DEPARTMENT OF TAXATION
2012 Fiscal Impact Statement

1. Patron Walter A. Stosch

2. Bill Number SB 681

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

3. Committee Passed House and Senate

4. Title Definition of income tax

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

5. Summary/Purpose:

This bill would clarify existing law by defining the types of taxes that constitute an "income tax" for purposes of the individual income tax credit for income taxes paid to other states, and by providing examples of taxes that do not meet this definition. This clarification is consistent with the original intent of the law, as administered by the Department of Taxation for more than fifty years.

This bill contains an emergency clause and would be in force from its passage.

6. Budget amendment necessary: No.

7. No Fiscal Impact. (See Line 8.)

8. Fiscal implications:

Administrative Costs

The Department of Taxation ("the Department") considers implementation of this bill as routine, and does not require additional funding.

Revenue Impact

This bill would have no revenue impact. As a result of recent litigation, the Department anticipates a high volume of refund requests from taxpayers claiming the credit for non-income taxes. If this bill is not passed, such requests would have an estimated revenue impact of approximately $22 million annually which, with refund claims for three years, would total a minimum of $88 million as early as FY 2012. This amount could be substantially more, depending on the amount of refund claims for taxes paid to other states. Additionally, there would be an ongoing annual impact of approximately $22 million in FY 2013 and each year thereafter.

The revenue impact that would result from the failure to pass this bill is shown in the following chart:

Fiscal Year	*Dollars*	*Fund*
2011-12	($88 million)	GF
2012-13	($22 million)	GF
2013-14	($22 million)	GF
2014-15	($22 million)	GF
2015-16	($22 million)	GF
2016-17	($22 million)	GF
2017-18	($22 million)	GF

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Background

Virginia allows an individual income tax credit for Virginia residents who are liable for income taxes in another state. This credit is designed and intended to apply only to other states' income taxes that are similar to Virginia's individual income tax. Several taxes do not qualify for the credit because they are not similar to Virginia's individual income tax. For example:

- The DC Unincorporated Business Franchise Tax is not an income tax similar to Virginia's tax because it is a franchise tax that treats an unincorporated business as if it was an incorporated business and taxes the business itself, rather than the income of the owner. In contrast, Virginia only taxes the individual owner's share of income from an unincorporated business, and not the business itself.
- Likewise, the Texas Margin Tax does not qualify for the credit because it is a franchise tax imposed on the business entity, rather than the individual owners.
- The Ohio Commercial Activity Tax does not qualify for the credit because it is a privilege tax based on gross receipts, rather than an income-based tax, and is imposed on the business, rather than the individual owners.

Although a franchise tax may be measured by income, it differs from an income tax because it is triggered by the exercise of a privilege or license to do business in a state. In a recent Circuit Court case, the judge determined that the DC Unincorporated Business Franchise Tax qualifies as an income tax for purposes of the credit, contrary to Virginia's long-standing policy that the Department has been enforcing since 1959. In response to an earlier court case, the General Assembly enacted legislation, 1991 Acts of Assembly,

Chapters 362 and 456, which attempted to clarify that taxes like the DC Unincorporated Business Franchise Tax did not qualify for the credit. Based on recent litigation, this clarification was not sufficient.

Proposal

This bill would clarify existing law by defining the types of taxes that constitute an "income tax" for purposes of the individual income tax credit for income taxes paid to other states, and by providing examples of taxes that do not meet this definition. This clarification is consistent with the original intent of the law, as administered Department of Taxation for more than fifty years.

This bill would define an "income tax" as a term of art that refers to a specific type of tax levied on all of a resident's earned and unearned income, and all income of a nonresident from sources within the jurisdiction, which is similar to the income tax that Virginia imposes on resident and nonresident individuals.

The bill includes examples of taxes that do not qualify for the credit, even though they may be measured by income. They do not qualify because (i) they are labeled as a franchise or license tax, and (ii) they do not tax all income of the individual. The latter distinction was explained by the by the U.S. Court of Appeals shortly after Congress imposed the unincorporated business tax. In holding that a nonresident individual was subject to tax on an apartment rental business, but not on certain lease payments, the court said:

> [T]he levy is upon the net income of an unincorporated business only. The privilege of receiving income from sources within the District, for which the statute imposes the tax, is, under this statute, a privilege being exercised by an unincorporated business. So, if there be no "business" within the meaning of the statute, there is no tax. ***It is striking that this act does not levy a tax upon nonresident individuals generally upon income from sources within the District, as the federal income tax law and the laws of many states do in respect to nonresidents of their respective jurisdictions***.

District of Columbia v. Pickford, 179 F.2d 271, 272 (1949) (emphasis added).

This bill is intended to clarify and restore the intent behind the long-standing policy of allowing a credit only for income taxes that are similar to Virginia's individual income tax. These clarifications would provide Virginia courts with a set of statutory guidelines for comparing the tax imposed by another state to Virginia's individual income tax to determine whether the two taxes are similar.

This bill is declarative of existing law and would be effective for taxable years beginning on and after January 1, 2007. This bill confirms not only the Department's policy for the last fifty years, but also follows the result of a 1997 decision of the Virginia Supreme Court, both of which have been consistently applied by the Department throughout the

retroactive period. Based on recent litigation, there is a potential for refund claims for the last three years. Accordingly, this bill also contains an emergency clause and would be in force from its passage.

cc : Secretary of Finance

Date: 2/24/2012 KLC
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