REVISED

DEPARTMENT OF TAXATION
2004 Fiscal Impact Statement

1. **Patron** Vivian E. Watts

2. **Bill Number** HB 5004
House of Origin:
X **Introduced**
____ **Substitute**
____ **Engrossed**

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

3. **Committee** House Finance

4. **Title** Omnibus Tax Reform

5. **Summary/Purpose:**

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

- The corporate income tax rate would be increased from 6% to 7%.
- The effects of transactions with intangible holding companies would be eliminated from the Virginia corporate income tax computation.
- Pass-through entities doing business in Virginia would be required to file an annual informational return with the Department listing its income and owners.
- The state cigarette tax would increase to $.25 per pack.
- The Virginia estate tax would be eliminated on all estates of $10 million or less and on estates valued at greater than $10 million provided the majority of the value of the estate's assets are made up of a closely held business or working farm.

The effective dates of these provisions are described in line 11.

6. **Fiscal Impact Estimates are:** Not available. (See Line 8.)

6a. Expenditure Impact:

Fiscal Year	*Dollars*	*Positions*	*Fund*
2003-04	$236,299	0	GF
2004-05	$2,217,321	8	GF
2005-06	$1,074,825	11	GF
2006-07	$921,826	11	GF
2007-08	$918,866	11	GF
2008-09	$933,426	11	GF
2009-10	$948,426	11	GF

6b. Revenue Impact:

Fiscal Year	*Dollars*	*Fund*
2003-04	$0	GF
2004-05	$210.8 million*	GF
2005-06	$257.6 million	GF
2006-07	$216.8 million	GF
2007-08	$208.2 million	GF
2008-09	$212.7 million	GF
2009-10	$232.0 million	GF

*Assumes effective date of August 1, 2004.

7. **Budget amendment necessary:** Yes.
ITEM(S): Page 1, Revenue Estimates
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8. **Fiscal implications:**

Administrative Impact

The Department would incur administrative costs of $236,299 in Fiscal Year 2004, $2,217,321 in Fiscal Year 2005, $1,074,825 in Fiscal Year 2006, $921,826 in Fiscal Year 2007, $918,866 in Fiscal Year 2008, $933,426 in Fiscal Year 2009, and $948,426 in Fiscal Year 2010. These administrative costs would be for systems development, forms revisions, and 11 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 impact statement has been revised to reflect the change in the effective date of the provisions of this bill that would be effective in due course. Article IV, § 13 of the Constitution of Virginia states that all laws enacted during a special session other than the Appropriations Act and emergency legislation will take effect on the first day of the fourth month following the month of adjournment of the special session. As the month of March has expired and the special session has not adjourned, **all laws enacted during a special session effective in due course will become effective on August 1, 2004, assuming the special session adjourns before the end of April.** This impact statement has been revised to reflect an August 1, 2004, effective date for the provisions of this bill affecting the cigarette tax.

This bill would result in an increase in state revenue of $210.8 million in Fiscal Year 2005, $257.6 million in Fiscal Year 2006, $216.8 million in Fiscal Year 2007, $208.2 million in Fiscal Year 2008, $212.7 million in Fiscal Year 2009, and $232.0 million in Fiscal Year 2010. This estimate is made assuming that the suggested technical amendment specifying the effective date of the increase in the corporate income tax rate is adopted.

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 HB 5004 on General Fund Revenue**	**General Fund revenue effect of the Governor's tax reform proposal**	**Difference between HB 5004 and the Governor's tax reform proposal**
2004	$0	$4.0 million	($4.0 million)
2005	$210.8 million	$495.2 million	($284.4 million)
2006	$257.6 million	$553.8 million	($296.2 million)
2007	$216.8 million	$511.9 million	($295.1 million)
2008	$208.2 million	$448.3 million	($240.1 million)
2009	$212.7 million	$407.6 million	($194.9 million)
2010	$232.0 million	$462.6 million	($230.6 million)

Impact on State Revenue by Component

($ millions)	**FY 2004**	**FY 2005**	**FY 2006**	**FY 2007**	**FY 2008**	**FY 2009**	**FY 2010**
Business Taxes	$0	$72.9	$111.9	$110.7	$114.7	$119.2	$124.1
Cigarette Tax	$0	$137.9	$145.7	$143.8	$143.8	$143.8	$143.8
Estate Tax	$0	$0	$0	($37.7)	($50.3)	($50.3)	($35.9)
Total	$0	$210.8	$257.6	$216.8	$208.2	$212.7	$232

Revenue Impact – July Effective Date

If the cigarette increase proposed by this bill is effective on July 1, 2004, this bill would result in an increase in state revenue of $4.0 million in Fiscal Year 2004, $219.4 million in Fiscal Year 2005, $257.7 million in Fiscal Year 2006, $216.8 million in Fiscal Year 2007, $208.2 million in Fiscal Year 2008, $212.7 million in Fiscal Year 2009, and $232.0 million in Fiscal Year 2010. This estimate is made assuming that the suggested technical amendment specifying the effective date of the increase in the corporate income tax rate is adopted.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: Yes.

Because cigarettes are sold in packs containing a number of cigarettes other than twenty, the following technical amendment is suggested:

Page 7, Line 422, After ~~cigarette~~
Strike: *twenty-five cents per pack of cigarettes*
Insert: 1.25 cents on each such cigarette

As this bill does not specify an effective date for the increased corporate income tax rate, the Department suggests the following amendment:

Page 7, Line 422, At the end of the line.
Insert: 2. That the provisions of this act amending § 58.1-400 of the Code of Virginia shall be effective for taxable years beginning on or after January 1, 2005.

In order to prevent existing code sections from conflicting with the pass-through entity proposal contained in this bill, the following technical amendment is suggested:

Page 7, Line 422, At the end of the line.
Insert: 3. That §§ 58.1-390 and 58.1-394 of the Code of Virginia are repealed.

11. Other comments:

Corporate Income Tax Rate

Assuming the suggested amendment is adopted, the Virginia corporate income tax rate would be raised from 6% to 7% for taxable years beginning on or after January 1, 2005.

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

For taxable years beginning on or after January 1, 2004, 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 <u>both</u> 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.

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 for taxable years beginning on or after January 1, 2004.

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.

State Cigarette Tax

Current Law

The current cigarette tax rate in Virginia is 2.5 cents per pack. Virginia has the lowest state cigarette tax in the nation. The current national average for state cigarette tax rates is 72 cents per pack.

Proposed Change

Effective August 1, 2004, the state cigarette tax would increase to 25 cents per pack. This provision would be effective on and after August 1, 2004.

Estate Tax

Background

Federal Estate Tax Credit for State Death Taxes

A credit is allowed against the Federal estate tax for estate taxes paid to any state with respect to property included in the decedent's gross estate. The maximum amount of the credit allowable for state death taxes is determined under a graduated rate table, based on the size of the decedent's adjusted taxable estate.

Virginia Estate Tax

Virginia imposes a "pick-up" estate tax that is equal to the maximum amount of the federal credit for state death taxes as it existed on January 1, 1978. Prior to federal legislation enacted in 2001, the maximum federal credit amounts have not changed since 1978.

2001 Federal Legislation

Under the Economic Growth and Tax Relief Act of 2001 (EGTRRA) enacted by Congress, the state death tax credit is reduced incrementally beginning in 2002, and is fully repealed in 2005. For 2005 and years thereafter, a deduction from the taxable estate is allowed for any state death taxes actually paid.

Year of Death	% Reduction of Federal Credit for State Death Taxes
2002	25%
2003	50%
2004	75%
2005	Credit Repealed

Current Law

The estate tax is imposed on the transfer of taxable estates in excess of $1.5 million. The federal estate tax is slowly being phased out until it is finally repealed in 2010. While most states automatically conform to the federal estate tax, Virginia bases its tax on a federal credit as it existed in 1978.

Proposed Change

This bill would eliminate the Virginia estate tax on all estates of $10 million or less and on estates valued at greater than $10 million provided the majority of the value of the estate's assets are made up of a closely held business or working farm. This would be effective for the estates of Virginia decedents dying after January 1, 2006.

For the purposes of this exemption, "closely held business" has the same definition as in Internal Revenue Code (IRC) § 6166, which allows estate taxes to be paid in installments in order to prevent the breakup of closely held businesses. A "working farm" is defined to be a closely held business that operates for agricultural purposes.

IRC § 6166 requires that "an interest in a closely held business" be an interest in a trade or business. Internal Revenue Service (IRS) Rulings clarify that:

- The decedent or his agents must conduct active, material management.
- The mere management of income producing assets from which decedent obtained income largely through ownership of property rather than the performance of management activities does not constitute an active business.
- In order for the rental of property to constitute an active business, the decedent or his employees or agents must perform substantial personal services in managing, maintaining, and leasing the property.
- An individual is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant, and if he receives a rental based upon farm production rather than a fixed rental. Farming under these circumstances is a productive enterprise as distinguished from management of investment assets.

IRS regulations provide that the determination whether an interest in a business is an interest in a closely held business is a factual matter.

cc : Secretary of Finance

Date: 4/5/2004 CT