TaxNewsFlash

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Regulations implementing funding to support state and local governments (COVID-19)

Regulations from the U.S. Treasury Department and published as an interim final rule in today's edition of the Federal Register implement funding provisions to support state and local governments as they manage the public health and economic consequences of the coronavirus (COVID-19) pandemic.

President Biden on March 11, 2021, signed into law the "American Rescue Plan Act of 2021" that allocates $350 billion in funds to support state and local governments with regard to COVID-19 challenges.

Today's **interim final rule** [PDF 885 KB] provides that eligible state and local government recipients may use the funds to:

- Support public health expenditures
- Address negative economic impacts caused by the public health emergency
- Replace lost public sector revenue
- Provide premium pay for essential workers
- Invest in water, sewer, and broadband infrastructure

Funds not to be used to offset a reduction in net tax revenue

In general, state and local government recipients have considerable flexibility to use the funds to address the diverse needs of their communities; however, the legislation specifically prohibits states from using the funding to directly or indirectly offset a reduction in net tax revenue—giving rise to a concern about a perceived possible coercive nature of such a restriction on a state's authority to set its own policy

The interim final rule details the manner in which Treasury will assess whether a state or locality has violated the tax cut restriction. A reduction in net tax revenues must result from a "covered change" during the "covered period."

- The covered period runs from March 3, 2021, through the last day of the fiscal year in which the funds provided have been spent.
- "Covered changes" include final changes in law, regulations or administrative interpretations when the phase-in or taking effect of those changes was not prescribed prior to the start of the covered period.

Covered changes specifically exclude the following: administrative interpretive changes intended to correct prior inaccurate interpretations; automatic statutorily or regulatory triggered rate changes in effect prior to the covered period; and changes that simply conform with recent changes in federal law (e.g., federal treatment of Paycheck Protection Program (PPP) loans).

To the extent that states use the funds to offset a reduction in net tax revenue, the funds will be required to be repaid.

To determine if there is a reduction in net tax revenue, a state must measure the difference between its actual tax revenues and its baseline revenue (2019 revenues adjusted for inflation). If there is a reduction, the state must demonstrate that the tax cuts were funded by permissible sources other than funds received under the legislation. Such permissible sources include enacted policies that raised other sources of revenue; spending cuts not offset with funds from the March 2021 legislation; and higher revenues due to economic growth.

If sufficient funds from other sources cannot be identified to cover the full cost of the reduction in net tax revenue, the remaining amount not covered by these sources will be considered to have been offset by funds from the legislation. If this occurs, the deficit funds will be subject to recoupment by the U.S. Treasury.

Read a **May 2021 report** prepared by KPMG State and Local Tax professionals

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