DEPARTMENT OF TAXATION
2010 Fiscal Impact Statement

1. Patron Mark R. Herring

2. Bill Number SB 428

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

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

3. Committee Senate Finance

4. Title Income Taxes; Subtraction for Capital Gains Income

5. Summary/Purpose:

TAX understands that the patron will introduce an amendment in the nature of a substitute for this bill. This fiscal impact statement is applicable to that substitute version.

This bill would allow an individual and corporate income tax subtraction for income taxed for federal income tax purposes as a long-term capital gain or as investment services partnership interest income (otherwise known as investment partnership carried interest income). The investments would be required to be related to investments in "qualified businesses" as defined for the purposes of the Qualified Equity and Subordinated Debt Credit (QESDC), or in any other technology business approved by the Secretary of Technology, provided its principal office or facility is in the Commonwealth and it has less than $3 million in annual revenues in the fiscal year prior to the investment. The applicable investment would be required to have been made on or after July 1, 2010, but before July 1, 2013.

This bill would also provide that a taxpayer who claims a tax credit for investment in a qualified business under the QESDC would not be allowed to claim this subtraction relating to investments in the same business.

This bill would be effective for taxable years beginning on or after January 1, 2011.

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 result in an unknown negative impact on General Fund revenues beginning in FY 2012. Because of the limit on the size of the qualifying business (less than $3 million in revenue), the tax liability of such businesses is limited. Only investments made between July 1, 2010, and June 30, 2013 qualify for the subtraction; therefore, the gains on those investments could be not be realized until after July 1, 2011, as investments must be held for at least one year to qualify as a long-term capital gain. This means that the fiscal impact from this bill would not occur until Fiscal Year 2012 and would likely not exceed $500,000 annually.

To the extent that this bill will incentivize individuals and corporations to make investments in Virginia businesses that would not otherwise have occurred, this bill would create an offsetting revenue impact of an unknown amount.

9. Specific agency or political subdivisions affected:

Department of Taxation

Technical amendment necessary: No.

11. Other comments:

Capital Gains

Almost everything owned and used for personal or investment purposes is a capital asset. Examples include homes, household furnishings, and stocks, bonds or other forms of investment. When a capital asset is sold, the difference between what the taxpayer paid for the asset (the “basis”) and the amount for which it is sold is a capital gain or a capital loss. A capital gain is realized if the asset sells for more than base amount, while a capital loss is realized if the asset sells for less than the base amount.

Capital gains and losses are classified as either long-term or short-term. If an asset is held for more than one year before it is sold, the capital gain or loss is long-term. A short-term capital gain is when the asset is held for one year or less.

If a net capital gain is realized, for federal income tax purposes, that gain may be taxed at a lower tax rate than the ordinary income tax rates. The "net capital gain" is the amount by which a net long-term capital gain for the year is more than the sum of the net short-term capital loss and any long-term capital loss carried over from the previous year. Currently, net capital gain is generally taxed at rates no higher than 15%, although, for 2008 through 2010, some or all net capital gain may be taxed at 0%, if it would otherwise be taxed at lower rates. Virginia does not currently have any preferential tax treatment for capital gains.

Investment Services Partnership Interest ("Carried Interest")

Carried interest is a share in the profits of a partnership given to its general partner or other managers, such as managers of investment partnerships, hedge funds, or private equity funds, in exchange for their management services. When a share of a partnership is purchased, the purchaser receives a capital interest, which is the share of ownership that was purchased, and a profits interest, which is the share of the profits earned by the partnership. A carried interest, therefore, is generally a profits interest without the capital interests.

Because the manager or general partner is compensated with a profits interest, the bulk of this income is taxed not as a compensation for services, but as a return on an investment. As the types of funds involved in these cases typically invest on a longer time horizon, this income is often taxed as a long-term capital gain.

On December 9, 2009, the House of Representatives passed H.R. 4213, which would extend a number of expiring tax provisions for both businesses and individuals. The legislation would also provide that all carried interest received in exchange for providing investment management services to a partnership will be taxed at ordinary income rates, with a top rate of 35%, even if it is capital gains income.

Qualified Equity and Subordinated Debt Credit

Under current law an individual or corporation is allowed a tax credit for investments made to a qualified business. The total amount of the tax credits that may be granted to taxpayers is capped at $3 million. The $3 million is bifurcated, with one-half of the $3 million reserved for qualified businesses created to commercialize research developed at or in partnership with an institution of higher education and the remaining portion available for all other qualified businesses.

A "qualified business" is one that has annual gross revenues of no more than $3 million in its most recent fiscal year; has its principal office or facility in the Commonwealth; is engaged in business primarily in or does substantially all of its production in the Commonwealth; and has not obtained during its existence more than $3 million in aggregate gross cash proceeds from the issuance of its equity or debt investments except for those from banking or savings and loan institutions.

Qualified businesses include those related to advanced computing, advanced materials, advanced manufacturing, agricultural technologies, biotechnology, electronic device technology, energy, environmental technology, medical device technology, nanotechnology, or any similar technology-related field.

No investment qualifies for this credit if the otherwise qualified business performs research in Virginia on human cells or tissue derived from induced abortions or from stem cells obtained from human embryos. This restriction does not apply to qualified businesses that conduct research using stem cells other than embryonic stem cells.

Proposed Legislation

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This bill would also provide that a taxpayer who claims a tax credit for investment in a qualified business under the QESDC would not be allowed to claim this subtraction relating to investments in the same business.

This bill would be effective for taxable years beginning on or after January 1, 2011.

Other Legislation

House Bill 523 is identical to this bill.

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cc : Secretary of Finance

Date: 2/1/2010 TG
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