

REPORT OF THE

**JOINT SUBCOMMITTEE TO STUDY AND
REVISE VIRGINIA'S STATE TAX CODE
(HJR 685/SJR 387, 2001; HJR 60, 2002)**

TO THE GOVERNOR AND
THE GENERAL ASSEMBLY OF VIRGINIA



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EXECUTIVE SUMMARY

The Joint Subcommittee was appointed to study and revise Virginia's state tax code. The subcommittee was created originally by House Joint Resolution 685 and Senate Joint Resolution 387 during the 2001 General Assembly Session for a two-year period. House Joint Resolution 60 (2002) confirmed the continuance of the study.

The joint subcommittee was specifically directed in HJR 685/SJR 387 to do the following: (i) examine the report and recommendations of the Commission on Virginia's State and Local Tax Structure for the 21st Century; (ii) seek broad input from all levels of government, the private sector, and citizens concerning the sufficiency of the Commonwealth's current tax system; (iii) consider the necessity and sufficiency of current taxes, fees, deductions and credits as well as the rates of taxation; (iv) consider current revenue capacity of localities and the sufficiency of their revenue tools; (v) clarify the definition of manufacturer for purposes of the business, professional, and occupational license tax; (vi) examine the number and costs of tax credits and deductions authorized each year; (vii) determine the loss in sales tax due to electronic commerce; (viii) evaluate the real estate assessment appeals process, the need for any changes to the process, and the effect that such changes would have on taxpayers and local governments; (ix) consider the long-term effect on the Commonwealth's revenues of the phase-out of personal property tax; (x) evaluate the appropriateness of the merchants capital tax and the business, professional and occupational license tax; (xi) consider a plan to more equitably address exemptions, deductions, and rates for personal and business income taxes; and (xii) determine the equitable division of support to be assumed by the state and localities for education and mandated services in light of the reforms recommended by the Commission.

Throughout 2001 and 2002, the joint subcommittee spent numerous hours in meetings receiving information provided by staff and a wide variety of interested parties both from the public and private sectors. During the first year, they studied the state and local taxes and administration of each broadly and then focused on more specific issues during the second year when they divided themselves into two task forces. They examined the individual and corporate income taxes, sales and use tax, property taxes, business, professional and occupational license (BPOL) tax and administrative issues, both state and local.

During that same time period the national and state economies began to suffer and Virginia's has worsened during this past year. Therefore, the joint subcommittee decided it would not be prudent at this time to go forward with all of

the changes they have been considering but instead to continue the study for one more year and make the following recommendations to the 2003 General Assembly:

1. Adopt House Finance Subcommittee (Orrock) Report with standards for charitable organization sales tax exemptions.
2. Restore conformity with federal income tax law, except for accelerated depreciation and carry back loss issues in order to essentially eliminate fiscal impact.
3. Revise administrative appeals process for income taxpayers to provide for no payment of tax in advance of adjudication.
4. Eliminate June accelerated sales tax collections in 2002-2004 budget.
5. Revise property tax appeals process to clarify procedures and standard of proof for taxpayer.
6. Phase out estate tax beginning in Fiscal Year 2005.
7. Impose no new state unfunded mandates on localities, and to maximum extent possible, eliminate existing ones.
8. Support a moratorium on new sales and use tax exemptions.
9. Maintain policy of no sales tax on access to Internet and digital downloads.
10. Continue working with the national Streamlined Sales Tax Project.
11. Require purchasers to report the greater of (i) the actual purchase price or (ii) the NADA value (less \$1,500) for casual sales of motor vehicles that are no more than five years old when titling the vehicle and paying the sales and use tax.
12. Continue the study in 2003 with final report in December 2003.

The joint subcommittee looks forward to the continuation of the study through 2003 in order to complete its monumental task of revising Virginia's state tax code. The changes they anticipate will have widespread, long-term effects, some known and some unknown. Therefore, they want to be as certain as possible that they make the best decisions for the Commonwealth and its citizens.

INTRODUCTION

Background

The Commission on Virginia's State & Local Tax Structure for the 21st Century was created following the 1999 General Assembly Session as a result of House Joint Resolution 578. Consisting of 13 voting and 2 non-voting members, none of whom were serving in an elected capacity, the Commission examined certain aspects of the state and local tax structure as well as the division of revenues and responsibilities for services between state and local governments. In January, 2001, it presented its final report containing extensive findings and recommendations to the Governor and General Assembly.¹

Determining that the findings and recommendations of the Commission required further analysis and only some of the issues that need to be examined to restructure the entire tax code, members of both the House of Delegates and the Senate introduced House Joint Resolution 685 and Senate Joint Resolution 387 during the 2001 General Assembly Session. (Appendix A). These identical resolutions called for the creation of a joint subcommittee to study and revise Virginia's state tax code. One of the 12 directives in each resolution required the joint subcommittee to "examine the report and recommendations of the Commission on Virginia's State & Local Tax Structure for the 21st Century." That report, along with the reports of the Governor's Commission on Government Finance Reform for the 21st Century (2001) and the Commission on the Condition and Future of Virginia's Cities, served as a starting point for the work of this joint subcommittee.

The patrons of HJR 685 and SJR 387 articulated a number of reasons for the restructuring of Virginia's tax code including:

1. No major changes in decades, while the economy changed dramatically from a manufacturing and goods oriented economy to a high-tech, services and tourism based economy.
2. A hodge-podge of tax policy, particularly in the area of tax preferences (subtractions, deductions, exemptions and credits) with no clear, common, underlying policy.
3. Local government revenue capacity reduction and changes inhibited their ability to meet constituent services demands.
4. Need to create final resolution of the personal property tax phaseout.
5. Need to act on recommendations of numerous citizen and business groups and committees urging changes to the state tax code.
6. Need to evaluate the ongoing efficacy of certain taxes and tax rates, some of such taxes dating back to the 1800's.

¹ Report of the Commission on Virginia's State and Local Tax Structure for the 21st Century, House Document No. 22 (2001).

The membership of the joint subcommittee in its first year, 2001, consisted of 14 members: 8 members of the House of Delegates, of whom 2 served as members of the Commission on the Condition and Future of Virginia's Cities; and 6 members of the Senate, of whom 1 served as a member of the Commission on the Condition and Future of Virginia's Cities. During its second year, the membership rose to 18 with the addition of 2 non-legislative citizen members as well as the Secretary of Finance and the State Tax Commissioner. (See House Joint Resolution 60--Appendix B)

Throughout the years there have been numerous studies that have examined a variety of state and local tax issues. Some were undertaken by legislative joint subcommittees created by resolutions, some by state agencies (e.g. Department of Taxation and Joint Legislative Audit and Review Committee), and some by special subcommittees made up of members of the Senate and House Finance Committees. A sampling of final reports from tax-related studies undertaken during the 1990's include (i) State and Local Government Responsibility and Taxing Authority (HD 88, 1998); (ii) Virginia's Gross Receipts Tax Imposed on Insurance Companies (HD 78, 1997); (iii) Business, Professional and Occupational License Tax (HD 59, 1995; HD 78, 1994); (iv) Local Revenue Resources (HD 69, 1995); (v) Criteria for Evaluating Sales and Use Tax Exemptions Requests (SD 61, 1994); (vi) Further Means of Combating Fuels Tax Avoidance and Evasion (SD 31, 1994); (vii) Imposition of Local Business, Professional and Occupational License Tax on Nonprofit Hospitals, Colleges and Universities (HD 17, 1993); and (viii) Review of the Department of Taxation (HD 49, 1992).

The majority of the earlier studies focused on one or a few tax-related issues. None of them encompassed as wide a scope of such issues as the current study has identified and examined throughout its first two years. The work was so voluminous that the joint subcommittee members and the issues were divided between two task forces. (Appendix C) The title of the study encompasses the enormity of the task----Joint Subcommittee to Study and Revise Virginia's State Tax Code.

ACTIVITIES OF THE JOINT SUBCOMMITTEE

The joint subcommittee met five times in 2001, five times in 2002 and had one public hearing in 2002. The task forces each met four times in 2002. Following are summaries of those meetings where the work of the joint subcommittee was undertaken.

2001 MEETINGS

June 25, 2001

In its organizational meeting, the joint subcommittee, elected co-chairmen, adopted a work plan, and received background information from staff concerning major general fund and nongeneral fund taxes and revenues.

General Fund Taxes

Approximately 90 percent of the general fund revenues are produced by three taxes: individual income tax, sales and use tax and corporate income tax. Sources making up the remaining ten percent are insurance premiums tax; inheritance, gift and estate taxes; public service corporation tax; interest and rent; wills, suits and deeds taxes and fees; ABC taxes; bank franchise tax; and cigarette tax. The general fund portion of the meeting focused on the top three taxes: individual income, sales and use, and corporate income.

Virginia's individual income tax accounted for about 64 percent of the general fund revenues in FY 2000. It is by far the largest general fund revenue producer followed by the sales and use tax at 21 percent and the corporate income tax at 5 percent. For the past 30 years, the trend has been for the Commonwealth to become more reliant on individual income tax collections and less reliant on other tax sources. As the economy has grown, so have the number of jobs and individuals' salaries, thereby increasing individual income tax revenues.

The individual income tax has experienced few changes during the same 30-year period. In 1971, Virginia conformed its income tax definitions to federal law, making it easier to administer and less complex for taxpayers. Also, the top rate of 5.75 percent was added that year. The only other recent change with regard to rates came in 1987 when the tax bracket for the top rate went from \$12,001 to \$17,001. The rates and brackets have not change since 1987.

Virginia Taxable Income	Rate
First \$3,000	2%
\$3,001 - \$5,000	3%
\$5,001-\$17,000	5%
\$17,001 or more	5.75%

The state sales and use tax, as the second highest general fund revenue producer at 21% in FY 2000, is imposed on the sale of tangible personal property at a rate of 3.5% with an additional 1% local option for a total sales tax of 4.5%. The state sales and use tax was enacted in the Commonwealth in 1966 at a rate of 2%. An additional 1% local option, which all counties and cities have adopted, was added in 1969. The state rate has been increased twice since then; in 1968 to 3% and in 1987 to 3.5%. Today, Virginia has one of the lowest state sales and use tax rates in the United States.

Distribution Formula of 3.5% State Sales Tax

2% to the general fund
1% to localities based on school-age population
0.5% to the Transportation Trust Fund

The sales tax is levied on the sales price of tangible personal property sold or leased at retail in the Commonwealth. The use tax is levied on the sales price of tangible personal property purchased outside the Commonwealth but used within its boundaries. The tax is imposed on the purchaser and collected by the seller who then sends it to the Department of Taxation. Sellers are compensated for collecting the tax.

The corporate income tax is the third largest source of general fund revenues accounting for approximately 5% of all general fund revenues in FY 2000. It is imposed on domestic corporations and foreign corporations (those incorporated outside Virginia) with income from Virginia sources. The tax is a net income tax levied on "bottom-line" profit at a flat rate of 6%.

Corporate income tax revenues are volatile and therefore, difficult to depend on and predict. During the 1990's, the annual growth for such revenues fluctuated from a low of -10% in 1991 to a high of + 34.6% in 1993 and 2000. There is no obvious explanation why this is the case. However, the corporate tax rate of 6% does not change as corporate profits increase, which is in contrast to the graduated individual income tax rates. Also, a corporation may elect to be treated for tax purposes as a type of legal entity that allows the profits to flow through to the shareholders/members who pay the individual income tax while the corporation pays no corporate income tax.

Nongeneral Fund Taxes

The majority of the revenues comprising the nongeneral fund are not generated by tax sources. In FY 2000 for example, over half of such revenues were generated by federal and other grants/donations (33.4%), and institutional revenues (21.8%) such as higher education tuition/fees and state hospital charges. Major nongeneral fund tax sources contributed the third highest percentage at 12.2%, followed by sales of property and commodities (8.4%), special services assessments (6.3%), rights and privileges fees (5.2%), interest, dividends and rent (3.9%), fines, forfeitures, costs, penalties and escheats (1.9%), and other (6.9%).

The major nongeneral fund tax sources (excluding the 0.5% of the state sales and use tax deposited in the Transportation Trust Fund) are the state fuels tax, the motor vehicle sales and use tax, and the special revenue regulatory tax. The Department of Motor Vehicles (DMV) administers both the state fuels tax and the motor vehicle sales and use tax. For FY 2000, the state fuels tax accounted for 43.5% of all nongeneral fund tax revenues collected by DMV while the motor vehicle sales and use tax accounted for 30.4% of such revenues.

The state fuels tax, known as the "tax at the rack" is assessed at the point the fuel is removed from the terminal rack, although the tax is passed on to the ultimate consumer at the gas pump. The main fuels tax rates per gallon are 17.5 cents for gasoline and gasohol and 16 cents for diesel fuel and alternative fuels. All fuels tax revenues are distributed to (i) the Transportation Trust Fund, (ii) the Highway Maintenance Operating Fund and (iii) DMV for its operations.

The motor vehicle sales and use tax is imposed on the consumer at a rate of 3% on the gross sales price of motor vehicles and manufactured homes and at a rate of 4% on the gross proceeds of motor vehicle rentals. This tax is in lieu of the retail sales and use tax. Revenues attributable to the motor vehicle sales and use tax are distributed to the Transportation Trust Fund and the Highway Maintenance Operating Fund.

The State Corporation Commission (SCC) administers the special revenue regulatory tax. The tax accounted for approximately 17% of all nongeneral fund revenues collected by the SCC in FY 2000. The rate of the tax may be up to 0.2% of gross receipts with the SCC authorized to adjust the rate. The tax is paid by certain corporations furnishing water, heat, light or power; certain companies owning and operating telegraph lines; telephone companies with gross receipts in excess of \$50,000; the Virginia Pilots' Association; railroads, except those exempt by federal law; and certain common carriers of passengers. Revenues generated support the making of appraisals and assessments against public service corporations, investigating the properties and services of public service corporations, and administering laws relating to such corporations.

Work Plan

The joint subcommittee decided to meet in August to hear staff presentations concerning local taxes and fees. In September, the joint subcommittee heard a presentation on the findings and recommendations of the Commission on Virginia's State and Local Tax Structure for the 21st Century, followed by comments from representatives of the Virginia Municipal League and the Virginia Association of Counties. The joint subcommittee also met in November and December and heard remarks by interested parties as well as follow-up answers to questions from earlier meetings.

August 6, 2001

At its August meeting, the joint subcommittee received background information from staff concerning major local taxes. In total, there are 26 different taxes that may be imposed by local governments. In general, cities and towns have been granted greater authority to levy local taxes than counties have. Cities and towns have charter authority, which permits them to levy any tax not specifically prohibited by the General Assembly. On the other hand, counties may only levy those taxes specifically authorized by the General Assembly, and under the conditions prescribed by the General Assembly. These differences are readily apparent in the maximum tax that may be charged by local governments. For example, counties are subject to maximum tax rates for the local transient occupancy, meals, cigarette, and admissions taxes. No such limitations are placed upon cities and towns with respect to these taxes.

Major Local Taxes

Approximately 84 percent of local tax revenue for all cities and approximately 91 percent of local tax revenue for all counties are produced by five taxes: the real property tax, personal property tax, sales and use tax, consumer utility taxes, and BPOL tax.

Real Property Tax

All counties and cities levy the real property tax. It is the leading source of local tax revenue and accounted for 47 percent of cities' local tax revenue and 55 percent of counties' local tax revenue in Fiscal Year 1999. As shown in the following table, effective tax rates (*i.e.*, the actual tax rate levied on the value of property) vary widely across the Commonwealth.

Effective Tax Rates on Real Property, FY 1998 (Rate per \$100 of "True" Value)

	<u>Cities</u>	<u>Counties</u>	<u>All</u>
Average	\$0.96	\$ 0.60	\$0.71
Median	0.98	0.57	0.61
Highest	1.39	1.28	1.39
Lowest	0.50	0.29	0.29

Real property tax rates are not capped under the *Code of Virginia*.

While local governments have much discretion in setting their real property tax rates, they must assess real estate at its fair market value for tax purposes (this is required by Article X, Section 2 of the Virginia constitution). Fair market value is

determined by an appraisal process, the frequency of which is defined by the *Code of Virginia*. The *Code* requires that (i) cities with populations of 30,000 or above must re-assess at least every two years; (ii) all other cities may elect to re-assess every four years; (iii) counties with populations above 50,000 are required to re-assess at least every four years; and (iv) all other counties may elect to re-assess every five or six years. As a result, actual assessment practices vary widely among localities.

The Department of Taxation annually reports a ratio comparing the assessed value of real property to the sales price paid for the property. These reports reveal that from 1994 through 1998 assessments by cities reflected about 90-92 percent of the actual sales price and assessments by counties reflected about 86-88 percent of the actual sales price.

The Virginia constitution provides several partial or full exemptions from local real estate taxes. As an example, local governments are authorized to partially exempt real estate that has undergone substantial renovation or real estate owned by persons 65 or older or permanently disabled. The General Assembly may also classify or designate as tax-exempt any real property used by its owner for religious, charitable, patriotic, historical, benevolent, cultural, or public park and playground purposes. On average, 20.3 percent of all real property in cities and 12.6 percent of all real property in counties is tax-exempt.

Tangible Personal Property Tax

The personal property tax is the second largest source of local tax revenue, totaling over \$1.4 billion in Fiscal Year 1999. It has comprised 14 to 15 percent of total local tax revenues since Fiscal Year 1994.

The personal property tax is levied on tangible personal property. Tangible personal property is property that, by its location and character, shows that the owner intends it to be movable, as opposed to property that is permanently affixed or attached to real estate. The owner of tangible personal property generally is the party liable for the personal property tax.

Motor vehicles, travel trailers, boats, and airplanes are taxable in the locality where the vehicle is normally garaged, docked or parked. All other tangible personal property is taxable in the locality in which it is physically located on the "tax day" (January 1 for most localities). Personal property tax rates also are not capped under the *Code of Virginia*.

The assessment of tangible personal property for tax purposes is based on two components: the rate classification and the determined value of the property. Currently, there are 31 separate rate classifications, 20 of which relate to different types of vehicles or drivers. Local governments are permitted to apply a lower personal property tax rate on the tangible personal property grouped in each classification.

Once the tangible personal property is classified, the value of the property for tax purposes must be established. The Commissioner of the Revenue or other local assessing officer is charged with establishing the value of tangible personal property, *i.e.*, the tax base. Article X, Section 2 of the Virginia constitution requires that the value determined by the Commissioner of the Revenue reflect fair market value.

In the last five years, the most significant change to the personal property tax was the passage of the Personal Property Tax Relief Act of 1998. The Act provides that the Commonwealth will pay an increasing share of the local personal property tax on the first \$20,000 of assessed value of qualifying vehicles. In general, qualifying vehicles are motor vehicles used for personal use. The Commonwealth's share is limited to the \$20,000 of assessed value multiplied by the personal property tax rate in effect in the summer of 1997.

Sales and Use Tax

Virginia's cities and counties were authorized to levy a 1 percent sales and use tax in 1969, three years after the state retail sales and use tax was enacted. The tax is imposed on the sale of tangible personal property for consumption. The provision of services generally is not taxable in Virginia.

All counties and cities impose the local option sales and use tax. The tax is collected by merchants at the same time that the state retail sales and use tax is collected and remitted to the Department of Taxation. The revenues collected from the local tax portion are then returned to localities based on the point of sale.

In Fiscal Year 1999, the local sales and use tax accounted for about 7.3 percent of all local tax revenue, making it the third highest source of local tax revenue. For cities, the sales and use tax accounted for 8.3 percent of local tax revenue in Fiscal Year 1999. For counties, the sales and use tax accounted for 6.8 percent of local tax revenue in Fiscal Year 1999.

Consumer Utility Taxes

Consumer utility taxes are imposed by counties, cities, and towns for use or consumption of utility services. Consumers of the utility service, including both individuals and businesses, are liable for the tax. Three different levies make up Virginia's consumer utility taxes:

- telephone and telegraph taxes,
- E-911 tax, and
- local taxes on heat and power.

The amount of telephone and telegraph and heat and power taxes generally are based on user consumption (as of January 1, 2001, heat and power taxes were based on consumption). The E-911 tax generally is a flat dollar tax unrelated to actual consumption.

In Fiscal Year 1999, 38 cities and 84 counties levied and collected telephone and telegraph and heat and power taxes. In addition, 118 localities levied and collected E-911 taxes.

Local governments collected \$465.1 million from consumer utility taxes in Fiscal Year 1999, making consumer utility taxes the fourth largest source of local tax revenues. E-911 tax collections accounted for \$71.9 million of this total.

In general, consumer utility taxes on residential consumers may not exceed \$3 per month (different rules apply for businesses). Localities with tax rates in excess of \$3 per month as of July 1, 1972, however, are grandfathered to charge such higher rates.

As a result of deregulation of the electricity industry (1999) and the natural gas industry (2000), taxes on electricity and natural gas (heat and power taxes) are now based on consumption or usage (effective January 1, 2001). Thus, localities are required to convert to kilowatt-hour tax rates (electricity) and CCF tax rates (natural gas) and must set their new tax rates so as to initially maintain current annual revenues. In any event, the new kilowatt-hour tax rate and the CCF tax rate may not result in a tax greater than \$3 dollar per month for residential consumers.

Business, Professional and Occupational License Tax (BPOL)

The BPOL tax is a privilege or license tax assessed by counties, cities, and towns upon Virginia businesses. Businesses cannot operate in Virginia without first obtaining a BPOL license. Fifty-four counties and all 40 cities impose the BPOL tax.

The BPOL tax generally is imposed on gross income or gross revenue, *i.e.*, income before deductions. The tax is imposed on the gross income or revenue from each "line of business", as opposed to a tax on the business entity as a whole. There are 5 major "lines of business" or activities to which the BPOL tax applies. These "lines of business" and the applicable maximum tax rates are:

Line of Business	Maximum Tax Rate
Wholesalers	\$.05 per \$100 of purchases
Construction Contractors	\$.16 per \$100 of gross receipts
Retailers	\$.20 per \$100 of gross receipts
Repair, Personal, and Business Services Providers	\$.36 per \$100 of gross receipts
Financial, Real Estate, and Professional Services Providers	\$.58 per \$100 of gross receipts

Approximately two-thirds (64.9%) of the 94 counties and cities that imposed the BPOL tax in Fiscal Year 1999 imposed the tax at rates below the maximum allowed under law.

In Fiscal Year 1999, local governments collected \$385.1 million from BPOL taxes. BPOL taxes were the fifth largest source of local tax revenues, accounting for approximately 4.1% of local tax revenues.

September 4, 2001

At the September meeting of the joint subcommittee presentations were made by representatives of the Commission on Virginia's State and Local Tax Structure for the 21st Century based on its report. Presentations also were made by officials from the Virginia Municipal League and the Virginia Association of Counties on the status of local revenues and services. (Because of time constraints a scheduled presentation by the Virginia Chamber of Commerce was postponed until the November meeting of the joint subcommittee.)

Commission on Virginia's State and Local Tax Structure for the 21st Century

The Commission on Virginia's State and Local Tax Structure ("Commission") was created by the 1999 session of the General Assembly to perform a two-year study of "all aspects of the state and local tax structure." The Commission's final report (House Document 22, 2001) recommended seven broad goals and eleven specific proposals to the General Assembly.

The chairman of the fourteen-member citizen commission gave the joint subcommittee a general overview of the process utilized by the Commission which

included numerous opportunities for public comment at various locations throughout the Commonwealth. There were seven broad goals arrived at by the Commission.

These goals are:

1. to establish a more efficient alignment of responsibility for the provision of public services with the revenue sources required for their provision;
2. to broaden the revenue base of localities generally;
3. to recognize in the formulation of state aid programs the considerable disparity that exists in the social, economic, and fiscal condition of our political subdivisions;
4. to arrest and reverse the erosion of existing state and local revenue bases that results in an upward impetus on tax rates;
5. to establish a permanent, broad-based entity committed to a continuing analysis of state and local fiscal concerns;
6. to protect and enhance an environment in Virginia that sustains equitably our vital business community; and
7. to promote greater equity in the development and application of tax instruments for all our citizenry.

Several of the final specific recommendations of the Commission stemmed from the principle embraced by the Commission that taxes should be broad-based and equitable, with few if any exceptions, exclusions, or credits, thereby permitting lower rates than otherwise would be required. It was also noted that, although it may be advisable to phase-in some of the Commission's recommendations over time, the bulk of the recommendations make sense only if implemented together as a package.

The Commission's findings and recommendations regarding Virginia's personal income tax were presented next. The personal income tax structure has become "dated." In particular, changes in income have outstripped changes to the tax structure resulting in relatively higher tax burdens at lower income levels than was originally intended.

In this regard, the first two tax brackets (\$0 to \$3000 and \$3000 to \$5000) have not been changed since they were established in 1926, and, if adjusted to 1998 dollars, those brackets would extend to \$27,523 and \$45,872, respectively. As a

result of this fact and other considerations, the Commission recommended that the rate structure be comprised of two brackets, with a rate of 5.0% applied to the first \$50,000 of taxable income and a rate of 5.75% applied to amounts above \$50,000.

Similarly, the Commission found that the value of the tax-free amounts created by the combination of standard deductions and personal exemptions had not kept pace with incomes. In fact, for most family sizes, the current aggregate of these tax-free amounts constitutes half or less than the relevant poverty threshold. Accordingly, the Commission recommended increasing the personal exemptions from \$800 to \$2500 (to be instituted as \$125 tax credits) and increasing the standard deduction from \$3000 (\$5000 if married filing jointly) to \$3500 (\$7000 if married filing jointly).

In addition, to promote equity among taxpayers, the Commission also recommended (i) ending personal exemptions based on blindness and age, (ii) ending deductions based on age, and (iii) replacing the current low-income credit with one patterned after the federal earned income tax credit and set at 20% of the federal credit.

In particular, regarding the "age deduction," poverty and wealth exist at all age levels and can be measured fairly and precisely without regard to age. Therefore, introducing age (or other non-income based preferences) as a distinct factor in computing income tax liability, "undoubtedly are popular with those whom they favor, but they come at a cost" of: (i) lower revenues available for services, (ii) higher rates on all other taxpayers, or (iii) some combination of the two. In other words, "one group's preference is another's penalty."

Virginia Municipal League/Virginia Association of Counties

Representatives from the Virginia Municipal League ("VML"), and the Virginia Association of Counties (VACo"), made a coordinated presentation to the joint subcommittee of: (i) local governments' service responsibilities, (ii) local governments' expenditures and revenues, and (iii) a proposal for sharing a dedicated portion of the state income tax revenue with localities.

Service Responsibilities

It was explained that cities and counties are created by the state and are required to provide the services that the Commonwealth assigns to them. The following chart was presented as a summary of local service responsibilities.

Summary of Current Local Service Responsibilities

Functional Area	Current Service Delivery and Funding Responsibility
Transportation	

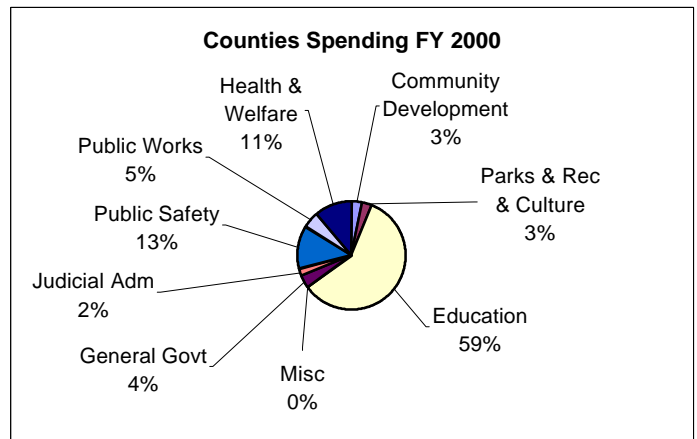
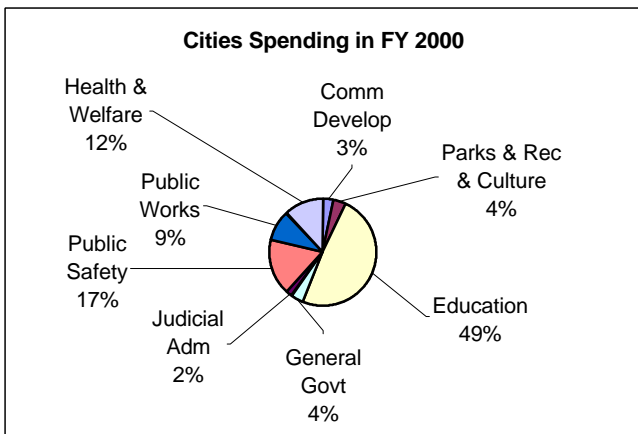
Street & Road Construction Cities	Locally provided Extensive State funding Required local funding share
Counties	State provided State funded Limited local flexibility
Traffic Operations Cities	Locally provided
Counties	State provided Limited local flexibility
Revenue Sharing	State Funded with a required local match Only counties allowed to participate State funding limited to \$10 million annually
<u>Social Services</u>	State supervised, locally provided Extensive State and Federal funding Moderate local funding
<u>Health Funding</u>	State run at local level Extensive local funding
<u>Environment</u>	State supervised, locally provided Extensive local funding, limited funding
<u>Education</u> Operations	State supervised, locally provided State and locally funded (with minor Federal funding)
School Construction	Locally provided and primarily funded State loans available Portion of State lottery proceeds and \$55 million per year in state general funds dedicated to school construction
<u>Administration of Justice</u> Law Enforcement Cities	Local responsibility Limited State oversight Extensive local funding
Counties	Local responsibility

	Limited State oversight Extensive State funding
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<p><u>Administration of Justice (cont'd)</u></p> <p>Local Jails Jail Operations</p> <p> Jail Construction</p> <p>Courts</p>	<p>Local responsibility Extensive State funding Limited local flexibility</p> <p>Local responsibility Moderate State funding</p> <p>State provided service Extensive State funding Local funding and administration of some support position Local funding for buildings Limited local flexibility</p>
<p><u>General and Financial Administration</u></p> <p>Local Financial Officers</p> <p> Processing State Income Tax Forms and Payments</p>	<p>State and locally provided State and locally funded</p>

Expenditures

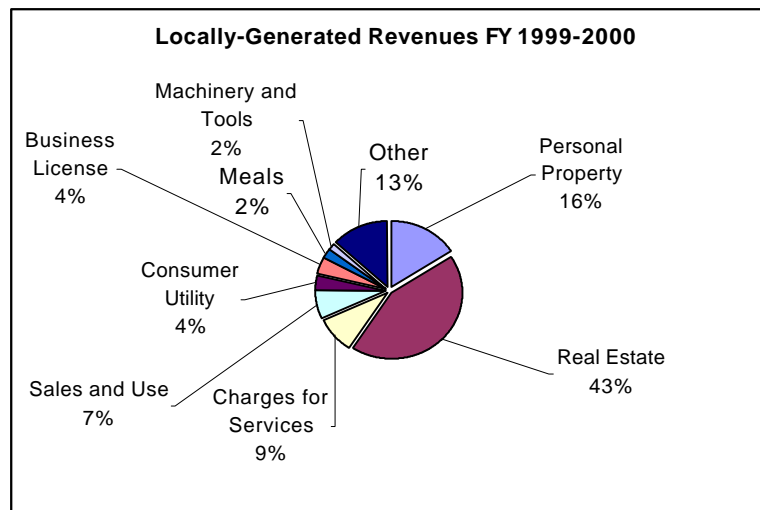
The following two charts were presented as depicting the percentage of revenues spent by cities and counties according to service category in FY 2000.



As shown above, the largest expenditure for localities by far is for education. In this regard, one of the major concerns of VML and VACo is the need for more funding from the state for education. They emphasized that (i) local governments fund *all* of the costs for 20% of the teachers (those exceeding the Standards of Quality), (ii) local spending exceeds the state's standards of quality by over \$2.8 billion per year (including capital outlay), and (iii) the state funds only about 12% of capital outlay for schools (including the state's new commitment for such funding).

Revenues

Of the total revenues spent by localities, 62% is locally generated through local taxes and fees, 32% comes from the Commonwealth, and 6% comes from the



federal government. The following chart was presented as depicting the particular sources of the locally generated taxes and fees.

It was emphasized that the foregoing chart depicts the average for all localities, and therefore understates or overstates the reliance of particular localities on particular taxes and fees. However, in general, localities are heavily dependent on real estate taxes, and such tax revenues, according to VML and VACo, are growing at a slower rate than the state's income tax revenues.

Income tax sharing

To provide localities with additional revenues from a source that "grows with the economy," VML and VACo proposed that the Commonwealth return to localities 10% of the state individual income tax revenues, to be phased in over a five year period. Under this proposal these revenues (estimated to be approximately \$800 million in FY 2002) would be distributed to localities according to the following formula: (i) 50% based on the relative share of the total state income tax paid by taxpayers filing returns in each locality, (ii) 40% based on where wages are earned, and (iii) 10% divided equally among all cities and counties.

November 13, 2001

Meeting for the fourth time, the joint subcommittee heard from several interested parties in its process of listening to concerns about and suggested changes to the state tax code. This was the first meeting that was opened up to interested group representatives and individuals for the purpose of addressing the joint subcommittee about their specific issues.

Presentations by Organizations' Representatives and Individuals

Representatives from four organizations and one individual addressed the joint subcommittee. The organizations were the Virginia Chamber of Commerce ("Chamber"), the National Association of Retired Federal Employees ("NARFE"), the Colony Condominium ("Colony"), and the Homebuilders Association of Virginia ("Homebuilders"). The individual was a taxpayer from the City of Newport News.

The Chamber favors a tax system that is "equitable and broad-based and that fosters a favorable business climate, encourages economic development and promotes prosperity for all Virginians." It believes that the tax burden should be distributed mainly among income, sales and property taxes. Finally, the tax system should be competitive with other states'.

Property taxes should remain as the major locally imposed source of local revenues. Any consideration of eliminating the personal property tax on personally owned motor vehicles must be part of a comprehensive revision of taxes and should include business-owned cars and light trucks in order to be equitable. Consideration could even be given to limiting property taxes to real property only; however, localities should not be allowed to establish a different tax rate for residential and commercial/industrial property.

With regard to sales and use taxes, the Chamber recognizes (i) the validity and usefulness of a competitive single-rate tax applied in a uniform manner on a statewide basis, and (ii) its importance as a revenue source for state and local governments. The Chamber supports Virginia's participation in the Streamlined Sales and Use Tax Project in order to ensure uniform definitions and other administrative matters that will simplify the implementation of the tax across state lines, if and when that happens. Finally with regard to the sales and use tax, the Chamber supports the exemptions that assist the business community while at the same time calling for containment of numerous organizational exemptions that narrow the tax base.

The income tax, according to the Chamber, should not have high marginal tax rates nor an excessive number of brackets. Business and personal rates should continue to be similar and conformity with federal law should also continue. The corporate income tax rate should remain competitive to keep businesses in Virginia, thereby providing employment to numerous citizens. The numerous tax preferences

(exemptions, deductions, and credits) move the Commonwealth further out of line with the federal tax law every time one is added and contribute to complexity in administration and understanding.

The Chamber opposes any tax imposed on taxpayers' gross receipts, such as the BPOL tax, but understands that it is a substantial revenue producer for localities and would require some means of replacement in order to be eliminated. Also, the administration of local taxes should be uniform. Finally, an administrative appeals procedure for all taxes that allows a simple, complete, and fair resolution of all tax issues is vital to a fair tax system, according to the Chamber. Reasonable audit authority should be granted and government employees should conduct tax audits. Taxpayers must have fair opportunities to contest tax liabilities that are unfairly assessed.

With regard to the Commonwealth's revenue system, the Chamber supports consideration of (i) sharing a portion of state income tax revenues with localities, (ii) transferring mandated social and health services from the localities to the state, (iii) funding fully the state's share of the Standards of Quality, and (iv) creating special local financing authorities funded by taxes imposed by citizens on themselves if the General Assembly fails to provide adequate funding for transportation and infrastructure needs.

NARFE focused on two issues. The first was the taxation of social security benefits, which it opposes vehemently. Currently, such benefits are excluded from income at the state level. The second issue involves the age deduction which allows certain elderly taxpayers to annually subtract \$6,000 (\$12,000 if filed jointly) or \$12,000 (\$24,000 if filing jointly), depending on age, in calculating their Virginia taxable income. Again, NARFE sees any change in this as a tax increase to be avoided at all costs. Many of the Commonwealth's elderly are on fixed income and cannot afford a tax increase, according to NARFE.

The Colony, a Virginia Beach condominium, had a problem with the BPOL tax being imposed on a common expenses fee that was paid by unit owners. Legislation was proposed during the 2002 Session to clarify that such fees should not be considered gross receipts for purposes of the BPOL tax.

The final organization addressing the joint subcommittee was the Homebuilders Association. The Homebuilders support property tax reform if it helps the housing industry, which was described as "the engine driving the U.S. economy" (one in eight jobs in Virginia is related to the housing industry). The Homebuilders also support revenue sharing of the state income tax with localities, the ability of localities to impose new taxes on their taxpayers, and equal taxing authority for cities and counties.

The final speaker, the individual from the City of Newport News, described himself as "an outspoken critic of the property tax system." His concerns focused on "helping the little guy." He pointed out that there is no formal definition in the Code of Virginia or in the Manual for Local Boards of Equalization of "equalization." Therefore, his concern was that members on local boards of equalization do not know what the term means and cannot properly carry out their duties. The other major concern was how unfair the personal property tax assessments and the appeals process are.

December 17, 2001

The joint subcommittee held its fifth and final meeting of 2001 in Richmond and heard from several interested parties. This was the second meeting during which group representatives and individuals were invited to address the joint subcommittee. In addition, one of the joint subcommittee members, who also served on Governor Gilmore's Commission on Government Finance Reform for the 21st Century, gave a brief overview of that commission's final report and recommendations to the subcommittee. (Appendix D)

Representatives of Interested Organizations

The organizations that sent representatives to speak to the joint subcommittee in December included the Virginia Retail Merchants' Association ("Retail Merchants"), the Commissioners of the Revenue Association ("CRA"), the Virginia Manufacturers' Association ("VMA"), the Virginia Interfaith Center for Public Policy ("Interfaith Center"), the Apartment and Office Building Association of Greater Washington ("AOBA"), the Virginia Association for Commercial Real Estate ("VACRE"), and the Retail Alliance.

The Retail Merchants oppose any regional referendum on retail sales tax because it could "open Pandora's box." Instead, uniformity should be maintained throughout the state with regard to the retail sales tax. Furthermore, they encourage the Commonwealth's participation in the Streamlined Sales Tax Project. Finally, the Retail Merchants favor the state providing localities with another source of revenues while eliminating the BPOL tax and the merchants' capital tax.

The CRA representative expressed the group's awareness of the complexity of the state tax code and explained that the complexity allows flexibility in administering the taxes and ensures compromise. An expanded role for the commissioners of the revenue in administering all taxes having a local connection, emphasizing convenience for and face-to-face contact with the taxpayer, was suggested to the subcommittee.

Whatever substantive changes in the Commonwealth's state and local tax system might be recommended by the joint subcommittee, the CRA believes the principles of fairness and equity should be paramount in the subcommittee's

deliberations. Furthermore, while uniformity may seem to be a laudable goal, one must not lose sight of the fact that economic, geographical, and demographic differences exist throughout the Commonwealth, making a "one size fits all" approach impractical. However, the CRA, the Weldon Cooper Center for Public Service and the State Compensation Board have created an educational program to ensure more uniformity as elected officers are trained. Commissioners of the revenue are underutilized when it comes to providing traditional state services and are more than willing to provide, with proper training and technology, more services with a higher degree of accessibility for the Commonwealth's citizens.

Four issues were addressed by the VMA. First, it favors the continued use of income, sales, and property taxes rather than creating new taxes that increase the number of returns filed by business and administered by government. Second, redistribution of existing taxes, based on specific local needs, is preferable to additional new taxes. Third, the Commonwealth should participate in the Streamlined Sales Tax Project. And fourth, taxpayers should be able to dispute a tax assessment prior to paying the tax, which is the current requirement. Taxpayers must "pay in order to play" (i.e. pay the tax before they may go to court). There are many ways the Commonwealth could change the current policy ranging from keeping the existing procedures but not requiring payment as a prerequisite to a court suit, to possibly creating an administrative board to hear taxpayers' appeals for both state and local tax assessments.

The focus of the comments by the Interfaith Center's representative was on tax equity; how the Virginia tax code affects those in poverty. Recognizing that taxation issues are of concern to all, the representative pointed out that they have an even greater effect on those living in poverty. It was suggested that a representative from the Center on Budget and Policy Priorities be invited to address the joint subcommittee during 2002 to offer its assessment of the burdens on and opportunities for relief for those living below the poverty line.

The AOBA and VACRE spokesperson talked about the unfairness of the local real estate assessment and appeals process. Many taxpayers pay the tax rather than fight city hall because the burden of proof is so difficult to overcome. The localities' Boards of Equalization should have the authority to determine fair market value. The taxpayer could appeal a real estate assessment to that board or the commissioner of the revenue and then go to court if dissatisfied with the board's or commissioner's decision, rather than go straight to court as is the case under current law. More uniform statewide assessment procedures for personal and real property based on a uniform fair market value methodology and better training for local assessors would improve the system greatly.

The final speaker for interested organizations spoke on behalf of the Retail Alliance, an organization representing over 1800 Hampton Roads retail businesses.

The focus of his comments was the BPOL tax. It was suggested that a good tax structure should (i) favor economic growth; (ii) take the taxpayer's ability to pay into consideration; (iii) be equitable and broadly based; and (iv) be simple to administer. The BPOL tax, according to the Retail Alliance, fails on all counts. The 1996 BPOL tax reform improved the administration of the tax but did nothing for its intrinsic inequity. While the business community did not have a proposed replacement for the BPOL tax, the Retail Alliance expressed an interest in working with the joint subcommittee, the Virginia Chamber, other business groups and local governments in all the tax issues facing the subcommittee.

2002 Legislation

Two pieces of legislation, both resolutions, were discussed and circulated for signatures. One of the resolutions supported the participation by members of the General Assembly, or their designees, in the Streamlined Sales Tax Project. The other continued the joint subcommittee's study of the state tax code and added four more members, bringing the total membership to eighteen. The new members include one from the House of Delegates, one from the Senate, the Secretary of Finance and the Tax Commissioner. Both resolutions were introduced and passed during the 2002 General Assembly Session.

Finally, the creation of two task forces comprised of members of the joint subcommittee and a tentative meeting schedule for 2002 were discussed.

2002 MEETINGS

April 29, 2002

During the joint subcommittee's first meeting of 2002 a presentation on underlying principles of tax systems was made. That presentation led to a discussion of tax principles it may adopt in making recommendations to restructure Virginia's tax system. The joint subcommittee also reviewed a list of issues for study this year and an initial framework for dividing the issues between two task forces.

Principles of Tax Systems

Dr. John H. Bowman, Professor of Economics, Virginia Commonwealth University, gave a presentation on principles underlying tax systems and identified various tax principles generally present in good tax systems.

There are four main principles or criteria to evaluate tax systems. They are equity, efficiency, adequacy, and predictability.

Equity

The equity of a tax system means the fairness of the tax burden upon the taxpayers impacted. One approach in analyzing equity is to determine to what extent the costs of providing government services are paid for by taxes or other charges upon the users of such services. This approach considers the degree to which a tax system is functioning as an economic market, i.e., is it the user who is demanding the service the person who is paying the tax or other charge imposed to fund the cost of providing the service. As with any approach in analyzing the equity of a tax system, there are limitations with this market approach. For instance, it is sometimes difficult to quantify or measure the benefits of particular government services.

A second approach in analyzing the equity of a tax system, the ability-to-pay approach, examines how taxes impact taxpayers with a greater ability to pay. This approach requires an agreement on the standard for measuring one's ability to pay taxes, whether that standard be income, wealth, family size, or other factors. Under this approach, taxpayers in similar circumstances should essentially be paying the same amount of tax. This is called horizontal equity. In addition, this approach favors differing tax burdens for those with different abilities to pay. This is called vertical equity.

Efficiency

Efficiency as it relates to tax systems means the avoidance of waste or getting as much as possible from available resources. There are two major considerations in evaluating the efficiency of a tax system. First, consumer and business decisions for purchasing or investing should not be directly affected by taxes. Second, a tax system should be simple to comply with and simple to administer. The level of resources required to administer and to comply with a tax system is key for purposes of evaluating simplicity.

Adequacy

Adequacy relates to the revenue-producing capacity of the tax base and the level of government services to be funded. The more inadequate a tax base (i.e., the ability to generate revenues is limited in relationship to the agreed upon level of government services), the more likely there will be a high effective tax burden imposed on those left to pay.

Predictability

As the Virginia constitution requires a balanced budget, predictable revenues are extremely important in appropriating state funds. Volatile tax bases are less desirable as they introduce more uncertainty in making appropriations.

Tax Principles Discussed by the Joint Subcommittee

The joint subcommittee discussed principles that it may adopt in revising Virginia's state tax code. The tax principles discussed by the joint subcommittee

were equity, efficiency, adequacy, and predictability, the same principles identified by Dr. Bowman.

In the process of discussing these principles the joint subcommittee raised several issues that could be the subject of further examination. The issues raised included:

- Are revenues and services allocated between state and local governments in an equitable manner?
- Are user fees a more equitable means of paying for certain services?
- Should all citizens share a portion of the tax burden?
- To what extent, if any, should the state tax code be a tool of social policy?
- Is the tax code easy to understand and administer (for the government and for the taxpayer)?
- Are the proposed changes to the tax code defensible?
- Will the proposed changes contribute to the state's competitiveness?
- Should tax preferences (subtractions, deductions, exemptions, credits) have an accountability component (appropriations v. expenditures)?
- Does the tax produce enough revenues to fund the necessary services?
- If changes are made to the tax code, is the total state and local tax burden the same as it was prior to the changes (revenue neutrality)?
- Is the tax base volatile or fairly secure?
- Does the state have a proper allocation and mix of taxes?
- To what degree would changes in the mix of taxes impact (i) the state and localities and (ii) taxpayers?

The meeting concluded with a discussion of issues that may be studied this year.

Given the long list of issues previously identified, the creation of two task forces comprised of members of the joint subcommittee was discussed and approved.

May 29, 2002

The joint subcommittee formally adopted tax principles intended to guide its work to revise Virginia's tax code. In addition, staff to the joint subcommittee gave a brief presentation that involved answering questions raised at April's meeting and explaining several new items of information distributed to subcommittee members. One of the items discussed was the assignment of subcommittee members and issues for study to two different task forces. Task Force #1 and #2 were created to study all of the tax and other issues identified as subjects of study at the April meeting. The work of each task force is, for the most part, intended to be mutually exclusive of the other.

At the conclusion of staff's presentation, the full subcommittee meeting ended and both Task Force #1 and #2 met to discuss the issues assigned to them.

Tax Principles Adopted

The joint subcommittee formally adopted the following tax principles to guide its work in revising the tax code:

1. equity;
2. efficiency;
3. adequacy;
4. predictability; and
5. revenue neutrality.

These are the same principles that were discussed at length in its April meeting.

Much debate preceded the adoption of these tax principles. One of the questions debated was whether the end result of all final recommendations should be revenue neutral in nature; that is the net effect of all recommendations would neither increase or decrease the Commonwealth's total annual revenue. The joint subcommittee ultimately agreed that its recommendations should be revenue neutral.

Staff Presentation

Staff provided several new pieces of information for joint subcommittee members to consider in upcoming meetings. These included information on the cost of administering taxes collected by the Department of Taxation, Department of Motor Vehicles, and State Corporation Commission (Appendix E); the additional annual cost in increasing Virginia's personal and dependent exemption (in \$100 increments) (Appendix F); and the Department of Taxation's Analysis of Sales and Use Tax Exemptions in Virginia. (Appendix G)

Task Force #1 Meeting

Task Force #1, chaired by Senator Hanger, began its first meeting by reviewing its list of issues. Those issues include several that deal with the state income tax, to what extent Virginia should conform with federal tax law, the local property tax on personally owned vehicles, telecommunications taxes, the sharing of income tax revenues with localities, and the equalization of the taxing authority granted to counties and cities. After reviewing the issues, the task force members decided to focus on the state income tax issues at its next meeting on June 24.

Task Force #2 Meeting

Task Force #2, chaired by Delegate McDonnell, began its first meeting by reviewing its list of issues and discussing certain sales and use tax exemptions, as reported in the Department of Taxation's Analysis of Sales and Use Tax Exemptions in Virginia. Among the issues to be considered by the task force include current exemptions from Virginia's sales and use tax, extending Virginia's sales and use tax to certain services, conformity with federal law repealing death and estate taxes, elimination of the BPOL tax, and additional revenue opportunities for local governments.

The task force asked for additional information on sales and use tax exemptions of public service corporations. The task force also asked for more information on the applicability of Virginia's sales and use tax to services.

June 24, 2002 -- Task Force #1

Task Force #1 met for the second time and focused on the state tax issues that the task force was assigned, primarily dealing with the income tax.

Staff presented an issue brief for each of ten income tax issues that described each issue, how the current law affects each issue, the suggested change in the law to deal with each issue, and any revenue impact resulting from the proposed change. The income tax issues included:

1. Conforming to federal law;
2. Eliminating the age deduction;
3. Increasing the standard deduction;
4. Providing a "personal exemption" tax credit or increasing the personal exemption amount;
5. Adopting two tax brackets--one with a five percent rate on the first \$50,000 of taxable income and one with a five and three quarters percent rate on taxable income above \$50,000;
6. Taxing social security income;
7. Increasing the tax credit for low-income taxpayers and making it refundable;
8. Eliminating the state income tax and replacing it with a higher sales tax;
9. Examining tax preferences (subtractions, deductions, tax credits); and
10. Overwithholding of income tax.

The task force decided to remove two of the issues from further consideration and make no changes in the current law. The two issues were numbers six and eight above. It was determined that taxing social security income (#6) was not good policy or politics. Eliminating the state income tax (#8) was also seen as bad policy because the sales and use tax rate would have to be more than three times what it currently is (assuming all of the sales and use tax exemptions remain in effect) to raise the same amount of revenues that the income tax raises.

The remaining issues were discussed at length but no final decisions were made regarding their outcome other than to continue examining all of them. There also was some discussion on tax rate reductions that could result if some or all tax preferences were eliminated. More information regarding the fiscal impact for each issue was to be gathered and presented during Task Force #1's next meeting. In addition, the task force planned to take up their remaining issues that include the elimination of the car tax and the revision of the state and local telecommunications taxes.

June 26, 2002 -- Task Force# 2

The Honorable Maurice P. McTigue, QSO, a Distinguished Visiting Scholar from the Mercatus Center at George Mason University, made a presentation concerning New Zealand's tax restructuring experience during the second meeting of Task Force #2. In particular, Mr. McTigue suggested certain recipes for successful tax restructuring based upon his experience with the New Zealand process.

He suggested, for example, that (i) the public must understand that a problem exists with the current tax structure; (ii) solutions must not be latched onto too quickly in the process of restructuring; and (iii) that the new tax system should be one that can last a long time.

Mr. McTigue said that some of the main principles that guided the tax restructuring in New Zealand included: simplicity, fairness, competitiveness, diminished impact on decision-making in the marketplace, and revenue neutrality. He said that all tax preferences should be examined closely. Those that are deemed not in furtherance of a well-defined desired public policy should be abolished and that those that are should be transformed into targeted direct appropriations.

Finally, Mr. McTigue advised that consideration be given to (i) "user fees" where appropriate, and (ii) the feasibility of transforming some government organizations into taxpaying entities.

The Task Force then briefly discussed many of the major issues assigned to it. These issues included: (i) what policy to recommend regarding current and future sales and use tax exemptions; (ii) whether to expand the services on which the sales and use tax is imposed; (iii) the appropriate rate of sales tax on motor fuels, vehicles, aircraft, and watercraft; (iv) whether Virginia should conform its estate tax to the federal law; (v) whether the BPOL tax should be abolished and if so, what revenue source(s) would be used to replace the lost revenue; and (vi) what sources of revenue (new and old) should localities be able to utilize to increase local revenue.

Regarding the issue of increasing revenues for localities, it was noted that there are three main ways of accomplishing this goal: (i) the Commonwealth sharing revenues with localities (e.g. a certain portion of income tax revenues); (ii) the Commonwealth assuming all or a portion of the cost of certain local services; and (iii) the Commonwealth permitting new or expanded sources of local revenues (e.g. a local income tax). Staff was requested to obtain information that shows the extent to which localities utilize current tax authority.

July 16, 2002--Task Force #1

The Task Force meeting began with a presentation on the Earned Income Tax Credit from Bob Zahradnick, a policy analyst with the Center on Budget & Policy Priorities. The task force reached a consensus that a state earned income tax credit is not an option. Instead the group is looking toward an aggressive approach to deductions and changing the rate structure. Additional discussion ensued around removing the sales tax from food.

Following the EITC speaker, the task force began its work session, picking up where it ended its June 24th meeting. It began with a discussion of the fiscal impact associated with a 100% repeal of the personal property tax to include personal vehicles, business vehicles as well as machinery and tools.

Staff gave a brief update on the work of the Telecommunications Tax Study (HJR 209, 2002) chaired by Delegate Preston Bryant. The subcommittee will continue its work by looking at the changes recently made in other states including Florida, North Carolina and Illinois and will report to the joint subcommittee studying the state tax code later this year.

The following issues, identified during previous task force meetings, were presented by staff and discussed by committee members:

1. Appropriate mix of general fund taxes.
2. Distribution of a portion of the state's annual individual income tax revenues to localities.
3. Constitutional amendment requiring a sharing of state individual income tax revenues with localities.

4. Maintenance of a low tax burden on businesses.
5. Tax incentives for economic growth.
6. Equalization of the taxing authority of counties and cities.
7. No new unfunded mandates on local governments by the Commonwealth.
8. Creation of a tribunal, not located within or reporting to the Department of Taxation, to hear taxpayer appeals.
9. Creation of a permanent body to analyze, on a continuing basis, the fiscal needs and resources of Virginia's state and local government.
10. Tax Simplification --- more user friendly.
11. Local user fees.

An additional subcommittee was formed to look at issues four and five, specifically the preferences (subtractions, deductions, exemptions, tax credits) outlined in the Code. The subcommittee will review the preferences and determine whether they are still effective or obsolete. The task force discussed issue six at length and requested additional information about state funding for counties and the difference in services offered between counties and cities.

Several questions were raised by the task force for its next meeting and a request that a representative from the Morris Commission come to explain issue nine, creation of a permanent body to analyze the fiscal needs and resources of state and local government. In addition, the discussion of local user fees and the administrative procedure for tax appeals was placed on the agenda for the next meeting.

July 30, 2002--Task Force #2

Task Force #2 held its third meeting on July 30, 2002 at 10:00 am. The committee's meeting began with comments from Delegate McDonnell regarding future meetings and public hearings. Delegate McDonnell reminded attendees that Task Force #1 and Task Force #2 will meet on August 19, 2002. The Joint Subcommittee will meet on September 12 at 10:00 am and September 30 at 1:00 pm. Public hearings across the state will begin in October.

Laurie Peterson, Vice President and Director of Membership for the Virginia Retail Merchants Association, gave a presentation on the Accelerated Sales Tax Collections. (Appendix H) Task Force members requested additional information on the policies and procedures of other states related to sales tax collections.

Donna Reynolds, Director of Community Relations for the American Lung Association of Virginia presented information on nationwide cigarette tax statistics, including tax increases nationwide (Appendix I).

Steve Pearson, Esq., representing various commercial property owners, gave a presentation on the Real Estate Tax Appeals Process. Mr. Pearson presented information from a working group which included assessors, assistant county attorneys and representatives from the Virginia Municipal League and the Virginia Association of Counties. (Appendix J) Following Mr. Pearson's presentation, Delegate McDonnell appointed Delegate Griffith to work with the group on the real estate tax appeals process.

Stuart Fleming, a citizen from the Newport News area, gave personal testimony regarding the real estate equalization process in the Newport News area.

Staff made a presentation regarding the BPOL Task Force. One proposal discussed at the task force meetings was to replace the BPOL tax with an income tax on all types of business. Staff reported that the Department of Taxation had stated it was unsure if it could develop reliable revenue estimates for business income generated in each Virginia locality.

Staff presented follow-up items from the Task Force #2 meeting (June 26). The items included the following:

1. Taxpayer appeals and "pay to play" provisions. Delegate McDonnell asked Delegate Johnson to work with Tax Commissioner Ken Thorsen on the feasibility of i) an independent hearing examiner and ii) prepayment for appeals.
2. Estimated revenues from a statewide 1% local individual income tax. (presented by Virginia Department of Taxation)
3. Impact of the increasing federal taxable estate threshold and options for repealing the Virginia estate tax. (presented by Virginia Department of Taxation)
4. General fund dollars spent on transportation.
5. Projected additional revenue from increasing the motor vehicle, aircraft, and watercraft sales and use taxes.

August 19, 2002 -- Task Force #1

Task Force #1 met for the fourth time this year in Richmond. The purpose of the meeting was to hear testimony related to specific issues on the task force list and make further recommendations regarding such issues.

Testimony before the Task Force

The first issue addressed dealt with the creation of a permanent body to review state and local revenues and expenditures issues on an ongoing basis. This proposal originally came from the Morris Commission. From 1968 to 1979, a body known as the Revenue Resources and Economic Study Commission (RRESC) existed. According to the testimony of John L. Knapp, Ph.D., the Research Director

of the Business and Economics section of the UVA Weldon Cooper Center for Public Service, RRESC's mission was to study the tax structure and sources of revenue of the Commonwealth and its localities and to recommend reforms. The membership of RRESC consisted of senators, delegates, and the public. Initially, the commission had a staff director, with research assistance provided by employees from the Division of State Planning and Community Affairs, the Department of Taxation and the Division of Legislative Services. It finally had its own five-person staff in 1978.

One of the many topics examined on a continual basis was the long-term outlook for state and local government finances using six-year projections. The commission issued numerous reports and many of its recommendations were adopted into law. As the Senate Finance and House Appropriations staffs, as well as those at the Department of Taxation, the Joint Legislative Audit and Review Commission (JLARC) and the Division of Legislative Services grew, the need for a separate RRESC became less obvious. These additional staff members have been doing much of the research that was formerly done by the RRESC. However, Dr. Knapp believes not enough research is being done to examine the long-term (i.e. six-year) outlook for finances and that a new study commission could take on that task.

Next, the staff directors of the House Appropriations and Senate Finance committees explained that each of their staffs as well as the Department of Planning and Budget routinely conduct technical reviews of funding formulas contained in statutory law and utilized in funding through the appropriations act. When a more thorough examination is required, their staffs rely on the work of JLARC, the State Crime Commission, joint study committees (such as this one), or the Executive Branch.

In addition, legislation was passed during the 2002 General Assembly Session that requires the governor to submit to the General Assembly Session in each even-numbered year a long-term financial plan providing a six-year financial outline consisting of (i) the Governor's biennial budget, (ii) estimates of anticipated general and nongeneral fund revenues for each major program, and (iii) estimates of general and nongeneral fund appropriations required for each major program.

It was the consensus of the task force that, while RRESC served a valuable and useful purpose during its tenure, it is not clear that it is currently needed with the additional executive and legislative branch personnel doing most if not all of the same work RRESC did. Also, with the current economic shortfall, finding the money to create such a commission is highly unlikely.

The 50/40/10 revenue sharing plan proposed in the Morris Commission report as a way to return more state income tax revenues to the localities was the next issue on which the task force focused. VML and VACO reported that they were still revising the plan and hoped to have more information for the full joint

subcommittee at its meeting in September. VML and VACO also reported that they were working on the list of local services mandates imposed by the state and which level of government should pay for the services.

Finally, regarding the appeals process issue, the Tax Commissioner described a number of ways the "pay-to-play" requirement and the creation of a separate tribunal might be addressed. The task force discussed allowing the posting of a bond instead of paying the tax, classifying an appeal to the Department of Taxation as a case decision under the APA, having an appellate officer in the Department of Taxation who deals only with appeals, and creating an external appeals process similar to the current process used by the Board of Insurance regarding managed care. The task force did not make a final recommendation regarding the appeals process.

Future work of the Task Force

Although the task force did not make any further recommendations concerning the issues before it, its members did decide that they should also take a closer look at the service responsibilities of both state and local government and whether some changes should be made in which level of government provides what service. The widely held opinion was that the amount of revenues needed and tax relief available could not properly be determined without deciding whether some changes in the delivery of services are necessary in order to serve the citizens of the Commonwealth in the best and most efficient manner. Several task force members expressed concern over the shortfall in revenues of the Commonwealth and suggested that any major tax restructuring might have to be delayed and that the study be continued for a third year. The chairman of Task Force #1 was to report to the full joint subcommittee at its next meeting on September 12th.

August 19, 2002 -- Task Force #2

Task Force #2 held its fourth and final meeting on August 19, 2002, in the General Assembly Building in Richmond.

Delegate Robert D. Orrock, Sr., as chairman of the House Finance Special Subcommittee on Sales and Use Tax Exemptions for Nonprofit Entities, presented the final report of his Subcommittee. His Subcommittee recommended that, effective July 1, 2004, the Department of Taxation administratively grant sales and use tax exemptions to any nonprofit entity that meets the following criteria to be established by the General Assembly:

- A. 1. The entity is federally tax exempt (i) under § 501 (c) (3) or (ii) under § 501 (c) (4) and the entity (if it is under § 501 (c) (4)) is organized for charitable purposes; or

2. The entity has annual receipts less than the threshold required under § 501 (c) (3) and § 501 (c) (4) (\$5,000), and
 - B. The entity is serving the public good and provides a statement as to the specific public good being served; and
 - C. The entity is in compliance with state solicitation laws; and
 - D. The entity's administrative costs are less than _____%, relative to its gross revenue (no consensus on specific restriction); and
 - E. If the entity's gross annual revenue was \$250,000 or greater in the previous year, then the entity must provide a financial audit performed by an independent certified public accountant; and
 - F. If the entity filed a federal 990 or 990 EZ tax form with IRS, then it must provide a copy of such form to the Tax Dept.
 - G. If the entity does not file a federal 990 or 990 EZ tax form with IRS, then the entity must provide the following information:
 1. A list of the Board of Directors or other responsible agents of the entity (comprised of at least two individuals), with names and addresses (addresses must be where the individual physically can be found); and
 2. The location where the financial records of the entity are available for public inspection.

The duration of each exemption granted by the Department of Taxation shall be no less than five years and no greater than seven years. To maintain an exemption that otherwise would expire, each entity must provide the Department of Taxation the same information as required upon initial exemption and meet the same criteria.

The Department of Taxation shall develop all other reasonable rules and regulations necessary to carry out the exemption process within the constraints set forth herein. The Department of Taxation shall file an annual report with the Chairmen of the House Finance Committee, the House Appropriations Committee, and the Senate Finance Committee, setting forth the annual fiscal impact of the exemptions for nonprofit entities.

David L. Bailey spoke briefly on behalf of the Coalition of Virginia Nonprofits generally endorsing the Orrock Subcommittee's recommendations.

Staff presented an update on the BPOL work group of interested parties. That work group has not reached a consensus on any alternatives to recommend. However, the work group will meet again the first week of September.

George Peyton, speaking on behalf of the Retail Merchants Association of Greater Richmond, the Retail Alliance of Hampton Roads, and the Virginia Retail Merchants Association presented two alternatives for replacing the BPOL tax: (i) gradually eliminate BPOL over a five-year period and replace the revenue with a 1/2 percent increase in the sales and use tax and, at the end of five years, by a .25% increase in the corporate income tax, or, alternatively (ii) gradually eliminate BPOL over a ten-year period and replace the lost revenue with a 1/2 percent increase in the sales and use tax, and, at the end of the ten-year period, by a .25% increase in the corporate income tax.

Delegate Robert D. Hull discussed a prior legislative study regarding local revenue resources (House Document No. 69 (1995)) and recommended that legislation be adopted giving counties the same taxing authority as cities and towns, as was provided in a bill he introduced last session (HB 16 (2002)). Representatives of various amusement industries urged the Task Force not to authorize counties to impose amusement taxes.

Donald L. Hall, President of the Virginia Automobile Dealers Association, made a presentation recommending that the sales and use tax on motor vehicles not be increased. He suggested that the task force examine revenue lost through the understatement of the actual purchase price on "casual sales" (i.e. sales not from a dealer).

Staff presented follow-up information from the July 30th Task Force meeting including: (i) categories of services on which sales and use tax might be imposed, (ii) state-by-state comparisons in vendors' payment schedules for remitting sales and use taxes collected, (iii) state-by-state comparisons of state death taxes, (iv) state-by-state comparisons of cigarette taxes, (v) local cigarette tax rates in Virginia, (vi) estimates for a tax on the manufacture of cigarettes, (vii) estimates on the fiscal impact of reducing the taxable price of a motor vehicle by the value of any trade-in, and (viii) information on the general and non-general funds for transportation in Virginia.

The Task Force then considered each of the issues that had been assigned to it. For a full accounting of all action taken on each issue refer to the revised Task

Force #2 Issue Form that will be posted on this site. Some of the Task Force's recommendations included: (i) adoption of the Orrock Subcommittee's recommendations on sales and use tax exemptions for nonprofit entities, with the proviso that the current moratorium on any new sales and use tax exemptions continue at least until budget pressures ease; (ii) impose the sales and use tax on personal services and repair services, and consider removing the exemption provided to various public service corporations; (iii) eliminate the accelerated sales tax payments by vendors; (iv) maintain the status quo of no new taxes on internet access or digital downloads; and (v) eliminate the 1978 "freeze date" in Virginia's estate tax so that the tax will be phased out over a four year period like most other states in conformity with the federal Tax Relief Act of 2001.

The Task Force reported its recommendations to the full joint subcommittee on September 12, 2002.

September 12, 2002

The joint subcommittee heard from the staff on follow-up information on questions raised during the August task force meetings and received the two task forces' reports that contained legislative recommendations. In addition to the August meetings, each task force met in May, June, and July to receive information about and discuss the issues assigned.

The joint subcommittee also determined what its work schedule would be for the remainder of this year and that it would be necessary to continue the study for one more year.

Staff Presentation

Staff presented information provided by the Department of Taxation regarding the revenues that could be raised by expanding the cigarette tax to include all tobacco products (snuff, chewing tobacco, cigars, and smoking tobacco). The most common way that states tax tobacco products other than cigarettes is to levy a tax on the wholesale price of the tobacco product. North Carolina imposes a tax of 2% on the wholesale price of such products, other than cigarettes, while Maryland imposes a 15% tax on the same tobacco products.

Assuming Virginia were to levy a 2% tax on the wholesale price of tobacco products other than cigarettes, the estimated revenues are \$2.7 million in FY04, \$2.9 million in FY05, and \$2.9 million in FY06. Also, sales tax revenues would increase by approximately \$120,000 in FY04, \$130,000 in FY05, and \$129,000 in FY06.

Next, a representative from the Department of Motor Vehicles (DMV) explained the process for collecting the motor vehicle sales and use tax on casual sales of vehicles. When a customer submits a completed application for a Certificate of Title and Registration, the customer may also provide documentation of the

selling price, which is generally accepted as the selling price on which the sales tax is based. If the customer fails to provide such documentation, the selling price is compared to the NADA Average Trade In Price, and the tax is based on that determination. According to DMV's most recent numbers, almost \$45 million was collected in sales tax revenues out of \$1.2 billion in casual sale of motor vehicles.

Recommendations (as of September 12)

Next, the chairmen of each task force reviewed the issues assigned to the two task forces and explained the recommendations made by each. Because of the (i) ever-growing revenue shortfall the Commonwealth was experiencing; (ii) uncertainty about when the economy would begin to grow again; (iii) sheer complexity and interconnection of issues, not all of which had been fully analyzed; (iv) lack of consensus among stakeholder task forces on key issues (i.e. revenue sharing, equalization of taxing authority, BPOL tax reform); and (v) unknown effects that major changes in the state's tax code might have on revenues, the consensus was to extend the study for a third year on major restructuring issues and propose fewer changes during the 2003 session.

The proposed recommendations of the task forces (the applicable task force and item/issue number are shown in parentheses) are:

1. Adopt Orrock Subcommittee Report with standards for charitable organization sales tax exemptions, with moratorium on new exemptions. (Task Force 2 -- Item 1)
2. Restore conformity with federal income tax law, with the exception of accelerated depreciation and carry back loss issues to essentially eliminate fiscal impact. (Task Force 1 -- Item 1)
3. Revise administrative appeals process for income taxpayers to provide:
 - a) an independent hearing officer (Task Force 1 -- Item 8)
 - b) no payment of tax in advance (Task Force 2 -- Item 8)
4. Eliminate June accelerated sales tax collections in 2002-2004 budget -- pushes \$118 million back to FY 03. (Task Force 2 -- Item 8)
5. Revise property tax appeals process to clarify procedures and standard of proof for taxpayer. (Task Force 2 -- Item 10)
6. Phase out death tax beginning in FY 05. (Task Force 2 -- Item 10)
7. Budget/state shall impose no new unfunded mandates on localities, and to maximum extent possible, eliminate existing ones. (Task Force 1 -- Item 7)
8. Support a moratorium on new categories of sales and use tax exemptions. (Task Force 2 -- Item 4)

9. Maintain policy of no sales tax on access to Internet and digital downloads.
(Task Force 2 -- Item 9)

September 30, 2002

The joint subcommittee heard from several work groups on issues assigned for study by the joint subcommittee and the General Assembly. Testimony was given regarding the Streamlined Sales Tax Project, the Telecommunications Tax Study (HJ 209; 2002), the BPOL tax, the individual income tax, appeals of state taxes to the Department of Taxation, appeals of real estate tax to local Boards of Equalization, and sales tax collected on non-dealer sales of motor vehicles.

Streamlined Sales Tax Project

The Streamlined Sales Tax Project was a project that was begun by several states and tax administrators (both government and business). The objective of the project is to simplify and make more uniform the administration of sales and use taxes for merchants who sell their goods over the Internet or who are active in interstate commerce. One result of the project may be the voluntary collection and remittance of use tax to state authorities by merchants who are not legally obligated to collect and remit the tax.

Legislation passed by the 2002 General Assembly enabled Virginia to join the Streamlined Sales Tax Project and for appointed members of the General Assembly to enter into multi-state discussions on behalf of the Commonwealth to consider whether the Commonwealth should enter into a multi-state sales and use tax simplification agreement (See Senate Bill No. 688). Virginia is one of 35 states (implementing states) that have entered into the multi-state discussions. The consensus of representatives of the implementing states is to not impose taxes on means of accessing the Internet. The group has also agreed that sales taking place over the Internet should be subject to sales and use taxes. (The United States Congress has passed legislation placing a moratorium on new taxes for accessing the Internet and on new sales and use taxes on goods sold over the Internet. This moratorium is due to end in 2003).

It was reported to the joint subcommittee that Virginia has an estimated loss of between \$225 million - \$260 million annually in sales and use tax revenues that are not collected for sales taking place over the Internet. The joint subcommittee was told that Virginia's annual loss is estimated to reach \$1 billion per year over the next 6 to 8 years if there are no changes in the law.

The implementing states have agreed to allow for more than one sales and use tax rate in a state, but the tax base must remain the same in every locality of the state. Rules on rounding the amount of tax are one area where agreement has

not been reached. Adoption of the agreement, once completed, is voluntary for each implementing state.

Telecommunications Tax Study

House Joint Resolution No. 209 (2002) established a joint subcommittee to study the state and local taxation of the telecommunications industry and its customers. This joint subcommittee reported that local taxes collected by telecommunications companies include consumer utility, E-911 and cable television fees. As a result, telecommunications companies must make many deposits to the accounts of local governments for each of these taxes.

The joint subcommittee studying telecommunications taxes found that state taxes on telecommunications are very low while local taxes on telecommunications are very high. The Commonwealth collects \$80 million annually in telecommunications taxes while local governments collect \$320 million annually from these taxes.

Businesses in the telecommunications industry would like a reduction in the number of telecommunications taxes and a reduction in the amount of tax on telecommunications. They also believe that local governments must be kept whole as part of any tax restructuring of telecommunications taxes.

Ideas discussed in meetings of representatives of the telecommunications industry and of local governments include the consolidation of all telecommunications taxes into one line item on customer bills, uniformity of tax rates across the state, and collection of all telecommunications taxes by a central administration, possibly the Department of Taxation.

The joint subcommittee studying telecommunications taxes will seek to continue its study for another year during the 2003 General Assembly to give the industry representatives and local government representatives additional time to develop a solution that all will support.

BPOL Tax

The joint subcommittee also heard from representatives of the business community and local governments in regard to the BPOL tax. The business community would like to see the BPOL tax repealed.

Representatives of the Virginia Chamber of Commerce believe that the tax can only be repealed as part of a larger restructuring of Virginia's tax code. The Greater Richmond Retail Merchants Association (the "Association") presented two alternatives for eliminating the BPOL tax. The first alternative would be to eliminate the BPOL tax over a five-year period by rolling back BPOL tax rates at twenty percent a year for five years. To offset the loss in revenue for local

governments, the Association suggested that local governments be paid the revenue from an immediate ½ percent increase in the retail sales tax and, at the end of the fifth year, a ¼ percent increase in the corporate income tax. The second alternative suggested was to eliminate the BPOL tax over a ten-year period by rolling back BPOL tax rates at ten percent a year for ten years. The Association suggested compensating local governments with the revenue from an immediate ½ percent increase in the retail sales tax and, at the end of the tenth year, a ¼ percent increase in the corporate income tax.

Representatives of the Virginia Association of Counties (VACO) and the Virginia Municipal League (VML) stated that the BPOL tax generated more than \$459 million in local revenue in fiscal year 2001. Statewide, the tax accounted for more than four percent of all locally generated revenue. Some localities rely on the BPOL tax for as much as twenty-five percent of their locally generated revenue. Towns have a much higher reliance on the BPOL tax.

VACO and VML stated that BPOL revisions in 1996 have improved administration of the BPOL tax for all involved. In addition, the revisions gave taxpayers a right to appeal their tax to the Tax Commissioner. VACO and VML also stated that the 1996 revisions eliminated the BPOL tax for many small businesses.

Individual Income Tax

The joint subcommittee received a recommendation for restructuring Virginia's individual income tax. The recommendation would eliminate all individual income tax exclusions, deductions and tax credits, with the exception of the current deduction for social security income. The tax would be applied to federal adjusted gross income reported on an individual's federal income tax return. The plan calls for no tax for the first \$20,000 of federal adjusted gross income reported on each individual income tax return. The new income tax brackets and tax rates would be:

<u>Federal Adjusted Gross Income</u>	<u>Tax Rate</u>
If FAGI is \$0-\$20,000;	Tax is \$0
If FAGI is \$20,000-\$30,000;	Tax is 0% on first \$20,000 of FAGI and 4% on FAGI between \$20,000 and \$30,000
If FAGI is \$30,000-\$50,000;	Tax is 0% on first \$20,000 of FAGI, 4% on FAGI between \$20,000 and \$30,000, and 5.5% on FAGI between \$30,000 and \$50,000

If FAGI is over \$50,000;

Tax is 0% on first \$20,000 of FAGI, 4% on FAGI between \$20,000 and \$30,000, 5.5% on FAGI between \$30,000 and \$50,000, and 6.25% on FAGI over \$50,000

The tax rates and tax brackets are intended to be revenue-neutral in regard to the revenue currently generated from Virginia's individual income tax.

Appeals of State Taxes to the Department of Taxation

The joint subcommittee heard recommendations from the Tax Commissioner for changes in the current process for appealing state taxes to the Department of Taxation. The Tax Commissioner proposed the creation of a limited right of appeal to an independent hearing officer located in the Department. The Tax Commissioner would have no right of review over the hearing officer's decision nor would the Tax Commissioner have any authority to direct or otherwise interfere with the independent hearing officer's determination. The independent hearing officer would be an attorney selected by the Tax Commissioner and would serve for renewable terms of four years.

Under the Tax Commissioner's recommendation, the hearing officer would only hear appeals that involve sales and use, corporate income, or individual income assessments of \$30,000 or more. A \$500 fee would be charged to each taxpayer filing an appeal with the independent hearing officer. The fee would help offset the cost of establishing an independent hearing officer position.

Decisions of the hearing officer would be rendered in 90 days. Both the Department of Taxation and the taxpayer would be able to appeal the hearing officer's decision, *de novo*, in circuit court.

The Tax Commissioner also recommended that there be no change to the current law requiring a taxpayer to pay his tax assessment prior to the circuit court hearing the taxpayer's appeal.

Appeals of Real Estate Tax to Boards of Equalization

The joint subcommittee received a report relating to the procedures for appealing local real estate taxes. Representatives of the business community and local governments have formed a work group to study the procedures for appealing real estate taxes to Boards of Equalization. The work group agreed on several issues relating to appeals of real estate taxes to Boards of Equalization, and will continue to meet to try to reach agreement on the remaining unresolved issues. Discussions have focused on, among other things, the taxpayer's burden of proof in appealing a real estate tax assessment and the term of service for members of Boards of Equalization.

Tax Collected on Non-dealer Sales of Motor Vehicles

The Department of Motor Vehicles that the sales price reported for automobile sales not involving dealers is much less than the sales price reported for sales of similar automobiles in which a dealer is a party to the sale. In collecting the motor vehicle sales and use tax on non-dealer sales, DMV will accept the sales price reported to it by the buyer provided the buyer provides documentation of the selling price. Acceptable documentation from the buyer can include a sales receipt or a certificate of title with the sales price filled in. DMV's analysis of 95,000 non-dealer sales of automobiles in which the buyer provided documentation of the selling price revealed that in every case the selling price reported by the buyer was at least \$1,500 less than the NADA Average Trade In Price for the same vehicle.

The work group is studying whether purchasers of automobiles are reporting the true sales price in transactions that do not involve dealers. Of course, if the sales price reported to DMV is less than the actual sales price agreed to, the amount of sales and use tax collected by DMV is less than what is required under current law. The work group will continue to meet to develop recommendations for improving the accuracy of information collected by DMV.

Public Hearing

The joint subcommittee scheduled a public hearing for Monday, October 28, at 7:00 p.m. in Senate Room B of the General Assembly Building in Richmond. The public was invited to comment on the recommendations proposed by the joint subcommittee. This was the only public hearing scheduled in 2002.

October 28, 2002 -- Public Hearing

On the evening of October 28, the joint subcommittee heard testimony for more than three hours from 36 individuals representing a variety of interest groups. Among the groups represented were the Virginia Farm Bureau, the Virginia Chamber of Commerce, VML, VACo, the Virginia Hospitality and Travel Association, Tax Reform Committee of Virginia, general contractors, towing and recovery operators, auto dealers, childcare businesses, state and local education associations, local boards of supervisors, retail merchants, religious organizations and other nonprofits.

The topics addressed included the estate tax, the BPOL tax, equalization of local taxing authority (grant counties the same taxing powers as cities and towns), unfunded state mandates imposed on localities, sales and use tax exemptions, the income tax age deduction, income tax rates and preferences, education funding, an independent appeals officer/process within the Department of Taxation, revenue neutrality, and conformity with the federal tax code

November 13, 2002

During its final meeting for 2002, the joint subcommittee received several brief reports regarding a number of issues and ended with the approval of twelve recommendations by a majority of the members present. Topics included the Streamlined Sales Tax Project, real estate tax assessments and appeals to Boards of Equalization, state tax appeals to a hearing officer and the elimination of the "pay to play" requirement, reporting requirements for casual sales of motor vehicles, and local sales tax revenues versus BPOL tax revenues.

Issue Reports

Having just returned from the Streamlined Sales Tax Project ("Project") meeting in Chicago, Senator Hanger reported on the Project. Virginia is one of 35 implementing states participating in the Project with a goal of reducing the burden of tax compliance. They have been working on a written draft agreement that 31 of the states voted on November 12 to support. The agreement explains what states have to do to implement the plan. Some of the provisions include state level administration of sales and use tax collections, simplification of rates, uniform definitions, and uniform sourcing rules. Once 10 states representing twenty percent of the United States population have amended their laws to implement the program, then the U.S. Congress will be asked to consider making the program applicable nationwide. The joint subcommittee agreed to continue to follow the Project.

Legislation dealing with real estate assessments and boards of equalization was reviewed. There was much discussion by the joint subcommittee related to the burden of proof that was the main issue of contention between local government and the business community. The burden involves a two-prong test that the taxpayer has to satisfy in order to prevail at the board of equalization level. A second area of contention between local government and the business community is the statute of limitations. It was proposed that there be a three-year statute of limitations for appealing to the circuit court plus a mandatory appeal to the board of equalization with a one-year statute for all localities. Currently, there is no statewide mandatory board of equalization appeal and a handful of localities have a one-year statute to appeal to the circuit court. The subcommittee adopted the three-year statute of limitations for appeals to the circuit court but there was ongoing concern about the burden of proof on the taxpayer.

The Tax Commissioner next reviewed again how the tax appeals process would work at the state level with a separate hearing officer appointed by the Department of Taxation. Due to lack of support from the business community and the need for additional funding in the Department in order to implement the process, the joint subcommittee decided to further study this issue next year.

The second issue addressed by the Tax Commissioner dealt with the requirement currently in the tax code that taxpayers who decide to adjudicate their tax liability must first pay the amount assessed ("pay to play"). A proposal was made and adopted by the joint subcommittee that will eliminate that requirement so that taxpayers may go to court without paying their taxes if they believe they have been assessed incorrectly. Legislation will be introduced during the 2003 General Assembly Session to accomplish this.

Next, a proposal was made with regard to the collection of the motor vehicle sales and use tax as a result of a casual sale of a motor vehicle. It was proposed that a purchaser of a motor vehicle that is 5 years old or less will report to DMV the greater of the purchase price or the NADA value (less \$1,500) of the motor vehicle when transferring the title. The joint subcommittee approved the proposal and added it to its list of recommendations.

The last speaker, who was from VML, presented a chart showing how much in revenues localities would raise from a half-percent increase in the sales and use tax and how much they currently raise from the BPOL tax. The chart was broken down locality by locality. It was determined that the information would be a good starting point when examining the BPOL tax issues further in 2003.

Finally, the joint subcommittee discussed one of the requirements of the House Finance (Orrock) Subcommittee report dealing with the percentage allowed for administration costs of nonprofit organizations. Current law says that no more than forty percent of gross annual revenues may be spent on administration costs. There was some discussion of making it a sliding scale (i.e. 40% for organizations with gross revenues less than \$1,000,000 and 20% for those with gross revenues of \$1,000,000 or more) but it was decided to leave it at 40 percent.

Recommendations and Draft Report Approved

As its final act of the year, a majority of the joint subcommittee approved an initial draft of its report and its recommendations. Two members abstained from voting while two voted against approval. Their concern centered on the issue of revenue neutrality, one of the principles adopted by the joint subcommittee to guide them in their decision-making regarding changes to the state tax code and how revenues are collected. At least two of the recommendations, if adopted by the legislature during the 2003 General Assembly Session, will result in a reduction in general fund revenues with no offsetting recommendation that would increase such revenues during the second year of the current budget cycle. It was agreed that in 2003, the joint subcommittee would continue to discuss and look for additional revenue sources

FINDINGS AND CONCLUSIONS

The monumental task of studying and revising Virginia's state tax code was undertaken by the joint subcommittee with expectations of making sweeping changes to a tax code that many call antiquated. Many hours, much effort and thorough preparation was contributed by all involved in the process to accomplish the assigned task. Key business, government, and citizen groups monitored and participated in all meetings to provide input and help develop viable policies.

Issues were identified and outlined. Tax principles were adopted and discussed when solutions to the issues were proposed. Progress was made toward developing the best solutions that were agreeable to all. No one fully expected the extent of the economic downturn that the nation and the Commonwealth have experienced in the last 18 months, the worst many have seen in the last 40 years. The downturn that required the joint subcommittee to take a step back and evaluate how the solutions they might propose might impact the economy further. While focusing on revenue neutral changes, there was a genuine concern that no action be proposed that might negatively impact the Commonwealth's already weak revenues. Therefore, the joint subcommittee decided to continue the study on the most complex issues for an additional year in 2003 and now recommends the less sweeping but important changes, which received broad support from the joint subcommittee.

RECOMMENDATIONS

The recommendations of the Joint Subcommittee to Study and Revise Virginia's State Tax Code for the 2003 General Assembly Session are:

1. Adopt House Finance Subcommittee (Orrock) Report with standards for charitable organization sales tax exemptions.
2. Restore conformity with federal income tax law, except for accelerated depreciation and carry back loss issues in order to eliminate fiscal impact.
3. Revise administrative appeals process for income taxpayers to provide for no payment of tax in advance of adjudication.
4. Eliminate June accelerated sales tax collections in 2002-2004 budget.
5. Revise property tax appeals process to clarify procedures and standard of proof for taxpayer.
6. Phase out estate tax beginning in Fiscal Year 2005.

7. Impose no new state unfunded mandates on localities, and to maximum extent possible, eliminate existing ones.
8. Support a moratorium on new sales and use tax exemptions.
9. Maintain policy of no sales tax on access to Internet and digital downloads.
10. Continue working with the national Streamlined Sales Tax Project.
11. Require purchasers to report the greater of (i) the actual purchase price or (ii) the NADA value (less \$1,500) for casual sales of motor vehicles that are no more than five years old when titling the vehicle and paying the sales and use tax.
12. Continue the study in 2003 with final report in December 2003.

Respectfully submitted,

The Honorable Emmett W. Hanger, Jr., Co-chairman
The Honorable Robert F. McDonnell, Jr., Co-chairman
The Honorable William T. Bolling
The Honorable Charles J. Colgan
The Honorable H. Morgan Griffith
The Honorable Phillip A. Hamilton
The Honorable William J. Howell
The Honorable Johnny S. Joannou
The Honorable Joseph P. Johnson, Jr.
The Honorable Allen L. Louderback
The Honorable Kenneth R. Melvin
The Honorable Kevin G. Miller
The Honorable Harry J. Parrish
The Honorable Kenneth W. Stolle
The Honorable Walter A. Stosch
The Honorable Mary Margaret Whipple
The Honorable John H. Rust, Jr.
Mr. Robert Scott

Ex Officio Members

The Honorable John M. Bennett, Secretary of Finance
Kenneth W. Thorson, Commissioner, Virginia Department of Taxation