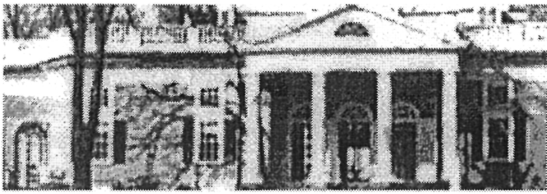

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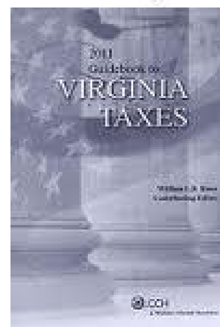
Tax Restructuring in Virginia

A Revenue Neutral Path for Improving Our Economy

By: Michael W. Thompson



Appendix I

April 2012

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Appendix I

Governor’s Commisson on Economic Development and Job Creation

(known as the “Jobs Commission”)

Pages 36-40

Virginia's Business Tax Policy

Economic development is dynamic and ever-changing and the competition between regions, states and countries for new jobs and investment is intense. As a result, Virginia must continuously examine government policies, particularly our tax policies, to ensure that Virginia maintains its competitive standing.

The Commission subgroups examined several areas of tax policy, including the corporate income tax, machinery & tools tax, business, professional and occupational licensing (BPOL) tax and the accelerated single sales factor transition. For each policy, several factors were considered, including purpose, fiscal impact to the state and local governments, fairness on specific industries, competitiveness with surrounding states and potential impact on economic growth and job creation.

As can be expected with tax policy issues, after lengthy discussion and consideration the subgroups found in some instances that arriving at consensus was difficult and additional research and data was needed.

The Commission offered the following analysis and recommendations on certain business related tax issues:

1. Corporate income tax
2. Machinery & Tools tax
3. Accelerated single sales factor
4. BPOL tax
5. Comprehensive comparative study of total tax burden on certain industries

Corporate Income Tax/Aligning Taxation with Long-Term Growth Sectors

Virginia is fortunate to have long enjoyed a stable tax environment and relatively low tax rates – in fact, our corporate income tax rate has remained flat at 6% since 1972. Both of these factors have been essential to the Commonwealth's ranking as one of the best places to do business. Yet those rankings are ever changing and actions being taken in other states and overseas can erode Virginia's historical position and leave the state at a competitive disadvantage.

While not the sole factor in determining corporate locations, tax policies are instrumental in corporation decisions as to where to invest scarce capital or in determining where entrepreneurs start their new businesses. Capital is mobile and flows to where the returns are the greatest.

There is a concern that the structure of Virginia's tax system can potentially act as a disincentive to further investment and job creation in the Commonwealth, particularly in light of actions being taken by competitors to streamline and harmonize tax policies. Our state corporate tax rate, combined with the federal corporate tax rate, is among the highest in the world, thus

discouraging investment here as opposed to overseas, where companies may also realize other cost efficiencies such as labor costs, transportation or access to raw materials. At the same time, the Commission realizes and appreciates that each of these taxes provides a vital funding stream to support programs at the state and local level. However, studies have suggested lowering the corporate income tax could have a positive impact on job creation and investment in Virginia.

At the direction of the General Assembly, the Joint Legislative Audit and Review Commission (JLARC) is examining Virginia's corporate income tax and the impact a reduction of the tax could have on economic development activities. The study results will not be available until November 2010, after the completion of the Governor's Commission on Economic Development and Job Creation.

The Commission also cautions against a reduction in the corporate income tax that would simultaneously be paired with the creation of new taxes, or changes to existing taxes, that could serve as a disincentive to job creation and investment. Such actions could diminish the impact of the change. Further, Virginia must continue to closely monitor the activities of other jurisdictions as they contemplate similar policies to ensure Virginia's competitive edge.

In the absence of the study results, the Commission is challenged in making a definitive recommendation on what should be done about Virginia's corporate income tax rate and did not come to a consensus recommendation. Nevertheless, the Subgroup offers the following guidance for consideration by Governor McDonnell as those results become clearer:

- A reduction in the corporate income tax rate should be considered so long as the reduction can be specifically linked to new job creation and new investments by employers in the Commonwealth. Such a decision could be made following the completion of an independent, dynamic modeling analysis of the likely impact of a change in the corporate tax rate.
- The revenue the Commonwealth receives from the corporate income tax, even if the level stays at the current rate, should be dedicated to economic development-related activities, including, but not limited to marketing, incentives, and higher education research and development efforts.

Machinery & Tools Tax

Several of Virginia's competitive states have repealed their machinery and tools (M&T) tax, including Alabama, Kentucky, North Carolina, South Carolina and Georgia. While Virginia has taken recent legislative actions to assist manufacturers, including the development of a mega-site fund and maintaining Ch. 199 exemptions, Virginia must offer manufacturers a competitive tax environment which will result in job creation and larger capital investment.

The M&T tax was identified in 2005 as a $200 million disparity on manufacturers as compared to the effective tax rate of all other industries in Virginia. Ultimately, the Commission's goal is to create a low cost solution that corrects these imbalances and increases

the capital investments, competitiveness and job creation in the manufacturing industry in Virginia.

The Commonwealth has clearly stated that manufacturing facilities are an economic priority. Unfortunately, the more manufacturers invest in new technologies and equipment, the more taxes they end up paying. The future success of the manufacturing industry will be based upon higher wages, higher skills, greater global competition and greater investments in new technology.

Additional Recommendations Regarding the Machinery & Tools Tax

The Commission does not take lightly the fiscal impact that elimination of the M&T Tax would have on local governments. Estimates have placed that fiscal impact at $200 million. At a time when revenues across all levels of government are unpredictable, the Commission understands that repeal could create a financial hardship for many local governments.

While the Commission believes a repeal of the M&T Tax is in the best interest for both manufacturers and the Commonwealth, they would like to offer additional recommendations relating to the M&T Tax to be enacted immediately while the Machinery and Tools Tax is phased out over a longer period of time and replacement sources of revenue are identified.

- All new investments in M&T are not taxable for the first three tax years of use after the purchase, transfer or restart date. This policy would motivate industry to purchase new equipment and tools, transfer machinery and tools from out-of-state to Virginia and/or restart idled machinery and tools.

- All in-service M&T over 10 years old would be assessed at a maximum value of 1% of the original cost until idled or disposed of (local rates and taxing methodology must remain constant until all existing taxable assets have aged to the 1% level). All machinery and tools, whether idled or not prior to reaching 10 years, would qualify once its age exceeds 10 years. Machinery and tools taxable under this provision would qualify regardless of prior ownership.

While less appealing to the industry than a repeal of M&T, this approach would allow Virginia to position itself as attractive for manufacturers considering Virginia as compared to the West Coast, Northeast, and Southern locations such as Alabama, Georgia, Kentucky, North Carolina, South Carolina and Tennessee.

Accelerated Single Sales Factor

Beginning in 2011, Virginia will allow manufacturers to transition to a single sales factor. The single sales factor is to be fully phased in by 2014. Manufacturers who elect to use the single sales factor will be locked into a three-year irrevocable election and are required to certify that their average weekly wages for full-time employees are greater than the lower of the state or local average weekly wages in their industry.

Using a single sales factor is beneficial to companies with material amounts of capital and labor in a state. The sales percentage is usually significantly smaller than the property and payroll percentages for manufacturers who ship out of state.

Transitioning to the single sales factor from 2011 to 2014 is expected to save manufacturers a total $55.7M in state income tax over a 4 year period. Immediate implementation would increase the savings by an additional $64.3M. When fully implemented, the single sales factor is expected to result in an annual tax savings of $30M.

BPOL Tax

The BPOL tax has a long history in the Commonwealth of Virginia. License taxes were one of the primary methods for obtaining revenues at the adoption of the federal constitution. Due to Virginia's share in the costs for the War of 1812, license tax rates were increased, and the types of businesses subject to taxation were expanded. By 1850, the policy of levying a license tax on practically all well-established businesses and professionals was adopted. While BPOL was initially a flat-fee that varied by type of business, the system was changed in the 20th century to taxes that are based on the gross receipts of businesses. In 1996, BPOL tax was significantly amended to help ensure more uniform local administration.

Because the BPOL tax is based on gross receipts, many small business owners believe it is unfair not to consider the burden on businesses when the tax is a derivative of total profits. For example, the BPOL tax is biased against new businesses, which typically experience losses in their early years.

The Commission heard from numerous small business owners whose companies lost money in a fiscal year but were still required to pay a BPOL tax. One such testimony was from a small businessman whose company lost $75,000 last year and still paid almost $5,000 in BPOL taxes.

Additionally, because BPOL taxes are administered by localities, inconsistent rules and lack of best practices exist from jurisdiction to jurisdiction that create significant administrative challenges business owners and franchisers.

A general improvement would be to make BPOL taxes more consistent and uniformly applied across localities. For example, a similar system to sales tax structures would allow the state to collect BPOL tax revenue and return them to localities. This approach can potentially reduce competition between Virginia jurisdictions for economic development expansion opportunities. Similarly, businesses with multiple locations across the state may prefer a centralized location for tax matters rather than interacting with multiple local governments.

Any changes to the current BPOL system should address the inherent issue of taxing gross receipts regardless of business profitability while maintaining the revenues for local governments' operations. The Commission understands that repealing BPOL taxes without

finding additional revenue sources would be difficult in the current budgetary environment and does not take lightly the static fiscal impact that elimination would have on local governments.

Therefore, the Commission recommends that the Department of Taxation collect for two years the necessary information to determine the fiscal impact if Virginia taxed small businesses on their relative profitably as opposed to gross receipts.

Once the Department of Taxation has collected the proper data and is able to provide an accurate fiscal impact of reforming BPOL from a gross receipt to a net profit tax, the Commission recommends that Virginia moves BPOL from the current formula of gross sales to a net profit model that is fair and truly represents a company's success.

Comprehensive Tax Study of Targeted Industry

Through the discussions of tax policy affecting certain industries, there was significant consideration of how a tax compared to that specific tax in other states, localities or industries. However, there was little discussion of the overall tax burden on specific industries in Virginia compared to those industries in other states.

The Commission leadership recommends conducting a comprehensive study of the overall tax burden on specific targeted industries such as manufacturing and technology in Virginia compared to our competitor states. The study will not only consider corporate income, M&T and BPOL taxes, but the total tax burden including property tax, sales tax, income tax and others. This will provide a more thorough analysis of which taxes are competitively detrimental to Virginia businesses and prohibitive to job creation and expanding industry.

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"... a wise and frugal government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government, and this is necessary to close the circle of our felicities."

Thomas Jefferson
1801

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