# DEPARTMENT OF TAXATION
# 2010 Fiscal Impact Statement

1. **Patron** Mamie E. Locke

2. **Bill Number** SB 705

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

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

3. **Committee** Senate Finance

4. **Title** Individual Income Tax; Corporate Income Tax; Land Preservation Tax Credit; Retail Sales and Use Tax; and Estate Tax.

5. **Summary/Purpose:**

**Individual Income Tax**

Wealth Bracket

This bill would impose an additional 3 percent tax on Virginia taxable income of residents and nonresidents for single taxpayers who have income in excess of $250,000 and for married taxpayers who have income in excess of $500,000.

This provision of the bill would be effective beginning on and after January 1, 2011, but before January 1, 2014.

Age Deduction

This bill would means test the age deduction for all taxpayers by requiring all taxpayers over 65 to reduce their $12,000 age deduction by $1 for every $1 of adjusted federal adjusted gross income above $50,000. Married individuals over 65 would be required to reduce their $12,000 income-related age deduction by $1 for every $1 of their total combined adjusted federal adjusted gross income above $75,000. Currently, taxpayers born before January 1, 1939 receive a $12,000 age deduction, without reduction.

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

**Corporate Income Tax**

Single Sales Factor Apportionment

This bill would delay the scheduled phase-in of the new apportionment factor percentages for manufacturers. This bill would delay the phase in as follows: for taxable years beginning on or after July 1, 2012, but before July 1, 2014, qualifying corporations may elect to use a triple-weighted sales factor; for taxable years beginning on or after July 1, 2014, but before July 1, 2015, qualifying corporations may elect to use a quadruple-weighted sales factor; and for taxable years beginning on or after July 1, 2015, qualifying corporations may elect to use the single sales factor method to apportion Virginia taxable income. Currently, the phase in of the new appointment factors is scheduled to begin on July 1, 2010.

The effective date of this provision of the bill is not specified.

"Throwback Rule"

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

The effective date of this provision of the bill is not specified.

Combined Reporting

The bill would require combined reporting and filing of all unitary entities that are subject to the Virginia Corporate Income Tax or that would be subject to the Virginia Corporate Income Tax if they were doing business in the Commonwealth. This bill would provide that business conducted by any corporation through a pass-through entity is treated as conducted directly by that corporation, to the extent of the corporation's distributive share of the partnership income.

The effective date of this provision of the bill is not specified.

## Land Preservation Tax Credit

This bill would extend the $50,000 limitation on the amount of Land Preservation Tax Credits that may be claimed on income tax returns through Taxable Year 2012. Currently, the annual amount of credit that may be claimed is limited to $50,000 for taxable years 2009 and 2010 only. This bill would also extend the carryover period by two years for those affected by this limitation.

This provision of the bill would be effective for taxable years beginning on and after January 1, 2011.

## Retail Sales and Use Tax

Digital Property

This bill would deem "digital property" as tangible personal property that is subject to the Retail Sales and Use Tax. "Digital property" would be defined as 1) an audio work; 2) an audiovisual work (3) a book, magazine, newspaper, newsletter, report, or another publication, or 4) a photograph or greeting card that is delivered or accessed electronically; is not sold in a tangible medium; and would be subject to the Retail Sales and Use Tax if sold in a tangible medium.

The effective date of this provision of the bill is not specified.

Computer Services

This bill would impose the Retail Sales and Use Tax on certain computer services.

The effective date of this provision of the bill is not specified.

Out-of-State Dealers Soliciting Business through ‘Affiliate Agreements’ with Residents

This bill would create a rebuttable presumption that an out-of-state dealer who enters into an agreement with a Virginia resident, under which the resident, for a commission or other consideration, refers potential customers to the dealer is soliciting or transacting business in Virginia by independent contractors, agents, or other representatives, and is thus required to collect the Retail Sales and Use Tax pursuant to Virginia’s nexus statute.

In order for the out-of-state retailer to be deemed to be soliciting or transacting business in Virginia, the cumulative gross receipts from sales by the dealer to purchasers in the Commonwealth who are referred to the dealer by residents with this type of agreement with the dealer must be in excess of $10,000 during the preceding four quarterly periods.

The effective date of this provision of the bill is not specified.

## Estate Tax

This bill would effectively reinstate the Virginia estate tax for residents whose gross estates exceed $5 million by requiring that the maximum amount of the federal credit for state estate taxes be equal to the federal credit as it existed on January 1, 1978. The estate tax would not be imposed on a gross estate if the majority of the assets of the total estate were an interest in a closely held business or a working farm.

This provision of the bill would be effective for the estates of Virginia decedents dying on or after July 1, 2010 but before July 1, 2013.

## Use of Revenue

This bill provides that all General Fund revenue generated by the provisions of this bill must be appropriated to fund the Standards of Quality.

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

**6a. Expenditure Impact:**

| ***Fiscal Year*** | ***Dollars*** | ***Positions*** | ***Fund*** |
|---|---|---|---|
| 2009-10 | $0 | 0 | GF |
| 2010-11 | $589,350 | 7 | GF |
| 2011-12 | $507,150 | 7 | GF |
| 2012-13 | $610,910 | 7 | GF |
| 2013-14 | $617,706 | 7 | GF |
| 2014-15 | $625,495 | 7 | GF |
| 2015-16 | $635,580 | 7 | GF |

**7. Budget amendment necessary:** Yes.
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A budget amendment would also be needed to allocate the General Fund revenue generated by this bill to the Standards of Quality.

**8. Fiscal implications:**

Administrative Costs

In order to implement this bill, TAX would incur administrative costs of $589,350 for Fiscal Year 2011, $507,150 for Fiscal Year 2012, $610,910 for Fiscal Year 2013, $617,706 for Fiscal Year 2014, $625,495 for Fiscal Year 2015 and $635,580 for Fiscal Year 2016. This estimate includes the personnel costs associated with the seven full-time employees TAX would need to implement the provisions of this bill. TAX would require three additional auditors and four full-time employees to resolve issues regarding the filing of the applicable tax returns. This estimate also includes the costs associated with changes to systems and forms as well as mailing of information to taxpayers regarding changes to the Corporate Income Tax and the Retail Sales and Use Tax. In addition, this estimate accounts for the fact that TAX would have to track the revenue associated with the provisions of this bill in order to allocate the funds to the Standards of Quality.

Revenue Impact

This bill provides that all General Fund revenue generated by the provisions of this bill must be appropriated to fund the Standards of Quality.

This revenue impact makes a number of assumptions:

Wealth Brackets

This estimate assumes that a taxpayer who is married filing separately would be subject to the $250,000 income threshold for the additional 3 percent tax.

## Age Deduction

This estimate assumes that the age deduction for taxpayers born before January 1, 1939 would remain in effect for Taxable Year 2010.

## Corporate Income Tax

This estimate assumes that the "throwback rule" and the combined reporting provisions of this bill would be applicable to all corporations, not just manufacturers. It is also assumed that the Corporate Income Tax provisions of this bill would be effective beginning January 1, 2011.

Estimating the impact of requiring corporations to file on a combined or unitary basis is problematic at best. There are several data issues that make any estimate of the impact of switching to combined reporting extremely unreliable. These issues are related to the composition of unified groups, the appropriate apportionment factors to use, the amounts and types of transactions that should be eliminated under combined reporting, and transition issues. While other states have produced revenue estimates for switching to combined reporting, it is unclear that their methodologies adequately address the concerns.

First and foremost, there is no data that would allow TAX to know the makeup of a unitary group. This information is critical to any estimate. The choice to include (or exclude) a single subsidiary can have a very large impact on a corporation's tax liability. TAX's current data only identify those subsidiaries with nexus in Virginia that corporations include on Virginia's combined or consolidated returns. These lists of subsidiaries are likely to include units that may be excluded from a unitary return, while omitting others that should be included. When corporations elect to file on a separate basis, TAX does not have sufficient information to link subsidiaries together or to make determinations if partially owned subsidiaries meet requirements to be included. States that currently have combined reporting relate that agreement on the composition of the unitary group is one of their most contentious matters in compliance work.

Also, TAX does not have sufficient data to compute the single apportionment factor required by combined reporting. Without detailed data on payroll, property, and sales for subsidiaries, no reliable estimate can be produced.

When Pennsylvania computed a revenue estimate of switching to combined reporting, they relied on data provided by Minnesota to estimate the revenue impact of switching to combined reporting. Such an estimate assumes a unitary group in Minnesota would be the same unitary group in Pennsylvania. This is extremely unlikely as the makeup of any two states' economies is very different. Furthermore, for subsidiaries included in Minnesota filings but not Pennsylvania filings, there is no way to adjust appropriately the apportionment factors. Virginia would face similar concerns if we attempted to use data from another state.

More recently, Maryland has tried to estimate the impact of combined reporting by collecting legislatively-mandated informational returns. These informational returns provided a corporation's reasonable assumptions about the makeup of the unitary group and necessary apportionment data. Staff in Maryland related that the quality of these returns varied greatly and that companies typically did not provide data on intercompany transactions. These are the transactions (e.g., payments to intangible holding companies or captive REITs) that combined reporting attempts to address. While TAX does have some data on add-backs currently required under Virginia law, there are other transactions for which TAX does not have data.

Combined reporting may increase, decrease or leave unchanged the taxable income reported on the combined return compared to the sum of the taxable incomes for the separate taxpayers, assuming that corporations in the combined group are already taxpayers in a state. The result depends on the difference in profitability per dollar of payroll, property and/or sales for the different corporations in the group.

Land Preservation Tax Credits

Because the introduced Executive Budget and revenue forecast assume that the $50,000 limitation on the amount of Land Preservation Tax Credits that may be claimed on income tax returns would be extended through Taxable Year 2011, the provision of this bill that extends the $50,000 cap through Taxable Year 2012 would have no impact in Fiscal Year 2012 and would increase revenue by $50 million in Fiscal Year 2013.

Retail Sales and Use Tax

This estimate assumes that the Retail Sales and Use Tax provisions of this bill would be effective beginning January 1, 2011. Because the introduced Executive Budget assumes the repeal of the dealer discount, the Retail Sales and Use Tax portion of this estimate also assumes the repeal of the dealer discount.

Out-of-State Dealers Soliciting Business through 'Affiliate Agreements' with Residents

The revenue impact of this provision of the bill would depend on the response to its enactment by affected online retailers. Given the response to similar legislation enacted in other states, it is unlikely that online retailers would comply with the provisions of the bill and begin to collect the Retail Sales and Use Tax.

When similar legislation was enacted in Rhode Island and North Carolina, large online retailers ended their affiliate programs. If this were to happen as a result of this bill, there would be no additional revenue from the enactment of this bill. In fact, by ending the affiliate program with Virginia vendors, such vendors would likely lose business and remit less Retail Sales and Use Tax to Virginia. Ending affiliate agreements in Virginia would also reduce or eliminate the commissions and profit that the affiliates receive from these agreements. Although there is only very limited publicly available data, the reduction or elimination of such commissions and profits would likely have a negative impact on those businesses' profits.

Alternatively, online retailers may comply with the provisions of this bill and file suit, challenging the constitutionality of the statute, as Amazon.com and Overstock.com have done in New York. While New York raised $53 million in state and local sales and use taxes during the three quarters that their statute was in effect in Fiscal Year 2008, and while they expect to raise $70 million in revenue for the current fiscal year, this amount will be reduced by the costs of litigation that New York incurs to defend its legislation. Similarly, if online retailers choose to take this approach in Virginia, any potential revenue gain from enactment of this bill would be offset by the costs to litigate this issue.

Assuming, however, that the online retailers comply with the provisions of the bill and begin to collect the Retail Sales and Use Tax, this bill would result in an unknown revenue increase for Virginia. Based on the revenue received by New York as a result of enacting its statute, adjusted for the differences in population and tax rates between the states, Virginia could realize as much as an additional $17 million in state and local revenue.

Other Provisions

See the chart below for the revenue impact of each additional provision of this bill.

## Combined Revenue Impacts
## (In Million of Dollars)

| Fiscal Year | Wealth Brackets | Means Testing Age Deduction | Delay Single Sales Factor by One Year | Throwback | Land Preservation Tax Credit | Digital Downloads and Computer Services | Estate Tax | Total Revenue Impact |
|---|---|---|---|---|---|---|---|---|
| **2011** | | | | | | | | |
| GF Unrestricted | 461.7 | 27.4 | | 11.8 | | 2.04 | 51.0 | 553.9 |
| GF Restricted | | | | | | 0.81 | | 0.8 |
| TTF | | | | | | 0.41 | | 0.4 |
| Local | | | | | | 0.81 | | 0.8 |
| **2012** | | | | | | | | |
| GF Unrestricted | 897.3 | 50.8 | 3.8 | 30.4 | 0.0 | 5.72 | 76.5 | 1,064.5 |
| GF Restricted | | | | | | 2.29 | | 2.3 |
| TTF | | | | | | 1.14 | | 1.1 |
| Local | | | | | | 2.29 | | 2.3 |
| **2013** | | | | | | | | |
| GF Unrestricted | 939.0 | 48.4 | 3.8 | 23.4 | 50.0 | 6.77 | 102.0 | 1,173.4 |
| GF Restricted | | | | | | 2.71 | | 2.7 |
| TTF | | | | | | 1.35 | | 1.4 |
| Local | | | | | | 2.71 | | 2.7 |
| **2014** | | | | | | | | |
| GF Unrestricted | 458.1 | 46.6 | 6.7 | 23.4 | | 8.13 | 76.5 | 619.4 |
| GF Restricted | | | | | | 3.25 | | 3.3 |
| TTF | | | | | | 1.63 | | 1.6 |
| Local | | | | | | 3.25 | | 3.3 |
| **2015** | | | | | | | | |
| GF Unrestricted | -25.2 | 44.6 | 15.7 | 24.0 | | 9.87 | 0.0 | 69.0 |
| GF Restricted | | | | | | 3.95 | | 4.0 |
| TTF | | | | | | 1.97 | | 2.0 |
| Local | | | | | | 3.95 | | 4.0 |
| **2016** | | | | | | | | |
| GF Unrestricted | 0.0 | 42.4 | 15.7 | 24.1 | | 12.14 | 0.0 | 94.3 |
| GF Restricted | | | | | | 4.86 | | 4.9 |
| TTF | | | | | | 2.43 | | 2.4 |
| Local | | | | | | 4.86 | | 4.9 |

**9. Specific agency or political subdivisions affected:**

Department of Taxation
Department of Conservation and Recreation
Department of Education

**10. Technical amendment necessary:** Yes.

This bill contains several technical inconsistencies and would require a substitute to correct.

**11. Other comments:**

### Individual Income Tax

Wealth Bracket

Current Law

The Virginia individual income tax applies to the Virginia taxable income of Virginia residents and nonresident individuals. The tax rate is dependent upon the amount of Virginia taxable income. The table below demonstrates the current tax rates.

| Virginia Taxable Income | Tax Rate |
|---:|---:|
| $0 - $3000 | 2% |
| $3001 - $5000 | 3% |
| $5001 - $17,000 | 5% |
| $17,001 and up | 5.75% |

Proposal

This bill would impose an additional 3 percent tax on Virginia taxable income of residents and nonresidents for single taxpayers who have income in excess of $250,000 and for married taxpayers who have income in excess of $500,000.

This provision of the bill would be effective beginning on and after January 1, 2011, but before January 1, 2014.

Age Deduction

Current Law

In 2004, the age deduction was modified in several ways. First, the $12,000 age deduction was subjected to a reduction based on income for taxpayer born after January 1, 1939 and the $6,000 age deduction was repealed. Taxpayers born before January 1, 1939 continue to receive the full $12,000 age deduction without reduction.

Taxpayers who have reached the age of 65 and were born after January 1, 1939 receive a $12,000 income-related age deduction and are required to reduce their age deduction by $1 for every $1 of adjusted federal adjusted gross income above $50,000. Married individuals must reduce their $12,000 income-related age deduction by $1 for every $1 of their total combined adjusted federal adjusted gross income above $75,000. For married taxpayers filing separately, the $12,000 income-related age deduction is reduced by $1 for every $1 the total combined adjusted federal adjusted gross income of both spouses exceeds $75,000.

"Adjusted federal adjusted gross income," means federal adjusted gross income minus any benefits received under Title II of the Social Security Act and other benefits subject to federal taxation solely under IRC § 86.

Proposal

This bill would means test the age deduction for all taxpayers by requiring all taxpayers over 65 to reduce their $12,000 age deduction by $1 for every $1 of adjusted federal adjusted gross income above $50,000. Married individuals over 65 would be required to reduce their $12,000 income-related age deduction by $1 for every $1 of their total combined adjusted federal adjusted gross income above $75,000.

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

## Corporate Income Tax

Single Sales Factor Apportionment

Current Law

In Virginia, multistate corporations are generally required to use a three-factor formula of property, payroll and double-weighted sales. The sum of the property factor, payroll factor and twice the sales factor is divided by four to arrive at the final apportionment factor. This amount is then multiplied by Virginia taxable income.

The 2009 Acts of Assembly, Chapter 821, modified the corporate apportionment formula by allowing manufacturing companies to use a single sales factor to determine their Virginia taxable income. This modification will be phased in as follows: for taxable years beginning on or after July 1, 2011, but before July 1, 2013, qualifying corporations may elect to use a triple-weighted sales factor; for taxable years beginning on or after July 1, 2013, but before July 1, 2014, qualifying corporations may elect to use a quadruple-weighted sales factor; and for taxable years beginning on or after July 1, 2014, qualifying corporations may elect to use the single sales factor method to apportion Virginia taxable income.

A "manufacturing company" was defined as a domestic or foreign corporation which is primarily engaged in activities that, in accordance with the North American Industrial Classification System (NAICS), United States Manual, United States Office of

Management and Budget, 1997 Edition, would be included in Sector 11, 31, 32, or 33. This includes the sectors of agriculture, forestry, fishing, and hunting and manufacturing.

Proposal

This bill would delay the scheduled phase-in of the new apportionment factor percentages for manufacturers as follows: for taxable years beginning on or after July 1, 2012, but before July 1, 2014, qualifying corporations may elect to use a triple-weighted sales factor; for taxable years beginning on or after July 1, 2014, but before July 1, 2015, qualifying corporations may elect to use a quadruple-weighted sales factor; and for taxable years beginning on or after July 1, 2015, qualifying corporations may elect to use the single sales factor method to apportion Virginia taxable income.

The effective date of this provision of the bill is not specified.

"Throwback Rule"

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). Because these sales are not counted in assigning income to any state, they are commonly referred to as "nowhere income."

State Comparison

For 2009, twenty-four jurisdictions had a "throwback rule." Those jurisdictions are: Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Illinois, Indiana, Kansas, Maine, Mississippi, Missouri, Montana, New Hampshire, New Mexico, North Dakota, Oklahoma, Oregon, Texas, Utah, Vermont, and Wisconsin. Nevada, South Dakota, Washington, and Wyoming do not have a corporate income tax. The remaining states do not have a "throwback rule," although a few of those states have laws aimed at taxing such income through different means, such as a "throwout rule."

Proposal

The definition of Virginia sales would include the sales of products shipped from Virginia by a corporation domiciled in 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."

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.

The effective date of this provision of the bill is not specified.

<u>Combined Reporting</u>

State Comparison

As of April 2009, 23 states and the District of Columbia had adopted combined reporting. The states are: Alaska, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Maine, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New York, North Dakota, Oregon, Texas, Utah, Vermont, West Virginia and Wisconsin. Nevada, South Dakota, Washington, and Wyoming do not have a corporate income tax. The remaining states have not adopted combined reporting.

Proposal

The bill would require combined reporting and filing of all unitary entities that are subject to the Virginia Corporate Income Tax or that would be subject to the Virginia Corporate Income Tax if they were doing business in the Commonwealth. This bill would provide that business conducted by any corporation through a pass-through entity is treated as conducted directly by that corporation, to the extent of the corporation's distributive share of the partnership income.

This bill would require the combination of eligible entities on a world-wide basis, unless taxpayers choose to make a water's-edge election. A water's-edge election would limit the combined group to eligible domestic corporations, foreign corporations with U.S. source income, and corporations doing business in tax-haven countries.

The combined report would not disregard the separate identities of the taxpayer members of the combined group. Each taxpayer member would be responsible for tax based on its apportioned share of the business income of the combined group, together with that member's own allocated nonbusiness income, and its apportioned share of business income from any other combined group of which the taxpayer is a member. Business income of the combined group would be calculated as the sum of all members' individually determined net business incomes. Dividends paid by one to another member of the combined group would be eliminated from income, and no special treatment would be provided for included foreign source income.

This bill would recognize individual group members as separate taxpayers; therefore, as a general rule, a deduction or credit could be taken only by the specific taxpayer that earned it, not against the total combined income or liability of the group.

The bill would provide one exception to this general rule preserving the separate identity of the taxpayer. A charitable contribution deduction would be allowed to be taken first against the business income of the combined group (subject to federal income limitations as applied to the entire business income of the group), and any remaining amount could then be treated as a nonbusiness expense allocable to the member that incurred the expense (subject to the federal income limitations applied to the nonbusiness income of that taxpayer member).

This bill would calculate the amount of total combined business income apportioned to Virginia as a function of each taxpayer's own factors in the Commonwealth (the *Joyce* method).

This bill could also require other commonly-controlled, unitary entities, not otherwise subject to required combination because they are not income taxpayers, to be included in the combined group by regulation if doing so would better reflect the proper apportionment of income of entire unitary businesses, or on a case-by-case basis if there is tax evasion.

The effective date of this provision of the bill is not specified.

## Land Preservation Tax Credit

### Current Law

The Land Preservation Tax Credit is currently equal to forty percent of the fair market value of land or interest in land located in Virginia which is conveyed for the purpose of agricultural and forestal use, open space, natural resource, and/or biodiversity conservation, or land, agricultural, watershed and/or historic preservation, as an unconditional donation by the taxpayer to a public or private conservation agency. For donations made prior to January 1, 2007, the percentage was fifty percent.

Beginning with calendar year 2007, the amount of Land Preservation Tax Credits that may be issued in any one year is subject to a cap. For 2007, the cap amount was $100 million. Starting in calendar year 2008, the $100 million cap will be increased by an amount equal to $100 million multiplied by the percentage by which the consumer price index for all-urban consumers published by the United States Department of Labor (CPI-U) for the 12-month period ending August 31 of the preceding year exceeds the CPI-U for the 12-month period ending August 31, 2006. For 2009, the cap was $106,647,000.

For Taxable Years 2009 and 2010, the amount of Land Preservation Credits that may be claimed on income tax returns was reduced from $100,000 per taxpayer to $50,000 per taxpayer. The carryover period was extended by two years for those affected by the limitation.

### Proposal

This bill would extend the $50,000 limitation on the amount of Land Preservation Tax Credits that may be claimed on income tax returns through Taxable Year 2012. This bill would also extend the carryover period by two additional years for those affected by this limitation.

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

## Retail Sales and Use Tax

Digital Property

### Current Law

The Retail Sales and Use Tax is currently imposed upon the sale or use of tangible personal property in Virginia. Tangible personal property is defined as "personal property which may be seen, weighed, measured, felt, or touched, or is in any other manner perceptible to the senses."

Under current law, the sale of music downloaded via the Internet constitutes the sale of a nontaxable service transaction, based on statutory language that provides that the Retail Sales and Use Tax does not apply to "services not involving an exchange of tangible personal property which provide access to or use of the Internet and any other related electronic communication service, including software, data, content, and other information services delivered via the Internet." Likewise, TAX’s longstanding policy has been that the sale of prewritten software delivered electronically to customers does not constitute the sale of tangible personal property, and is therefore generally not subject to sales and use taxation. This policy is conditioned on the fact that no disc, tape, or other tangible medium is subsequently provided to the customer (by mail or other means) before or after the electronic download of the software. The same policy applies to electronic software updates furnished to customers.

Digital products delivered electronically, such as software, downloaded music, ring tones, and reading materials are specifically excluded from the Communications Sales and Use Tax. TAX has opined that "digital products" do not include any products that require continued payments from the purchaser or products that are sold without the right of permanent use granted by the seller.

Effective July 1, 2009, legislation enacted in the 2009 Session of the General Assembly imposed a new Digital Media Fee on the in-room rental or purchase of digital media at the rate of ten percent of the charge for the digital media. "Digital media" is defined as any audio-visual work provided through the in-room television in any guest room in any temporary lodging for a separate charge, including but not limited to, any motion picture, television or audio programming, or game, regardless if it is transmitted in an analog or digital format." "Digital media" does not include Internet access, telephone services, or television programming provided by a Provider for no separate charge, i.e., basic cable, or premium channels. The Digital Media fee is imposed in facilities offering guest rooms rented out for continuous occupancy for fewer than 90 days, such as hotels and motels. This tax is in addition to any Retail Sales and Use Tax that applies to the accommodation.

### Proposal

This bill would deem "digital property" as tangible personal property that is subject to the Retail Sales and Use Tax, regardless of whether the purchaser of the item has a right to use the property permanently or to use it without making continued payments. The tax would not apply to a service that is otherwise subject to the Retail Sales and Use Tax or to an information service.

The definition of "digital property" would be broader than the definition for "digital products" set forth in the Communications Sales and Use Tax. "Digital property would be defined as 1) an audio work; 2) an audiovisual work (3) a book, magazine, newspaper, newsletter, report, or another publication, or 4) a photograph or greeting card that is delivered or accessed electronically; is not sold in a tangible medium; and would be subject to the Retail Sales and Use Tax if sold in a tangible medium. An "audio work" would be defined as a series of musical, spoken, or other sounds, including a ringtone. An "audio visual work" would be defined as a series of related images and any sounds accompanying the images that impart an impression of motion when shown in succession.

Under this proposal, certain purchases of digital property would be subject to both the Retail Sales and Use Tax and the Communications Sales and Use Tax. For example, the purchase of a ringtone for use for a limited time is currently subject to the Communications Sales and Use Tax. As this proposal uses a broader definition for "digital property" than is used for purposes of the Communications Sales and Use Tax, which is not dependent on whether the purchaser of the item has a right to use the property permanently or to use it without making continued payments, the purchase of the ringtone would also be subject to the Retail Sales and Use Tax.

The effective date of this provision of the bill is not specified.

Computer Services

Current Law

Charges for services are generally exempt from the Retail Sales and Use Tax, unless such services are provided in connection with the sale of tangible personal property. In addition to this general rule, Virginia law currently provides a specific exemption from the Retail Sales and Use Tax for custom computer programs. A "custom program" is a computer program that is specifically designed and developed for only one customer. The combining of two or more prewritten programs does not constitute a custom computer program. A prewritten program that is modified to any degree remains a prewritten program and does not become custom.

While custom programs are exempt from the Retail Sales and Use Tax, prewritten software programs are subject to sales tax, unless the sale is delivered electronically to customers. A "prewritten program" is a computer program that is prepared, held or existing for general or repeated sale or lease, including an in-house program and subsequently sold or leased to unrelated third parties.

Proposal

This bill would impose the Retail Sales and Use Tax on certain computer services.

"Computer services" would be defined to include: 1) computer facilities management and operation; 2) custom computer programming; 3) computer system planning and design that integrate computer hardware, software, and communication technologies; 4) computer disaster recovery; 5) data processing, storage, and recovery; or 6) hardware or software installation, maintenance, and repair."

"Computer services" would not include 1) Internet access; 2) typing or data entry on word processing equipment; 3) computer training; 4) the installation, maintenance, or repair of tangible personal property, other than computer hardware or software that includes computer hardware or software as a component part; or 5) one of the taxable computer services, listed above, that is provided in connection with a) electronic fund transfers, financial transactions, automated teller machine transactions, or other banking or trust services; b) business management, account management, personnel, payroll, employee benefit, or other administrative services, c) educational, legal, accounting, architectural, actuarial, medical, medical diagnostic, or other professional services, or d) telecommunications services.

Under the terms of this bill, the Retail Sales and Use Tax would not apply to custom computer software services, relating to procedures and programs that 1) are otherwise taxable; 2) are to be used by a specific person; 3) are a) created for that person, or b) contain standard or proprietary routines that incorporate significant creative input to customize the procedures and programs for that person; and 4) do not constitute a program, procedure, or documentation that is mass produced and sold to either the general public or persons associated in a trade, profession, or industry.

In addition, under this bill, the tax would not apply to the sale of an optional computer software maintenance contract if the buyer does not have a right, as part of the contract, to receive at no additional cost software products that are separately priced and marketed by the vendor.

Because these provisions would be imposed in a separate imposition statute, these provisions would override any existing exemptions from the Retail Sales and Use Tax for computer services.

The effective date of this provision of the bill is not specified.

<u>Out-of-State Dealers Soliciting Business through 'Affiliate Agreements' with Residents</u>

Constitutional Nexus

The Commerce Clause of the U.S. Constitution reserves to Congress the power to regulate commerce among the states and with foreign nations. The U.S. Supreme Court has established a four-prong test to be used in determining whether a state tax on an out-of-state corporation's activities in interstate commerce violates the Commerce Clause. A state may require an entity engaged in interstate commerce to collect taxes on its behalf provided the tax is 1) applied to an activity with a substantial nexus with the taxing State; 2) is fairly apportioned; 3) does not discriminate against interstate commerce; and 4) is fairly related to the services provided by the state. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). The U.S. Supreme Court has also determined, in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) that the Commerce Clause barred a state from requiring an out-of-state mail-order company to collect use tax on goods sold to customers located within the state when the company had no outlets, sales representatives, or significant property in the state. In this case, the Court determined that only Congress has the authority to require out-of-state vendors, without a physical presence in a state, to register and collect that state's tax.

Virginia law specifically sets out the standards for requiring out-of-state dealers to collect the Virginia Retail Sales and Use Tax on sales into the Commonwealth. The law provides that a dealer is deemed to have sufficient activity within the Commonwealth to require that dealer to register to collect the Virginia Retail Sales and Use Tax if the dealer:

- Maintains an office, warehouse, or place of business in the Commonwealth;
- Solicits business in the Commonwealth, by employees, independent contractors, agents or other representatives;
- Advertises in Commonwealth publications, on billboards or posters located in the Commonwealth, or through materials distributed in the Commonwealth;
- Regularly makes deliveries into the Commonwealth by means other than common carrier;
- Continuously, regularly, seasonally, or systematically solicits business in the Commonwealth through broadcast advertising;
- Solicits business in the Commonwealth by mail, provided the solicitations are continuous, regular, seasonal, or systematic and the dealer benefits from any banking, financing, debt collection, or marketing activities occurring in the Commonwealth;
- Is owned or controlled by the same interests which own or control a business located within this Commonwealth;
- Has a franchisee or licensee operating under the same trade name in the Commonwealth, if the franchisee or licensee is required to obtain a certificate of registration; or
- Owns tangible personal property that is rented or leased to a consumer in the Commonwealth, or offers tangible personal property, on approval, to consumers in the Commonwealth.

Restricted by the United States Constitution and the Supreme Court's decision in *Quill*, many states have similar nexus statutes that restrict their ability to require remote sellers to collect taxes on sales made into Virginia. With growing retail sales on the Internet and declining tax receipts, some state tax collectors have turned their attention to the revenue being lost from sales by out-of-state retailers to the residents of their states. Although individuals who purchase goods from out-of-state firms via the Internet or mail order owe their states of residence use tax on their purchases in lieu of sales tax, states find it difficult to enforce this obligation. As a result, many states lose out on substantial revenue.

Two proposals have developed from the difficulty among states in collecting sales and use taxes on remote purchases. Some states have become involved with the Streamlined Sales Tax Project, which is an effort among states to simplify and unify state and local sales taxes in order to encourage Congress to overturn *Quill*. Other states have enacted "Amazon statutes," which impose a Retail Sales and Use Tax collection requirement on out-of-state online retailers that have affiliate agreements with residents, provided certain requirements are met.

## Streamlined Sales Tax Agreement

The Streamlined Sales Tax Project ("SSTP") was founded in March, 2000, with the purpose of developing measures to simplify and unify state and local sales taxes. Streamlining is primarily an effort by states to enhance sales tax collection on mail order, catalog, Internet, and other remote sales. In reaction to the *Quill* decision and in an attempt to create a level playing field, whereby out-of-state vendors and in-state vendors are both operating under the same tax rules, 40 states and the District of Columbia came together through the SSTP and endorsed the concepts embodied in the Streamlined Sales and Use Tax Agreement ("SSUTA"). States expect that out-of-state businesses without a requirement to collect sales tax will voluntarily collect tax when the states adequately streamline their sales tax.

The SSUTA seeks to improve the sales and use tax administration systems used by the states through:

- State level administration of sales and use tax collections.
- Uniformity in the state and local tax bases.
- Uniformity of major tax base definitions.
- Central, electronic registration system for all member states.
- Simplification of state and local tax rates.
- Uniform sourcing rules for all taxable transactions.
- Simplified administration of exemptions.
- Simplified tax returns.
- Simplification of tax remittances.
- Protection of consumer privacy.

Currently, there are 20 full member states and 3 associate member states that make up the Streamlined Sales Tax Governing Board. Since 2002, Virginia has been an active member of the Streamlined Project, but is not a member of the Governing Board.

## New York’s "Amazon Statute"

Amazon.com operates a retail Internet business with in-state affiliates that are authorized to maintain links to Amazon.com on their own websites and are compensated for any referrals that lead to a sale. Several other retailers, such as Overstock.com, have similar business structures. On April 23, 2008, the state of New York enacted a statute identical to this bill (N.Y. Tax. Law § 1101(b)(8)(vi)), which required the collection of New York sales taxes by out-of-state sellers that contractually agree to pay commissions to New York residents for referring potential customers to them, provided that more than $10,000 was generated from such New York referrals during the preceding four quarterly periods. On April 25, 2008, Amazon.com brought suit against the New York State Department of Taxation, alleging that the Commission Agreement Statute violated the U.S. Constitution’s Commerce Clause, Due Process Clause, and Equal Protection Clause. The Supreme Court of the State of New York, a lower trial level court in New York, dismissed Amazon’s complaint in its entirety, ruling that Amazon had no basis for legal action. Amazon has appealed this decision.

## State Comparison

New York, North Carolina and Rhode Island have all adopted legislation that is similar to the provisions set forth in this bill. In California and Hawaii, Amazon-type statutes have been approved by the state legislatures, only to be subsequently vetoed by the states' governors. In several other states, including Connecticut, Illinois, Minnesota, Maryland, and Tennessee, legislation has been proposed but rejected.

North Carolina's Amazon statute, which was adopted in 2009, is substantively identical to this bill (N.C. Gen. Stat. § 105-164.8(b) (3)). The statute has met with opposition since before its inception, prompting Amazon.com and Overstock.com to end their affiliate programs before the bill became effective. It has been reported that Market America, an affiliate marketing company with 3 million customers, also relocated to Florida as a result of this legislation.

Rhode Island's statute differs from this bill in that the gross receipts from sales by the retailer to customers in Rhode Island who are referred to the retailer through this type of an agreement must be in excess of $5,000, rather than $10,000. The statute does not specify how the presumption can be rebutted. As in North Carolina, Amazon.com and Overstock have ended their affiliate programs in this state. Nevertheless, there is no effort under way currently to repeal the Amazon Law in Rhode Island.

Upon New York's adoption of its Amazon statute, Overstock.com canceled affiliate agreements with its New York affiliate advertisers in May, 2008, and later announced that it would discontinue its use of affiliate advertisers in California, as well as other states. When California's legislature voted in factor of the Amazon statute, Governor Schwarzenegger quickly announced its veto on July 1, 2009, citing the potential for job and business losses in the state. He then notified Overstock.com, which immediately reversed its decision to cease its affiliate agreements in California.

In 2009, Hawaii governor Linda Lingle also vetoed versions of the Amazon law passed by her state legislature. Governor Lingle stated that it would be premature to enact legislation similar to New York's, noting that the New York law was still being litigated, and adding that the legislation was "not well thought out" and could have negative consequences for many smaller businesses.

## Proposal

This bill would create a rebuttable presumption that an out-of-state dealer who enters into an agreement with a Virginia resident, under which the resident, for a commission or other consideration, refers potential customers to the dealer is soliciting or transacting business in Virginia by independent contractors, agents, or other representatives, and is thus required to collect the Retail Sales and Use Tax pursuant to Virginia's nexus statute. The referral could be provided by a link on the out-of-state retailer's Internet site, or by some other means.

In order for the out-of-state retailer to be deemed to be soliciting or transacting business in Virginia, the cumulative gross receipts from sales by the dealer to purchasers in the Commonwealth who are referred to the dealer by residents with this type of agreement with the dealer must be in excess of $10,000 during the preceding four quarterly periods. The statute provides that the presumption may be rebutted by proof that the resident with whom the dealer has an agreement did not engage in any solicitation in the Commonwealth on behalf of the dealer that would satisfy the nexus requirement of the Untied States Constitution during those four quarterly periods.

The effective date of this provision of the bill is not specified.

## Estate Tax

### Current Law

The 2006 Acts of Assembly, Chapter 4, effectively repealed the Virginia estate tax by equating the Virginia estate tax to the current amount of the federal credit allowable for state estate taxes. As there is no federal credit for state estate taxes allowed at this time, there is also no Virginia estate tax.

Prior to the 2006 legislation, Virginia imposed a "pick-up" estate tax that was equal to the maximum amount of the federal credit for state estate taxes as it existed on January 1, 1978. The federal credit for state estate taxes was eliminated by the Economic Growth and Tax Relief Act of 2001 in 2005, but the freeze to 1978 preserved the Virginia estate tax. By striking the language tying the tax to 1978, the 2006 Acts of Assembly, Chapter 4, effectively repealed the Virginia estate tax.

Under the Economic Growth and Tax Relief Act of 2001, the threshold amount of the federal taxable estate was increased over time. The amount was $1.5 million for 2004 and 2005, $2 million for 2006 through 2008, and $3.5 million for 2009. Any estate with a value less than the applicable amount is not subject to the federal estate tax. Currently, there is no federal estate tax applicable for 2010.

The federal law that eliminated the credit for state estate taxes is scheduled to expire after 2010, which would mean that the current Virginia estate tax would be reinstated when the federal credit was again allowed. While Congress is expected to pass estate tax legislation before 2011, the nature of its action cannot be predicted.

Congress has begun to take action on this matter, however. The House of Representatives passed H.R. 4154 on December 3, 2009. This bill would amend the Internal Revenue Code to establish a permanent $3.5 million exclusion amount for decedents dying after December 31, 2009. H.R. 4154 would not, however, reinstate a federal credit for state estate taxes. This bill received a second reading in the Senate on January 20, 2010, but there has been no further action.

### State Comparison

As of January 9, 2010, more than two thirds of states did not have an estate tax. The 14 states that have an estate tax in effect are: Connecticut, Delaware, District of Columbia, Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, Ohio, Oregon, Rhode Island, Vermont, and Washington.

## Proposal

This bill would effectively reinstate the Virginia estate tax for residents whose gross estates exceed $5 million by requiring that the maximum amount of the federal credit for state estate taxes be equal to the federal credit as it existed on January 1, 1978. The estate tax would not be imposed on a gross estate if the majority of the assets of the total estate were an interest in a closely held business or a working farm.

For the personal representative of any estate subject to the Virginia estate tax that is not required to file a federal estate tax return, a Virginia estate tax return would be required to be filed within the 180 days immediately following the death of the decedent. TAX would be allowed to grant an extension of time for filing the Virginia estate tax return or remitting the tax due. TAX would also establish procedures and conditions for an extension.

Personal representatives have nine months after the date of death to file a federal return. This requirement is not applicable to those dying on or after January 1, 2010 but before January 1, 2011 because there is currently no federal estate tax return due for 2010. Therefore, the Virginia estate tax return would be due within 180 days for those dying on or after July 1, 2010 but before January 1, 2011. The federal estate tax is scheduled to return in 2011; therefore, the Virginia estate tax return would be due nine months after the date of death for those dying on or after January 1, 2011.

"Interest in a closely held business" would be defined as an interest as a proprietor in a trade or business carried on as a proprietorship or an interest as a partner in a partnership carrying on a trade or business, if 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent, such partnership had 45 or fewer partners, or stock in a corporation carrying on a trade or business if 20 percent or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent, or such corporation had 45 or fewer shareholders.

"Working farm" would be defined as an interest in a closely held business that operates as an active trade or business for agricultural purposes.

This bill would be effective for the estates of Virginia decedents dying on or after July 1, 2010, but before July 1, 2012.

## **Use of Revenue**

This bill provides that all General Fund revenue generated by the provisions of this bill must be appropriated to fund the Standards of Quality.

cc : Secretary of Finance

Date: 2/15/2010 JKM
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