DEPARTMENT OF TAXATION
2010 Fiscal Impact Statement

1. Patron Richard H. Stuart

2. Bill Number SB 325

House of Origin:
X **Introduced**
_____ **Substitute**
_____ **Engrossed**

3. Committee Senate Finance

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

4. Title Corporate Income Tax; Small Business Reduced Rate

5. Summary/Purpose:

This bill would reduce the corporate income tax rate by three percent for corporations that establish a new office or operation or expand an existing office or operation in areas of Virginia that are not designated by the United States Environmental Protection Agency as nonattainment areas under the Clean Air Act. This rate would be effective for the first three taxable years that the new or expanded offices were in operation. The tax rate would return to six percent beginning in the fourth taxable year that the offices were in operation.

This bill would provide that in order to be eligible for the reduced tax rate the taxpayer would be required to (i) make a capital investment of at least $250,000 in the new office or its expansion, or (ii) hire five or more full-time employees.

For corporations that qualify under the $250,000 capital investment requirement, this bill would prohibit the benefits of the reduced tax rate to exceed the amount of the capital investment in the new office or the expansion of an existing office or operations.

The tax rate reduction would be effective for taxable years beginning on or after January 1, 2010.

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

7. Budget amendment necessary: No.

8. Fiscal implications:

<u>Administrative Costs</u>

TAX has not assigned any administrative costs to this bill because the changes required by a single bill such as this can be implemented as part of the annual changes to our systems and forms. As stand-alone legislation, TAX considers implementation of this bill as “routine,” and does not require additional funding.

TAX will provide specific administrative costs on any legislation that is not "routine." Additionally, TAX will review all state tax legislation likely to be enacted prior to the passage by each house. If the aggregate number of routine bills likely to pass either house is unusually large, it is possible that additional resources will be required. If so, TAX will identify the costs at that time.

Revenue Impact

This bill would have an unknown, but potentially significant, negative impact on General Fund Revenue beginning in FY 2011. The proposed rate reduction benefit covers a very broad range of business expansion. Because the requirements would easily be met by the largest corporations, the actual impact is likely very significant.

Any revenue impact in FY 2010 would depend on whether the bill was enacted soon enough by the General Assembly for companies to adjust their estimated payments based on whether they establish a new office or operation or expand an existing office or operation in areas of Virginia that are not designated as a nonattainment area.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: Yes.

If the intent of this bill was to prohibit the benefits of the reduced tax rate from exceeding the amount of the capital investment, and not to limit the benefit for those hiring five or more full-time employees, the following technical amendment is suggested.

Page 1, Line 24, after In
Insert: the case of corporations qualifying for this tax rate reduction under (i), in

11. Other comments:

Virginia Corporate Income Tax

The corporate income tax is imposed at the rate of six percent on the Virginia taxable income of domestic and foreign corporations doing business in Virginia. A "corporation" is any entity created as a corporation under the laws of any state or local domestic or foreign jurisdiction, and any association, joint stock company, or any other entity subject to corporate income tax under the Internal Revenue Code § 7701.

A corporation's taxable income is determined by allocation and apportionment when the income is derived from sources both within and without Virginia. Multistate corporations allocate and apportion federal taxable income after Virginia modifications are made to determine the amount of attributable to Virginia. There is no allocation or apportionment needed when the entire business of a corporation is conducted or transacted within Virginia. Instead, the Virginia corporate income tax is imposed upon the entire Virginia taxable income of the corporation for each taxable year.

The corporate income tax has become a major revenue source for Virginia. According to the Annual Report for Fiscal Year 2009, the corporate income tax produced $648 million in revenue. The corporate income tax produces the third highest amount of revenue behind the individual income tax and the state sales and use tax.

There are other business entities that are not subject to corporate income tax. Banks and trust companies are subject to a bank franchise tax, and insurance companies are subject to a premiums tax. Businesses organized as pass-through entities, such as partnerships, LLPs, LLCs, etc., are not taxed at the entity level, but their members are typically subject to the individual income tax. Individuals who operate businesses as sole proprietorships also are subject to the individual income tax. For Taxable Year 2007, over 170,000 pass-through entity returns were filed, as compared to under 71,000 corporate income tax returns. In addition, based on IRS data, there were 535,294 individual returns filed for Taxable Year 2007 in Virginia that were sole proprietorships. This number includes a broad range of businesses, from people selling products part-time, to tradesmen (plumbers, electricians, carpenters, etc.) running a full-time business.

Nonattainment Areas

According to the United States Environmental Protection Agency, a "nonattainment area" is an area of the country where air pollution levels persistently exceed the national ambient air quality standards.

In Virginia, the following localities qualify as nonattainment areas: Alexandria, Arlington County, Fairfax, Fairfax County, Falls Church, Loudoun County, Manassas, Manassas Park, and Prince William County. However, the federal government is currently reviewing the standards for nonattainment areas which could either increase or decrease the number of Virginia localities and qualify.

Proposed Legislation

This bill would reduce the corporate income tax rate by three percent for corporations that establish a new office or operation or expand an existing office or operation in areas of Virginia that are not designated by the United States Environmental Protection Agency as nonattainment areas under the Clean Air Act. This rate would be effective for the first three taxable years that the new or expanded offices were in operation. The tax rate would return to six percent beginning in the fourth taxable year that the offices were in operation.

This bill would provide that in order to be eligible for the reduced tax rate the taxpayer would be required to (i) make a capital investment of at least $250,000 in the new office or its expansion, or (ii) hire five or more full-time employees.

For corporations that qualify under the $250,000 capital investment requirement, this bill would prohibit the benefits of the reduced tax rate to exceed the amount of the capital investment in the new office or the expansion of an existing office or operations. There would be no limitation on the benefit for corporations that hire five or more full-time employees. In addition, this bill does not require the taxpayer to maintain the higher level of employment to qualify for the reduced tax rate.

The broad qualifications that would be established in this bill would impact larger corporations and smaller corporations differently. While an investment of $250,000 or hiring five new full-time employees could be easily accomplished by larger corporations, it can be a significant expansion for smaller corporations. The tax benefit to the larger corporation would be much more significant, however. Such corporations would be allowed to halve their tax liability simply by expanding by five full-time employees.

There would also be differences between those corporations that qualify by investing at least $250,000 and those that qualify by hiring five or more full-time employees. For example, if, under the current 6% tax rate, Corporation A has a tax liability of $3 million and hires five new full-time employees, its tax rate will be reduced to 3%. Therefore, its tax liability would be cut by $1.5 million. In contrast, if Corporation A made a capital investment of $250,000 in an office expansion, the amount of the tax rate reduction would be limited to $250,000. Therefore, Corporation A's tax liability for hiring five new employees would be $1.5 million while its tax liability for making a $250,000 investment would be $2.75 million, a difference of $1.25 million.

Finally, unlike the Major Business Facility Jobs Tax Credit, which prohibits a business relocating an existing facility from one Virginia locality to another from claiming a tax credit, this bill would allow a business that simply relocates an existing office or operation from one locality to another to qualify for the reduced tax rate.

The tax rate reduction would be effective for taxable years beginning on or after January 1, 2010.

Similar Legislation

House Bill 94 would reduce the corporate income tax rate by one percent for small businesses that increase the number of their employees by a minimum of five percent over the number of employees in the immediately preceding year. This bill would also provide that the one percent tax rate reduction would be allowed for no more than three taxable years.

House Bill 119 would eliminate Virginia's corporate income tax for taxable years beginning on and after January 1, 2010.

House Bill 860 would reduce the corporate income tax rate from 6.0% to 5.75%.

House Bill 896 and Senate Bill 421 would reduce the corporate income tax rate from 6% to 5.4% for every small business defined as an independently owned and operated business that has 250 or fewer employees.

cc : Secretary of Finance
Date: 1/24/2010 TLG
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