DEPARTMENT OF TAXATION
2004 Fiscal Impact Statement

1. **Patron** L. Louise Lucas

2. **Bill Number** SB 589
   House of Origin:
   X **Introduced**
   ____ **Substitute**
   ____ **Engrossed**

   Second House:
   ____ **In Committee**
   ____ **Substitute**
   ____ **Enrolled**

3. **Committee** Senate Finance

4. **Title** Tax Reform

5. **Summary/Purpose:**

This bill would make the following changes to Virginia's tax code:

- The current individual income tax rates would be changed to 2% on income up to $3,000, 5% on income above $3,000 up to $25,000, 5.75% on income above $25,000 up to $60,000, 6.5% on income above $60,000 up to $80,000, 7% on income above $80,000 up to $100,000, and 7.5% on income in excess of $100,000.

- Individual income tax standard deductions would be increased to $7,000 for married taxpayers and $3,500 for single and married filing separately taxpayers.

- Individual income tax personal exemption amounts would be raised to $2,500 per exemption.

- The individual income tax age deduction would be repealed.

- A nonrefundable income tax credit for sales taxes paid would be created for individuals whose Virginia taxable income is less than $50,000.

- The income tax credit for low-income taxpayers would be repealed.

- Pass-through entities doing business in Virginia would be required to file an annual informational return.

- The corporate income tax rate would be increased from 6% to 7.5%.

- The following two corporate income tax provisions will be changed:

    - The effects of transactions with intangible holding companies would be eliminated from the Virginia corporate income tax computation.

   - A sales throwback rule would be used to eliminate the effect of nowhere income by ensuring that profits on goods shipped from Virginia are taxed in Virginia, unless they are taxed in another state.

- The retail sales and use tax would be expanded to include most personal services.

- The entire retail sales and use tax would be eliminated on sales of food.

All of the provisions of this bill, except for the provisions amending the sales and use tax, would be effective for taxable years beginning on or after January 1, 2005. The sales and use tax provisions amended by this bill would be effective July 1, 2004.

6. Fiscal Impact Estimates are: Tentative. (See Line 8.)

6a. Expenditure Impact:

Fiscal Year	***Dollars***	***Positions***	***Fund***
2003-04	$1,008,353	8	GF
2004-05	$2,541,843	23	GF
2005-06	$1,740,290	23	GF
2006-07	$1,276,164	23	GF
2007-08	$1,236,533	23	GF
2008-09	$1,251,951	23	GF
2009-10	$1,267,831	23	GF

6b. Revenue Impact:

Fiscal Year	***Dollars***	***Fund***
2003-04	$0	GF
2004-05	$18.1 million	GF
	<$5.3 million>	TTF
	<$10.6 million>	Local
2005-06	$47.5 million	GF
	<$10.7 million>	TTF
	<$21.4 million>	Local
2006-07	$129.3 million	GF
	<$11.3 million>	TTF
	<$22.5 million>	Local
2007-08	$235.3 million	GF
	<$11.8 million>	TTF
	<$23.5 million>	Local
2008-09	$352.3 million	GF
	<$12.3 million>	TTF
	<$24.6 million>	Local

2009-10	$463.6 million	GF
	<$12.8 million>	TTF
	<$25.6 million>	Local

7. **Budget amendment necessary:** Yes.
ITEM(S): Page 1, Revenue Estimates
284 and 286, Department of Taxation

8. **Fiscal implications:**

Administrative Impact

The Department would incur administrative costs of $1,008,353 in Fiscal Year 2004, $2,541,843 in Fiscal Year 2005, $1,740,290 in Fiscal Year 2006, $1,276,164 in Fiscal Year 2007, $1,236,533 in Fiscal Year 2008, $1,251,951 in Fiscal Year 2009, and $1,267,831 in Fiscal Year 2010. These administrative costs would be for systems development, forms revisions, and 23 additional employees.

Some of the administrative costs that the Department would incur as a result of this bill are similar to the costs for some of the changes in the Governor's tax reform plan that are assumed in the Executive Budget. Assumed in the Executive Budget are costs of $493,724 for Fiscal Year 2004, $3,017,970 for Fiscal Year 2005, and $1,835,206 for Fiscal Year 2006 to implement the changes proposed in the Governor's tax reform plan.

Revenue Impact

This bill would result in an increase in state revenue of $12.8 million in Fiscal Year 2005, $36.8 million in Fiscal Year 2006, $118.0 million in Fiscal Year 2007, $223.5 million in Fiscal Year 2008, $340.0 million in Fiscal Year 2009, and $450.8 million in Fiscal Year 2010. The bill would decrease in local revenue of $10.6 million in Fiscal Year 2005, $21.4 million in Fiscal Year 2006, $22.5 million in Fiscal Year 2007, $23.5 million in Fiscal Year 2008, $24.6 million in Fiscal Year 2009, and $25.6 million in Fiscal Year 2010. This estimate is made assuming that the sales tax on services imposed by this bill is implemented on July 1, 2004. However, because of the large number of new dealers that would be required to collect the sales tax on the services they provide, it would be extremely difficult for the Department to properly implement this change by July 1, 2004. As an alternative, a July 1, 2005, implementation date for this provision would allow the Department an adequate time frame to implement this change.

This estimate reflects additional revenues on only selected services for which data is available. The total increase of subjecting all services, as proposed in this bill, to the sales and use tax is unknown. With the number of structural changes made to the tax system under this bill, the responses of taxpayers and the resultant impacts on their tax liability are difficult to predict. Therefore, the revenue estimates should be considered highly tentative.

The Executive Budget assumes the passage of the Governor's tax reform proposal. The Governor's tax reform proposal contains provisions that would amend the individual income tax, sales tax, corporate income taxes, cigarette tax, estate tax, and personal property tax. The following chart compares the General Fund revenue effects of this bill on current law with the changes to the General Fund revenue forecast, assumed in the Executive Budget, caused by the provisions in the Governor's tax reform proposal.

Fiscal Year	**Effect of SB 589 on General Fund Revenue**	**General Fund revenue effect of the Governor's tax reform proposal**	**Difference between SB 589 and the Governor's tax reform proposal**
2005	$18.1 million	$495.2 million	($477.1 million)
2006	$47.5 million	$553.8 million	($506.3 million)
2007	$129.3 million	$511.9 million	($382.6 million)
2008	$235.3 million	$448.3 million	($213.0 million)
2009	$352.3 million	$407.6 million	($55.3 million)
2010	$463.6 million	$462.6 million	($1.0 million)

Impact on State Revenue by Component

($ millions)	**FY 2005**	**FY 2006**	**FY 2007**	**FY 2008**	**FY 2009**	**FY 2010**
Individual Income Tax	($94.8)	($120.6)	($22.9)	$78.7	$190.8	$296.3
Business Taxes	$106.9	$172.1	$158.0	$163.8	$170.1	$177.4
Sales Tax	$0.7	($14.7)	($17.1)	($19.0)	($20.9)	($22.9)
Total	$12.8	$36.8	$118.0	$223.5	$340.0	$450.8

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: Yes.

If it is the intent of this bill is to continue taxing income not exceeding $3,000 at a rate of 2%, the following technical amendment is suggested.

Page 3, Line 132, After: on income
Strike: equal to or less than
Insert: in excess of $3,000, but not in excess of

11. Other comments:

Individual Income Tax Components

Income Tax Brackets

Current Law

The top two brackets have not been changed since 1987. The bottom two brackets have not been changed since 1926. The table below shows the current individual income rate and bracket structure.

Virginia Taxable Income Range	Rate
$3,000 or less	2%
$3,001 to $5,000	3%
$5,001 to $17,000	5%
$17,001 or more	5¾%

Proposed Change

Under this bill, the rates and brackets would be changed as shown below and would be effective for taxable years beginning January 1, 2005, assuming the technical amendment is adopted.

Virginia Taxable Income Range	Rate
$3,000 or less	2%
$3,001 to $25,000	5%
$25,001 to $60,000	5¾%
$60,001 to $80,000	6½%
$80,001 to $100,000	7%
$100,001 or more	7.5%

Standard Deduction

Generally

Currently, individual income taxpayers are entitled to claim a standard deduction on their Virginia return if they claimed a standard deduction on their federal return. The deduction amounts are as follows: $3,000 for single taxpayers; $5,000 for married taxpayers filing jointly; and $2,500 for married taxpayers filing separately. These amounts have been in effect since the 1989 taxable year.

Proposed Change

This bill would increase the standard deduction amounts for taxable years beginning on or after January 1, 2005 as follows: $7,000 for married individuals filing jointly; $3,500 for married taxpayers filing separately; and $3,500 for single taxpayers.

Personal Exemptions

Current Law

Virginia currently allows a deduction of $800 for each personal exemption allowed on a taxpayer's individual federal income tax return. An additional exemption amount of $800 is allowed for taxpayers who are blind or age 65 and over. This personal exemption amount was last increased by the General Assembly in 1987. From 1972 to 1986, Virginia's exemption amount remained constant at $600. For 1987, the exemption was $700.

Proposed Change

This bill would increase the personal exemption amount from $800 to $2,500. This would also apply to the additional exemption for those taxpayers who are blind or age 65 and over.

Age Deduction

Current Law

Virginia currently allows an age deduction for taxpayers age 62 or older. The deduction amounts are $6,000 for taxpayers age 62 through 64 and $12,000 for taxpayers age 65 and over. These amounts have remained unchanged since the 1996 taxable year.

Proposed Change

Effective for the 2005 taxable year, this bill would repeal the age deduction.

Tax Credit For Sales Taxes

This bill would create a nonrefundable individual income tax credit for sales and use tax paid by individuals whose Virginia taxable income is less than $50,000. The credit would be equal to the amount of sales and use tax paid during the taxable year not to exceed $120. An additional $150 in credit would be allowed for each dependent claimed on an individual's income tax return.

Tax Credit for Low-Income Taxpayers

The 2000 General Assembly enacted legislation that provided a $300 nonrefundable income tax credit for each personal and dependent exemption for individuals or married persons filing a joint return whose family Virginia adjusted gross income (“VAGI”) does not exceed 100% of the federal poverty guideline amount.

This bill would repeal the credit for low income taxpayers enacted by the 2000 General Assembly.

Business Tax Components

Pass-Through Entities

Current Law

Pass-through entities are business entities, such as partnerships, limited liability companies and Subchapter S corporations that are not subject to federal and state income taxes at the entity level. The partners, members or shareholders (the "owners") of the pass-through entity report their share of the income from the entity on their own income tax returns.

Under current law, the owners of pass-through entities are liable for Virginia income taxes on Virginia source income. However, the Department does not have an effective way of identifying these owners and verifying that they have properly paid tax on Virginia income. The revenue loss attributable to noncompliance on the part of the owners of pass-through entities has grown with the increased popularity of pass-through entities.

Pass-through entities are currently required to file informational returns with the IRS and most other states. Virginia formerly required partnerships to file such returns, but repealed the practice in 1988. New technology will enable the Department to utilize effectively the proposed informational returns to ensure that the owners of pass-through entities properly report and pay tax on Virginia income.

Proposal

This proposal would require every pass-through entity doing business in Virginia or having income from Virginia sources to file an annual informational return with the Department listing its income and owners.

This proposal would authorize the Department to establish an income threshold for the filing requirement. Pass-through entities with income below this threshold would not be required to file returns. This proposal would also allow pass-through entities to apply to the Department to file a single composite return for all nonresident shareholders. These provisions would help reduce the compliance burden on affected individuals.

Under this proposal, entities would be required to file returns using an electronic medium prescribed by the Department. However, the Department would be authorized to waive this requirement for businesses with small numbers of owners.

Corporate Income Tax Rate

The Virginia corporate income tax rate would be raised from 6% to 7.5%.

Intangible Holding Companies

Current Law

Corporations start with federal taxable income, which reflects deductions taken for royalties, interest and other expenses paid to an affiliated intangible holding company. If the corporation has done its planning correctly (i.e., established a nontax reason for the intangible holding company's existence and arm's length rates for their transactions), then Virginia cannot invoke its authority under existing law to correct transactions between related companies that improperly reflect income. In extreme cases, a corporation may contribute a valuable patent or trademark to an affiliated intangible holding company in a tax-free transaction, pay royalties for its use, then borrow the funds back from the intangible holding company and pay interest for the use of its own money.

Proposed Change

Corporations would be required to add back to federal taxable income any interest and intangible expenses directly or indirectly paid to one or more related members. A related member is defined by reference to the Internal Revenue Code. Two safe-harbors would be allowed:

- The add-back would not be required if in the same taxable year of the payment the item of income received by the related member is subject to a tax on or measured by the related member's net income in any state of the United States or a foreign country that has an income tax treaty in force with the United States.
- The add-back would not be required if the corporation can establish to the satisfaction of the Tax Commissioner both of the following:
    - The related member directly or indirectly incurred the same costs to a person who is not a related member (e.g., interest paid to a bank); and
    - The transaction did not have as a principal or primary purpose the avoidance of any state tax.

Nowhere Income

Current Law

A corporation that is doing business in multiple states and is subject to a corporate income tax in at least one other state apportions its income to the several states in which it makes sales based on a formula based upon the amount of property, payroll, and sales in each of those states. Currently, these corporations treat sales shipped out of Virginia as non-Virginia sales even if the corporation is not subject to an income tax in the destination state. (Foreign countries are "states" for this purpose.) Since these sales are not counted in assigning income to any state, they are commonly referred to as "nowhere income."

Proposed Change

The definition of Virginia sales would include the sales of products shipped from Virginia to a destination state (or foreign country) in which the corporation is not taxable. Because such sales are thrown back from the destination state to the shipping state, this provision is commonly referred to as a "throwback rule." This bill would restore a throwback rule that existed in Virginia's corporate income tax law until 1981.

For example, Corporation A is located in Virginia and New York. During the year, Corporation A ships all of its goods from Virginia to customers in Virginia, Maryland and New York. The goods shipped to New York increase the share of the corporation's income taxed by New York. Under current law, the goods shipped to Maryland reduce the share of the corporation's income taxed in Virginia even though no Maryland income tax is paid. With the proposed sales throwback rule, the goods shipped to Maryland would be treated as Virginia sales and correspondingly increase the share of the corporation's income taxed in Virginia.

Sales Tax Components

Sales and Use Tax on Services

Current Law

The sales and use tax is not currently imposed on the majority of services. However, other certain services are subject to the sales and use tax in Virginia. Typically, services provided in connection with the sale of tangible personal property where the tangible personal property is the true object of the sale are subject to the sales and use tax.

Proposal

This bill would impose the sales and use tax on all activities engaged in for other persons for a consideration that involve the rendering of services. Services provided to businesses for a legitimate business purposes and related to the rendering of health-care would be exempt.

Because of the large number of new dealers that would be required to collect the sales tax on the services they provide, it would be extremely difficult for the Department to properly implement this change by July 1, 2004. As an alternative, a July 1, 2005, implementation date for this provision would allow the Department an adequate time frame to implement this change.

Sales and Use Tax on Food

Current Law

As originally enacted, the Food Tax Reduction Program was to reduce the state sales and use tax rate on food products purchased for human consumption by 0.5% per year over a four year period. Beginning January 1, 2000, the state tax rate decreased to 3% for the period January 1, 2000 through March 31, 2001. Thereafter, the rate was scheduled to decrease to 2.5% for the period April 1, 2001 through March 31, 2002, 2% for the period April 1, 2002 through March 31, 2003, and to 1.5% effective April 1, 2003.

The tax rate reductions for April 1, 2001 and thereafter were to be effective provided two conditions were satisfied: (1) the next level of the phase-out of the tangible personal property tax under the Personal Property Tax Relief Act of 1998 was implemented for that fiscal year, and (2) actual General Fund revenues for the fiscal year preceding a fiscal year in which a rate reduction is contemplated exceeded the official revenue estimates for that second preceding fiscal year by at least 1 percent.

The current state sales and use tax rate on food products is frozen at 3%.

Current Allocation of Revenues from Sales of Food

Under the current Food Tax Reduction Program, the revenue generated from the 4.0% sales and use tax is allocated to the General Fund, the Transportation Trust Fund, and the localities. The General Fund currently retains tax revenues generated by the 1.5% tax rate for unrestricted use by the Commonwealth. The tax revenue from the 1% tax rate goes into the General Fund for educational purposes and is returned to the localities based on school-age population. The Transportation Trust Fund receives sales tax revenues from the 0.5% tax rate, and the remaining 1% represents the local option sales and use tax revenues.

Proposal

This bill would eliminate the entire retail sales and use tax on food purchased for human consumption. This would affect: (1) revenues dedicated to the General Fund for unrestricted use by the Commonwealth, (2) revenues returned to the counties and cities for educational purposes, (3) Transportation Trust Fund revenues, and (4) local option sales and use tax revenues.

Other Tax Reform Plans

House Bill 108 would (i) create separate individual income tax brackets for single filers (0% rate for the first $15,000 of taxable income, 3.5%, from $15,001 to $25,000, 4%, from $25,001 to $30,000, 5.5% from $30,001 up to $50,000, and 6.25% above $50,000) and married filers (0% rate for the first $30,000 of taxable income, 5.5% from $30,001 to $50,000, and 6.25% above $50,000); (ii) increase the filing threshold to $15,000 for single taxpayers and married taxpayers filing separately, and $30,000 for married taxpayers filing jointly; (iii) repeal all individual income addition, subtractions, exemptions and deductions with the exception of the subtractions for federal obligations and taxable social security income; (iv) repeal all individual income tax credits; (v) reduce the state sales and use tax rate from 3.5% to 3.0%; (vi) eliminate the sales tax on food; (vii) impose the sales tax on most services; (viii) retain the sales and use tax exemptions for manufacturing, industrial processing, coal mining and Internet services; (ix) repeal the agricultural, commercial and industrial, service, media-related, miscellaneous, and nonprofit sales and use tax exemptions; (x) eliminate the prepayment of their June sales tax collections for dealers with annual sales of $1.3 million or more; (xi) distribute 10.75% of state sales and use tax revenues to the transportation trust fund; (xii) distribute 21.5% of state sales and use tax revenues to localities based on school age population; (xiii) conform the Virginia estate tax to the maximum amount of the federal tax credit for state death taxes as permitted under federal estate tax law; (xiv) repeal the business, professional and occupation license (BPOL); and (xv) repeal the gas severance tax.

House Bill 1081 and Senate Bill 467 would (i) lower the income tax for most Virginians by increasing the personal exemption amount from $800 to $1,000, increasing the standard deduction amount to $4,000 for single taxpayers and married filing separately and to $8,000 for married filing jointly taxpayers, and raising the filing thresholds to $7,000 and $14,000, (ii) reduce the food tax by 1.5 cents and add 1 cent to the sales and use tax, (iii) tighten certain corporate income tax provisions, (iv) increase Virginia's state cigarette tax to 25 cents per pack to pay for health care needs while giving counties the authority to levy the tax up to a cap, (v) complete the plan to end the car tax on personal vehicles valued at $20,000 or less, (vi) eliminate the estate tax for certain working farms and family-owned businesses, and (vii) end the accelerated sales tax collection for retailers. The effective date for the individual income tax provisions of this bill is generally January 1, 2005. The effective date for the sales tax provisions of this bill is generally July 1, 2005. The effective date of the other provisions of this bill varies.

Senate Bill 530 would (i) increase the personal exemption amount from $800 to $2,500, and increase the standard deduction amount to $3,500 for singles and married filing separately and to $7,000 for married filing jointly, and raise the filing thresholds to $7,000 and $13,000, (ii) make food fully subject to sales and use tax but provide a refundable tax credit for the sales tax paid on food equal to $40 per person, (iii) tighten certain corporate income tax provisions, (iv) increase Virginia's state cigarette tax to 30 cents per pack, distribute all state cigarette tax revenues to local governments, and repeal all local cigarette taxes, (v) beginning January 1, 2005, provide personal property tax relief at 100 percent on personal use vehicles, regardless of vehicle value, (vi) conform the amount of Virginia estate tax due from an estate to the maximum amount of the federal estate tax credit for state estate taxes, (vii) end the accelerated sales tax collection for retailers, (viii) increase the retail sales and use tax by one-half percent to five percent, (ix) conform Virginia's tax law to make available certain federal tax law changes to military, reservists, and National Guard families, (x) change Virginia's individual income tax brackets and add a six percent and 6.5 percent income tax bracket, (xi) make the age deduction dependent upon federal adjusted gross income, and (xii) increase the tax on motor fuels by an additional five cents per gallon.

Senate Bill 635 would (i) tighten certain corporate income tax provisions. Personal property tax relief, (ii) provide for 100% personal property tax relief on qualifying vehicles level beginning January 1, 2005, (iii) increase the state sales tax from 3.5% to 4.5%, (iv) dedicate a portion of the additional sales and use tax revenues generated to the Virginia Water Quality Improvement Fund and the Virginia Land Conservation Fund, (v) reduce the state sales tax on food to 1%, (vi) dedicate the sales tax revenues from the 1986 0.5% increase and an additional 1% of the current 3.5% state tax to reimburse localities for personal property tax relief, (vii) eliminate provisions requiring vendors to make accelerated sales and use tax payments, (viii) add new tax brackets of 6.25% for income between \$100,000 and \$150,000 and 6.5% for income above \$150,000, (ix) increase the standard deduction for single taxpayers to \$3,500 and to \$7,000 for married taxpayers, (x) increase the personal exemption amount to \$1,000, (xi) increase the filing threshold for married taxpayers to conform to the new level of standard deduction and personal exemption, (xii) adds a means test to the age deduction tax preference, (xiii) eliminate eligibility for the \$6,000 age deduction for those born after January 1, 1949 in tax year 2011, (xiv) conform the amount of Virginia estate tax due from an estate to the maximum amount of the federal estate tax credit for state estate taxes, as permitted under federal estate tax law, (xv) dedicates the revenues from the state license tax on insurance companies that are attributable to automobile insurance premiums to the Priority Transportation Fund, (xvi) repeal current law dedicating one-third of all insurance license taxes to the Priority Transportation Fund, (xvii) increase the recordation tax from 15 cents to 45 cents per \$100 and would dedicate the revenues from the increase to the Rainy Day Fund through June 30, 2006, and to the Transportation Trust Fund thereafter, (xviii) increase the titling tax on motor vehicles from 3.5% to 5.5% but allows a deduction for trade-ins, (xix) increase motor vehicle registration fees by \$10 annually, (xx) increase the gasoline tax by three cents per gallon, (xxi) increase the tax on diesel fuel by 4.5 cents per gallon, and (xxii) imposes an additional 5.5% wholesale tax on gasoline and diesel fuel.

cc : Secretary of Finance
Date: 2/8/2004 dtm