mean a decrease in state personal income tax collections from withholding and from annual returns.

Potential State Legislative Responses

The states will want to find a way to make up for the projected shortfall in state tax collections resulting from COVID-19. While states will surely look for ways to reduce spending, it must be expected that they will also consider state tax legislation that would increase their coffers as well.

State legislative action during the 2009 recession seems a fair point of reference for what states might do in 2020. In 2009, many states passed legislation that created higher tax brackets for individuals, raised the rates on excise taxes such as cigarette taxes, and suspended or eliminated certain deductions, such as net operating losses and capital losses. States also proposed new sales tax laws designed to increase revenue (click-through nexus laws started to become more widely adopted in 2009, for example). Borrowing from the 2009 playbook, it would not be surprising to see states raise top rates, suspend some deductions, and enact new base-broadening sales tax laws in 2020 to try to mitigate the decrease in tax collections resulting from COVID-19.

Impact on State Tax Audits and Controversies

States seeking increased revenue are likely to ramp up audits of high dollar value issues, such as sales of interests in pass through entities, taxability of computer software, residency audits, remote seller sales tax nexus, and inclusion of foreign income in state combined returns. Audits launched in 2020 would generally cover older "boom years" in which the stock market was steadily climbing and many individuals and businesses had positive net income.

In the case of "old and cold" state tax appeals, some states may wish to cut a deal to receive immediate payment rather than continue to let an old controversy continue to slowly wend its way through the administrative appeals system. As a result, there may be opportunities to resolve old, lingering controversies that up till now have been difficult to settle, since states now have a new incentive to settle, namely to receive immediate payment in 2020 to boost tax collections for the year.

And speaking of administrative appeals systems – COVID-19 is likely to put the brakes on audits and appeals in many states, at least in the short term. Audit meetings, appeals conferences, and trials will need to be postponed or held via audio. This will slow the appeals process down and may create a backlog or further contribute to an already existing one.

Increased Focus on Amnesty and State Voluntary Disclosure Programs

Amnesty and voluntary disclosure programs are great tools for producing immediate revenue (i.e., revenue in 2020) in down economic years. The states do not need to chase after this revenue either, as taxpayers "come out of the woodwork" to apply for these programs. Both programs thus offer states the potential for a "shot in the arm" of immediate revenue in exchange for the waiver of at least some penalties and interest for tax issues disclosed through the programs.

In light of the immediate benefit of these programs, it is likely that states will offer new amnesty programs and will more aggressively promote their already-existing voluntary disclosure programs.

Extension of Filing Deadlines

States are beginning to offer extensions of tax filing deadlines in response to COVID-19. It should not be assumed that all deadlines for all state taxes will be extended or that all extensions are automatic (in some cases, it may be necessary to apply for an extension). Hopefully states will waive penalties where returns are filed late due to a taxpayer's regular tax return preparer (or in-house accountant) experiencing COVID-19-like symptoms that prevent regular work during filing season. In the past, the states have generally agreed that a taxpayer's serious illness provides "reasonable cause" to waive penalties for a late filed return, but have not always granted the same relief where a tax return preparer is ill. Given that most states have declared a "state of emergency" due to COVID-19, one would hope that on the whole states would be lenient about waiving penalties where there is a supportable COVID-19-related basis for a late-filed return.

Suggested Course of Action for Business Taxpayers

Business taxpayers should do four things in light of the anticipated response by the states to COVID-19. First, they should monitor state tax legislation and administrative guidance to get a sense of what states intend to do to generate more tax revenue and think about the impact any new legislation or administrative positions will have on their business models. Second, they should objectively consider their own potential soft spots, including intercompany transactions or sales of interests in pass-through entities, that might be targeted in a state tax audit, making sure to develop their best defenses to any state tax audits of those issues. Third, they should look at the deadline extensions being offered by states and decide whether they want to take advantage of any of the extensions and what, if anything, they must do to obtain an extension. Finally, they should be opportunistic, looking to see if they can clean up any old audits or potential exposures as a result of the states being more open to "cut a deal" for immediate payment to offset tax collection shortfalls directly or indirectly caused by COVID-19.

Footnotes

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[1]Richard Baldwin and Beatrice Weder di Mauro (editors), *Economics in the Time of COVID-19*, page 1.

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