

**REPORT OF THE
JOINT SUBCOMMITTEE**

**To Study and Revise
Virginia's State Tax Code**

**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.
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.

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

6. Need to evaluate the ongoing efficacy of certain taxes and tax rates, some of such taxes dating back to the 1800's.

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.

| <u>Virginia Taxable Income</u> | <u>Rate</u> |
|--------------------------------|-------------|
| 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

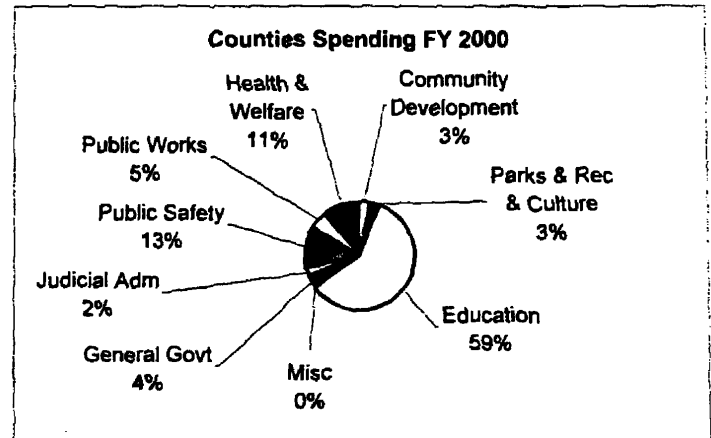
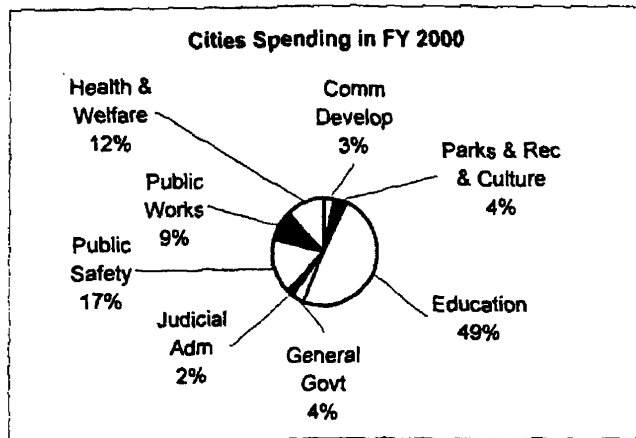
| Functional Area | Current Service Delivery and Funding Responsibility |
|---|---|
| <u>Transportation</u> Street & Road Construction Cities | Locally provided Extensive State funding Required local funding share |

| | |
|----------------------------------|---|
| 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 |

| | |
|---|--|
| <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

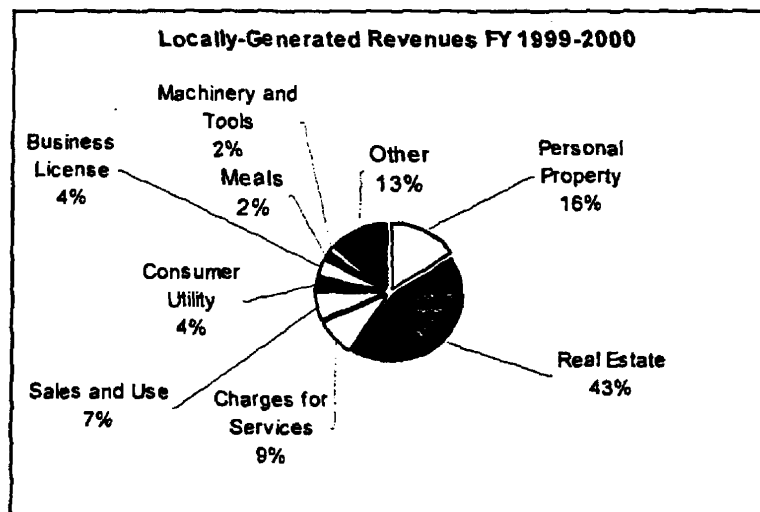
The following two charts were presented as depicting the percentage of revenues spent by cities and counties according to service category in FY 2000.



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 casuals 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 $\frac{1}{2}$ percent increase in the retail sales tax and, at the end of the fifth year, a $\frac{1}{4}$ 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 $\frac{1}{2}$ percent increase in the retail sales tax and, at the end of the tenth year, a $\frac{1}{4}$ 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

Senator Hanger reported on the Streamlined Sales Tax Project ("Project") having just returned from the group's meeting in Chicago. 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 make the program mandatory 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 concept of the legislation 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.

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 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.

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.
12. Continue the study in 2003 with final report in December 2003.

Respectfully submitted,

The Honorable Emmet 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

GENERAL ASSEMBLY OF VIRGINIA -- 2001 SESSION

HOUSE JOINT RESOLUTION NO. 685

Establishing a joint subcommittee to study and revise Virginia's state tax code.

Agreed to by the House of Delegates, February 22, 2001

Agreed to by the Senate, February 21, 2001

WHEREAS, the Commonwealth of Virginia generates more than 85 percent of its total general fund revenue from the individual and corporate income taxes and the sales and use tax; and

WHEREAS, the current individual income tax structure, which conforms to the federal income tax, was adopted in 1971 but has experienced modest changes during the past three decades; and

WHEREAS, the state sales and use tax was enacted in 1966 with only one rate change adopted since that time when the 1986 Special Session added an additional one-half cent sales tax for transportation purposes; and

WHEREAS, the 1998 General Assembly enacted a Personal Property Tax Relief Act of 1998 (§ 58.1-3523 et seq.), which began to phase out the personal property tax on the first \$20,000 value of automobiles and other vehicles over a five-year period; and

WHEREAS, the business, professional and occupational license (BPOL) tax is a local tax levied on certain businesses, professionals and occupations; and

WHEREAS, there are several categories of businesses that are exempt from the BPOL tax, of which manufacturers are one such category; and

WHEREAS, the definition of manufacturer has changed with the changes in technology, and its is not always clear to local commissioners of the revenue and manufacturers who falls within the definition and therefore qualifies for the exemption; and

WHEREAS, property taxes are the most important source of revenue for local governments, and localities need to be able to collect fairly assessed taxes promptly and efficiently so as not to interfere with their ability to provide necessary services to their inhabitants and to meet other needs of citizens; and

WHEREAS, the property tax assessment process, including consideration of administrative and judicial challenges by taxpayers, is a complex process that varies administratively from jurisdiction to jurisdiction; and

WHEREAS, the changes in the state tax structure including tax deductions and credits have evolved in a piecemeal fashion in an effort to correct specific problems or advocate certain policies rather than in a systematic way and thus a comprehensive review of such tax policy is warranted; and

WHEREAS, the state tax structure, with its reliance on income and sales taxes, has experienced strong revenue growth while the local tax structure, which is dependent on the property tax and other ad valorem taxes, has experienced slower revenue growth; and

WHEREAS, there are many different taxes and fees levied by state government, some of which may not be appropriate for today's economy; and

WHEREAS, the tax system could be more citizen-friendly, and a review of regulatory policies is needed to lessen the burden on taxpayers to comply with the Commonwealth's tax laws, while also imposing large costs on the Commonwealth to administer; and

WHEREAS, the Commission on Virginia's State & Local Tax Structure for the 21st Century, comprised entirely of citizens, has completed its charge and issued a report with recommendations for consideration by the Governor and the 2001 General Assembly; and

WHEREAS, there is an emerging consensus that the state tax code must be revised to reflect not only the changing nature of our economy, but also to make it more equitable and to generate the revenues needed to provide services to its citizens; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, That a joint subcommittee be established to study and revise Virginia's state tax code. The joint subcommittee shall consist of 14 members, who shall be appointed as follows: 8 members of the House of Delegates, of whom 2 shall have served as members of the Commission on the Condition and Future of Virginia's Cities to be appointed by the Speaker of the House in accordance with the principles of proportional representation contained in the rules of the House and 6 members of the Senate to be appointed by the Senate Committee on Privileges and Elections, of whom 1 shall have served as a member of the

Commission on the Condition and Future of Virginia's Cities.

The joint subcommittee shall ensure that Virginia's tax code is fair, uniform, understandable and contemporary. The joint subcommittee shall perform the following:

1. Examine the report and recommendations of the Commission on Virginia's State and Local Tax Structure for the 21st Century.

2. Seek broad input from all levels of government, the private sector and citizens concerning the sufficiency of the Commonwealth's current tax system.

3. Consider the necessity and sufficiency of current taxes, fees, deductions and credits as well as the rates of taxation.

4. Consider current revenue capacity of localities and the sufficiency of their revenue tools.

5. Clarify the definition of manufacturer for purposes of the business, professional, and occupational license tax.

6. Examine the number and costs of tax credits and deductions authorized each year.

7. Determine the loss in sales tax due to electronic commerce.

8. 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.

9. Consider the long-term effect on the Commonwealth's revenues of the phase-out of personal property tax.

10. Evaluate the appropriateness of the merchants capital tax and the business, professional and occupational license tax.

11. Consider a plan to more equitably address exemptions, deductions, and rates for personal and business income taxes.

12. 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.

The direct costs of this study shall not exceed \$26,000.

The Division of Legislative Services shall provide staff support for the study. The Weldon Cooper Center at the University of Virginia and the Department of Taxation shall provide technical assistance to the joint subcommittee.

All agencies of the Commonwealth shall provide assistance to the joint subcommittee, upon request.

The joint subcommittee shall complete its work in time to submit its written findings and recommendations by November 30, 2002, to the Virginia Code Commission and to the Governor and the 2003 Session of the General Assembly as provided in the procedures of the Division of Legislative Automated Systems for the processing of legislative documents.

Implementation of this resolution is subject to subsequent approval and certification by the Joint Rules Committee. The committee may withhold expenditures or delay the period for the conduct of the study.

SENATE JOINT RESOLUTION NO. 387

Establishing a joint subcommittee to study and revise Virginia's state tax code.

Agreed to by the Senate, February 22, 2001

Agreed to by the House of Delegates, February 21, 2001

WHEREAS, the Commonwealth of Virginia generates more than 85 percent of its total general fund revenue from the individual and corporate income taxes and the sales and use tax; and

WHEREAS, the current individual income tax structure, which conforms to the federal income tax, was adopted in 1971 but has experienced modest changes during the past three decades; and

WHEREAS, the state sales and use tax was enacted in 1966 with only one rate change adopted since that time when the 1986 Special Session added an additional one-half cent sales tax for transportation purposes; and

WHEREAS, the 1998 General Assembly enacted a Personal Property Tax Relief Act of 1998 (§ 58.1-3523 et seq.), which began to phase out the personal property tax on the first \$20,000 value of automobiles and other vehicles over a five-year period; and

WHEREAS, the business, professional, and occupational license (BPOL) tax is a local tax levied on certain businesses, professionals and occupations; and

WHEREAS, there are several categories of businesses that are exempt from the BPOL tax, of which manufacturers are one such category; and

WHEREAS, the definition of manufacturer has changed with the changes in technology, and it is not always clear to local commissioners of the revenue and manufacturers who falls within the definition and therefore qualifies for the exemption; and

WHEREAS, property taxes are the most important source of revenue for local governments, and localities need to be able to collect fairly assessed taxes promptly and efficiently so as not to interfere with their ability to provide necessary services to their inhabitants and to meet other needs of citizens; and

WHEREAS, the property tax assessment process, including consideration of administrative and judicial challenges by taxpayers, is a complex process that varies administratively from jurisdiction to jurisdiction; and

WHEREAS, the changes in the state tax structure including tax deductions and credits have evolved in a piecemeal fashion in an effort to correct specific problems or advocate certain policies rather than in a systematic way and thus a comprehensive review of such tax policy is warranted; and

WHEREAS, the state tax structure, with its reliance on income and sales taxes, has experienced strong revenue growth while the local tax structure, which is dependent on the property tax and other ad valorem taxes, has experienced slower revenue growth; and

WHEREAS, there are many different taxes and fees levied by state government, some of which may not be appropriate for today's economy; and

WHEREAS, the tax system could be more citizen-friendly, and a review of regulatory policies is needed to lessen the burden on taxpayers to comply with the Commonwealth's tax laws, while also imposing large costs on the Commonwealth to administer; and

WHEREAS, the Commission on Virginia's State and Local Tax Structure for the 21st Century, comprised entirely of citizens, has completed its charge and issued a report with recommendations for consideration by the Governor and the 2001 General Assembly; and

WHEREAS, there is an emerging consensus that the state tax code must be revised to reflect not only the changing nature of our economy but also to make it more equitable and to generate the revenues needed to provide services to its citizens; now, therefore, be it

RESOLVED by the Senate, the House of Delegates concurring, That a joint subcommittee be established to study and revise Virginia's state tax code. The joint subcommittee shall consist of 14 members, who shall be appointed as follows: six members of the Senate, to be appointed by the Senate Committee on Privileges and Elections, of whom one shall have served as a member of the Commission on the Condition and Future of Virginia's Cities, and eight members of the House of Delegates, of whom two shall have served as members of the Commission on the Condition and Future of Virginia's Cities, to be appointed by the Speaker of the House in accordance with the principles of proportional representation contained in the rules of the House.

The joint subcommittee shall ensure that Virginia's tax code is fair, uniform, understandable, and contemporary. The joint subcommittee shall perform the following:

- 1. Examine the report and recommendations of the Commission on Virginia's State and Local Tax Structure for the 21st Century.**
- 2. Seek broad input from all levels of government, the private sector, and citizens concerning the sufficiency of the Commonwealth's current tax system.**
- 3. Consider the necessity and sufficiency of current taxes, fees, deductions and credits as well as the rates of taxation.**
- 4. Consider current revenue capacity of localities and the sufficiency of their revenue tools.**
- 5. Clarify the definition of manufacturer for purposes of the business, professional, and occupational license tax.**
- 6. Examine the number and costs of tax credits and deductions authorized each year.**
- 7. Determine the loss in sales tax due to electronic commerce.**
- 8. 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.**
- 9. Consider the long-term effect on the Commonwealth's revenues of the phase-out of personal property tax.**
- 10. Evaluate the appropriateness of the merchants capital tax and the business, professional and occupational license tax.**

11. Consider a plan to more equitably address exemptions, deductions, and rates for personal and business income taxes.

12. 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.

The direct costs of this study shall not exceed \$26,000.

The Division of Legislative Services shall provide staff support for the study. The Weldon Cooper Center at the University of Virginia and the Department of Taxation shall provide technical assistance to the joint subcommittee.

All agencies of the Commonwealth shall provide assistance to the joint subcommittee, upon request.

The joint subcommittee shall complete its work in time to submit its written findings and recommendations by November 30, 2002, to the Virginia Code Commission and to the Governor and the 2003 Session of the General Assembly as provided in the procedures of the Division of Legislative Automated Systems for the processing of legislative documents.

Implementation of this resolution is subject to subsequent approval and certification by the Joint Rules Committee. The committee may withhold expenditures or delay the period for the conduct of the study.

Legislative Information System

2002 SESSION

ENROLLED

HOUSE JOINT RESOLUTION NO. 60

Continuing the Joint Subcommittee to Study and Revise Virginia's State Tax Code.

Agreed to by the House of Delegates, February 12, 2002

Agreed to by the Senate, March 5, 2002

WHEREAS, House Joint Resolution No. 685 (2001) was established to study and revise Virginia's state and tax code; and

WHEREAS, the Commonwealth of Virginia generates more than 85 percent of its total general fund revenue from the individual and corporate income taxes and the sales and use tax; and

WHEREAS, the current individual income tax structure, which conforms to the federal income tax, was adopted in 1971 but has experienced modest changes during the past three decades; and

WHEREAS, the state sales and use tax was enacted in 1966 with only one rate change adopted since that time when the 1986 Special Session added an additional one-half cent sales tax for transportation purposes; and

WHEREAS, the 1998 General Assembly enacted a Personal Property Tax Relief Act of 1998 (§ 58.1-3523 et seq.), which began to phase out the personal property tax on the first \$20,000 value of automobiles and other vehicles over a five-year period; and

WHEREAS, the business, professional, and occupational license (BPOL) tax is a local tax levied on certain businesses, professionals and occupations; and

WHEREAS, property taxes are the most important source of revenue for local governments, and localities need to be able to collect fairly assessed taxes promptly and efficiently so as not to interfere with local governments' ability to provide necessary services to residents and to meet other needs of citizens; and

WHEREAS, the property tax assessment process, including consideration of administrative and judicial challenges by taxpayers, is a complex process that varies in administration from jurisdiction to jurisdiction; and

WHEREAS, the real estate tax imposed by local governments constitutes another financial challenge faced by farmers that contributes to farm failures or causes farmers to sell their land; and

WHEREAS, despite the economic, ecologic and aesthetic importance of farming and agriculture to the Commonwealth, the number of farms within the Commonwealth has been reduced by half since 1960; and

WHEREAS, much of the land that used to be farm land has been converted to nonagricultural uses; and

WHEREAS, the loss of this land undermines the Commonwealth's food production capabilities and reduces the amount of open spaces; and

WHEREAS, there is a need to review the current method of imposing taxes on farm real estate to encourage the continued use of the land for farming; and

WHEREAS, the changes in the state tax structure, including tax deductions and credits, have evolved in a piecemeal fashion in an effort to correct specific problems or advocate certain policies rather than in a systematic way and thus a comprehensive review of such tax policy is warranted; and

WHEREAS, the state tax structure, with its reliance on income and sales taxes, has experienced strong revenue growth while the local tax structure, which is dependent on the property tax and other ad valorem taxes, has experienced slower revenue growth; and

WHEREAS, the state tax system strives to be citizen-friendly, but a review of policies is needed to lessen the burden on taxpayers to comply with the Commonwealth's tax laws and reduce administrative costs to the Commonwealth; and

WHEREAS, there is an emerging consensus that the state tax code must be revised to reflect not only the changing nature of our economy but also to make it more equitable and to generate the revenues needed to provide services to Virginia's citizens; and

WHEREAS, the joint subcommittee began its work in 2001 and much remains to be done; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, That the Joint Subcommittee to Study and Revise Virginia's State Tax Code be continued. The joint subcommittee shall consist of 18

members, who shall be appointed as follows: 9 members of the House of Delegates, of whom 2 shall have served as members of the Commission on the Condition and Future of Virginia's Cities to be appointed by the Speaker of the House in accordance with the principles of proportional representation contained in the Rules of the House of Delegates; and 7 members of the Senate to be appointed by the Senate Committee on Privileges and Elections, of whom 1 shall have served as a member of the Commission on the Condition and Future of Virginia's Cities. In addition, the Secretary of Finance and the Tax Commissioner, or their representatives, shall serve as non-voting, ex-officio members.

The joint subcommittee shall ensure that Virginia's tax code is fair, uniform, understandable, and contemporary. The joint subcommittee shall continue the work it began in 2001 and undertake the following:

1. Examine the report and recommendations of the Commission on Virginia's State and Local Tax Structure for the 21st Century.
2. Seek broad input from all levels of government, the private sector, and citizens concerning the sufficiency of the Commonwealth's current tax system.
3. Consider the necessity and sufficiency of current taxes, fees, deductions and credits as well as the rates of taxation.
4. Consider current revenue capacity of localities and the sufficiency of their revenue tools.
5. Examine the number and costs of tax preferences including income tax subtractions, deductions and exemptions, and income tax credits currently in the tax code.
6. Estimate the loss in sales tax due to electronic commerce.
7. 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.
8. Consider the long-term effect on the Commonwealth's revenues from the phase-out of the personal property tax.
9. Evaluate the appropriateness of the merchants' capital tax and the business, professional and occupational license tax.
10. Consider a plan to more equitably address tax preferences and rates for personal and business income taxes.
11. 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.
12. Review the current method of imposing taxes on farm real estate and alternative methods for imposing farm real estate taxes, including the feasibility of replacing the current method with a tax on the value of what is produced by farms.

The direct costs of this study shall not exceed \$32,000.

The Division of Legislative Services shall provide staff support for the study. The Weldon Cooper Center at the University of Virginia and the Department of Taxation shall provide technical assistance to the joint subcommittee.

All agencies of the Commonwealth shall provide assistance to the joint subcommittee, upon request.

The joint subcommittee shall complete its work by November 30, 2002, and shall submit its written findings and recommendations to the Virginia Code Commission and to the Governor and the 2003 Session of the General Assembly as provided in the procedures of the Division of Legislative Automated Systems for the processing of legislative documents.

Implementation of this resolution is subject to subsequent approval and certification by the Joint Rules Committee. The committee may withhold expenditures or delay the period for the conduct of the study.

TASK FORCE #1 ISSUE FORM
09/12/2002

| <u>Issues for Consideration</u> | <u>Fiscal Impact</u> | <u>References to Source Documents</u> | <u>Tax Principles</u> | <u>Interested Parties</u> | <u>Comments/Other</u> | <u>Task Force Recommendations</u> |
|---|---|--|-----------------------|---------------------------|---|--|
| STATE TAXES | | | | | | |
| Income Tax | | | | | | |
| 1. Conformity with federal law - conformity or deconformity, fixed date [Jt. Sub.] ¹ | If language had not been included in the current budget to create a fixed date conformity the fiscal impact would have been as follows: FY 03 (\$191.42 mil) FY 04 (89.24 mil) FY 05 (17.38 mil) FY 06 51.13 mil Source: TAX | 1. Estimated Fiscal Impact on VA of The Victims of Terrorism Relief Act of 2001 & The Job Creation and Worker Assistance Act of 2002- TAX 6/24/02 Tab 7-A 2. Va's Conformity with the IRC TAX 8/15/02 Tab 5 3. Reactions of Other States TAX 8/15/02 Tab 5 4. Changing VA's Individual Inc. Tax Starting Point from FAGI to FTI TAX 8/15/02 Tab 5 | Efficiency | VA Retail Merchant's | Currently, language in budget conforms to Federal law as of 12/31/01 | Conform as much as possible; deconform only when necessary |
| 2. Eliminate the age deduction [Morris] | FY 03 \$288.3 mil FY 04 304.2 mil FY 05 320.9 mil FY 06 338.5 mil Source: TAX | 1. Options for making Age Deduction Dependent on Income-- TAX 5/29/02 Tab 7-A ² 2. Morris (pp. 31-32) 3. Reducing Individual Income Tax Rates by Eliminating the Age Deduction TAX 8/19/02 Tab 5 4. Grandfathering the Age Deduction TAX 8/19/02 Tab 5 | Equity | NARFE AARP | Instead of outright elimination, consider grandfathering or making it needs based | Defer until 2003 |

¹ Designates the source of the recommendation (Jt. Sub.= HJR 60 Joint Subcommittee; Morris = Report of the Commission on Virginia's State and Local Tax Structure for the 21st Century ("Morris Commission") House Doc. 22 (2001); and Bliley = Report of the Governor's Commission on Government Finance Reform for the 21st Century ("Bliley Commission Report") (Dec. 17, 2001)).

² "Tab" refers to Jt. Subcommittee notebook; Morris refers to Morris Commission Report; and Bliley refers to Bliley Commission Report.

| <u>Issues for Consideration</u> | <u>Fiscal Impact</u> | <u>References to Source Documents</u> | <u>Tax Principles</u> | <u>Interested Parties</u> | <u>Comments/Other</u> | <u>Task Force Recommendations</u> |
|---|--|--|------------------------|--|-----------------------|--|
| 9. Examine tax preferences (subtractions, deductions, tax credits) [Jt. Sub.] | Total tax relief in addition to car tax: FY 02 (\$494.9 mil) FY 03 (550.6 mil) FY 04 (594.7 mil) Source: TAX and SFC; TAB 7-G | 1. Tabs 7-F and 7-G 2. Individual Income Tax Credits Claimed in TY 1999 TAX 7/15/02 Tab 5 3. Corp. Inc. Tax Credits Claimed in TY 1999 TAX 8/16/02 Tab 5 | Equity Adequacy | | | Defer until 2003 |
| 10. Overwithholding of income | Unknown | | | Taxpayers | | Defer action now but eventually Allow taxpayers to adjust withholding to match their tax liability |
| PERSONAL PROPERTY TAX/LOCAL TAXES | | | | | | |
| 1. Car tax phase out-- How to integrate with other tax laws? Complete phase-out or revise administrative procedures. [Jt. Sub.] | Costs of reimbursing 100% tax for all vehicles: FY 02 (\$1,407.4) FY 03 (1,423.6) FY 04 (1,474.1) FY 05 (1,540.4) FY 06 (1,618.0) | Tab 8-B (p. 8) | Adequacy | VML/VACO | | Defer until 2003 |
| 2. Telecommunications tax -- Consider Del. Bryant's Subcommittee recommendations (HJ 209) [Jt. Sub.] | Unknown (HJR 209 recommendations to be issued in September) | Report to be issued September 2002 | Adequacy Efficiency | VML/VACO Tele-communications Companies | | Wait for 9/30 report from Del. Bryant but probably defer until 2003 |
| OTHER | | | | | | |
| 1. Appropriate mix of general fund taxes (Individual income tax equals 64% of general fund revenues and sales tax equals 21% of general fund revenues) [Jt. Sub.] | N/A | Tab 7-A (pp. 1-3) | All | | | Do not shift burden from business to individuals-Defer until 2003 |

| <u>Issues for Consideration</u> | <u>Fiscal Impact</u> | <u>References to Source Documents</u> | <u>Tax Principles</u> | <u>Interested Parties</u> | <u>Comments/Other</u> | <u>Task Force Recommendations</u> |
|---|---|---------------------------------------|----------------------------------|--|-----------------------|---|
| 2. Distribute at least 6% of the state's annual individual income tax collections to local governments [Morris] | Based on FY 2002 income tax collections of \$6.7 million, the estimated amount returned to localities would be approximately \$405 million. | Tab 8-E (p. 27) Morris (p. 26) | Adequacy | VML/VACO Localities | | Defer until 2003 |
| 3. Constitutional amendment requiring a sharing of state income tax revenues with localities and eliminating the personal property tax on all non-business vehicles [Bliley] | Cost of eliminating the personal property tax on all non-business vehicles: FY 02 (\$1,196.3 mil) FY 03 (1,210.1 mil) FY 04 (1,253.0 mil) FY 05 (1,309.3 mil) FY 06 (1,375.3 mil) Source: TAX | Bliley (pp. 27-28) | Adequacy | VML/VACO Localities | | Defer until 2003 |
| 4. Maintain a low tax burden on businesses [Bliley] | Unknown | Bliley (p. 25) | Equity Adequacy Efficiency | VMA VA Chamber VA Retail Merchant's | | Support the concept |
| 5. Tax incentives for economic growth [Bliley] | Unknown | Bliley (p. 25) | Equity Adequacy Efficiency | VA Chamber | | |
| 6. Equalization of the taxing authority of counties and cities [Jt. Sub., Morris, Bliley] | Unknown | Morris (p. 33) Bliley (p. 30) | Equity | VML/VACO | | Defer until 2003 |
| 7. No new unfunded mandates on local governments by the Commonwealth [Bliley] | None | Bliley (p. 31) | Equity | VML/VACO | | Support the concept Defer specifics until 2003 |

| <u>Issues for Consideration</u> | <u>Fiscal Impact</u> | <u>References to Source Documents</u> | <u>Tax Principles</u> | <u>Interested Parties</u> | <u>Comments/Other</u> | <u>Task Force Recommendations</u> |
|---|----------------------|---------------------------------------|-----------------------|---------------------------|--|---|
| 8. Creation of a tribunal, not located within or reporting to the Department of Taxation, to hear taxpayer appeals [Bliley] | Unknown | Bliley (p. 35) | Equity Efficiency | | Possibly have an appeals office within TAX that only deals with appeals | Will hear recommendations from TAX at 9/30 mtg. Support the concept |
| 9. Creation of a permanent body to analyze, on a continuing basis, the fiscal needs and resources of Virginia's state and local governments [Morris] | Unknown | Morris (p. 34) | All | | JLARC, the Senate Finance Committee Staff, the House Appropriations Committee Staff and DPB currently do much of this analysis | No new organization needed; maybe formalize more what currently is done |
| 10. Tax simplification - more user friendly [Jt. Sub.] | Unknown | | Efficiency | | | Support the concept |
| 11. User Fees--Consider expanding use [Jt. Sub.] | Unknown | Tab 3 - April 29th mtg. summary | Equity | | | Defer until 2003 |
| 12. 2002 Referred Legislation [HFC, SFC] | Unknown | Tab 9 | All | Bill Patrons | | Review at 9/30 mtg. |

TASK FORCE #2 ISSUE FORM

09/12/2002

| <u>Issues for Consideration</u> | <u>Fiscal Impact</u> | <u>References to Source Documents</u> | <u>Tax Principles</u> | <u>Interested Parties</u> | <u>Comments/ Other</u> | <u>Task Force Recommendations</u> |
|---|--|---|----------------------------------|--|--|---|
| STATE TAXES | | | | | | |
| Sales and Use Tax | | | | | | |
| 1. Exemptions--(consider Orrock Sub. recommendations for nonprofit entities, reported 8/19/02) [Jt. Sub.] ¹ | All exemptions (including services) estimated to have resulted in lost revenue of \$3.57 billion in FY 1999 [Source: Tax Dept.] | TAB 6 (Issue sheet fr. 6/26/02 mtg); TAB 7-C ² ; Morris p. 27-28; Legislator's Guide to Taxation in Va. p. 48-53 | Equity Efficiency Adequacy | Va. Chamber of Commerce, Va. Retail Merchants Assoc., Va. Manufacturers' Assoc., Va. Interfaith Center for Public Policy | Orrock Subcommittee of House Finance Report of 8/19/02 deals only with exemptions for nonprofit entities | Adopt Orrock Subcommittee's recommendations for nonprofit entities, but maintain current moratorium until budget pressures ease (see issue # 4) |
| 2. Extension of sales tax to services/commerce [Jt. Sub.] | Estimated that it would have generated additional \$1.1 billion of revenue in FY 1999 [Source: Tax Dept.] | TAB 6 (Issue sheet fr. 6/26/02 mtg); TAB 7-C; Morris p. 27 | Equity Efficiency Adequacy | Va. Chamber of Commerce, Va. Retail Merchants Assoc., Va. Manufacturers' Assoc., Va. Interfaith Center for Public Policy | Del. McDonnell and Sen. Whipple to examine this issue as a work group | |

¹ Designates the source of the recommendation (Jt. Sub.= HJR 60 Joint Subcommittee; Morris = Report of the Commission on Virginia's State and Local Tax Structure for the 21st Century ("Morris Commission" House Doc. 22 (2001); and Bliley = Report of the Governor's Commission on Government Finance Reform for the 21st Century ("Bliley Commission Report") (Dec. 17, 2001).

² "TAB" refers to Jt. Subcommittee notebook; Morris refers to Morris Commission Report; and Bliley refers to Bliley Commission Report.

| <u>Issues for Consideration</u> | <u>Fiscal Impact</u> | <u>References to Source Documents</u> | <u>Tax Principles</u> | <u>Interested Parties</u> | <u>Comments/ Other</u> | <u>Task Force Recommendations</u> |
|---|---|---|----------------------------------|---|------------------------|-----------------------------------|
| 5. Continued | Increasing the aircraft sales and use tax from 2% to 3% would generate an additional \$1.7 million annually. Increasing the watercraft sales and use tax from 2% to 3% would generate an additional \$2.9 million annually. | | | | | |
| 6. Use tax modifications; efficiency in collecting the tax [Jt. Sub.] | | TAB 6 (Issue sheet fr. 6/26/02 mtg); TAB 7-C; Legislator's Guide to Taxation in Va. p. 42-46 and p. 53-55 | Efficiency | Va. Chamber of Commerce, Va. Retail Merchants Assoc., Va. Manufacturers' Assoc., Va. Interfaith Center for Public Policy | | Table |
| 7. Streamlined Sales Tax Project Ongoing activities of the project Virginia's level of participation [Morris and Jt. Sub.] | | Morris p. 27-28 | Equity Efficiency Adequacy | Va. Retail Merchants Association, Va. Chamber of Commerce, Va. Manufacturers' Assoc., Va. Interfaith Center for Public Policy | | Defer |

| <u>Issues for Consideration</u> | <u>Fiscal Impact</u> | <u>References to Source Documents</u> | <u>Tax Principles</u> | <u>Interested Parties</u> | <u>Comments/ Other</u> | <u>Task Force Recommendations</u> |
|---|--|--|--|--|--|-----------------------------------|
| 8. Accelerated Sales Tax Payments by Vendors (added at mtg. on 7/30/02) | Repealing this provision would result in lost revenue of \$155 mil. to State and \$40 mil. to localities | § 3-501 of the Budget Bill 2002-2004 | Equity | Virginia Retail Merchants Association; 6,800 vendors are affected | This provision affects approximately 6,800 vendors | Eliminate |
| 9. Maintain status quo of no new taxes on Internet access or digital downloads [Bliley] | No new fiscal impact because not currently being taxed. Unknown amount of new revenue if the services were taxed | Bliley p. 31-32 (Recommendation No. 9); Legislator's Guide to Taxation in Va. p. 53-55 | Efficiency (competitiveness) Predictability | Va. Chamber of Commerce, Va. Retail Merchants Assoc., Va. Manufacturers' Assoc., Va. Interfaith Center for Public Policy | | Maintain status quo |

| <u>Issues for Consideration</u> | <u>Fiscal Impact</u> | <u>References to Source Documents</u> | <u>Tax Principles</u> | <u>Interested Parties</u> | <u>Comments/ Other</u> | <u>Task Force Recommendations</u> |
|---|--|--|-----------------------|--|---|---|
| Estate Tax 10. Conformity with federal law repealing death and estate taxes [Bliley] | <p>If Va. repeals the 1978 "freeze date" the revenue lost would be: FY 03 (\$23.8 mil.) FY 04 (\$47.8 mil.) FY 05 (\$87.7 mil.) FY 06 (\$119.5 mil.) FY 07 (\$127.5 mil.).</p> <p>If Va. leaves estate tax statute as it is, the reduction in revenue due to increases in the federal taxable estate threshold will be : FY 03 (\$8.6 mil.) FY 04 (\$11.5 mil.) FY 05 (\$16.2 mil) FY 06 (\$15.0 mil).</p> <p>If Va. repeals the estate tax effective 1/1/04 the reduction in revenue will be: FY 05 (\$97.7 mil) FY 06 (\$129.8 mil) Source: TAX</p> | TAB 6 (Issue sheet fr. 6/26/02 mtg and handout fr. 7/30/02mtg).;TAB 7-H; Bliley p. 34-35; Legislator's Guide to Taxation in Va. p. 95-97 | Equity Adequacy | Virginians for Death Tax Repeal, Nat'l Federation of Independent Businesses, Associated Gen Contractors of Va., Va. Food Dealers Assoc., Nat'l Taxpayers Union, Va. Soybean Assoc., Va. Petroleum and Convenience Store Assoc., Policy and Taxation Group, 60 Plus Assoc., American Fam Business Inst, Austin Brockenhrough & Assoc LLP, Builders & Assoc of Central Va., Catholic.org, Proprietary Child Care Assoc. of Va., Richmond Home Builders Assoc., Va. Assoc. of Roofing Contractors, Brookneal Area Chamber of Commerce | Three aspects of changes in fed'l estate tax are involved: (i) gradual increases in the federal taxable estate threshold, and (ii) reduction in federal tax credit allowed for state estate taxes paid, and (iii) the potential elimination of the federal estate tax in 2011 | Repeal 1978 "freeze date" and thereby eliminate Va. estate tax within 4 years |

| <u>Issues for Consideration</u> | <u>Fiscal Impact</u> | <u>References to Source Documents</u> | <u>Tax Principles</u> | <u>Interested Parties</u> | <u>Comments/ Other</u> | <u>Task Force Recommendations</u> |
|--|---|--|-----------------------|---|---|--|
| Misc. | | | | | | |
| 11. Replace some tax revenues with user fees [Jt. Sub.] | | | | Va. Interfaith Center for Public Policy | Sen. Stosch to examine this issue with Weldon Cooper and DLS | Defer |
| LOCAL TAXES | | | | | | |
| 1. Enact or expand use of urban revitalization tax credits and increase state funding to promote revitalization of blighted commercial and industrial properties [Bliley] | | Bliley, p. 31 | | | | Table |
| 2. Local authority to impose gas/sales tax for roads [Jt. Sub.] | An additional 1% local sales and use tax would generate approximately \$778 million in fiscal year 2002-2003. Each additional 1¢ increase in the fuels tax would generate an additional \$45 million statewide. | | Equity Adequacy | | | Table at least until the Nov. regional referenda |
| 3. Eliminate BPOL, machinery and tools, and merchants' capital tax--replace with an increase in the corporate income tax [Jt. Sub.] | Fiscal cost of eliminating BPOL, merchants' capital, and machinery and tools tax is \$640 million. Each 1% of the corporate income tax in 2002- | TAB 6 (Issue sheet fr. 6/26/02 mtg); TAB 7-B, "Selected Revenue Estimates" | | VA Chamber of Commerce, Retail Alliance, Colony Condominium, Va. Retail Merchants Association | The BPOL Task Force discussed several options for eliminating the BPOL tax. | Wait for recommendations fr. BPOL Work Group |

| <u>Issues for Consideration</u> | <u>Fiscal Impact</u> | <u>References to Source Documents</u> | <u>Tax Principles</u> | <u>Interested Parties</u> | <u>Comments/ Other</u> | <u>Task Force Recommendations</u> |
|---------------------------------|--|---------------------------------------|-----------------------|---------------------------|---|-----------------------------------|
| 3. Continued | 2003 is expected to generate \$60 million. | | | | These were replacing it with one flat fee charged to all businesses, a graduated fee determined by gross receipts level, a sales tax, a combination of an increase in the corporate income tax with a fee charged to all businesses, and a net income tax on business income (this would include corporations, partnerships, proprietorships, limited liability companies and all other business entities). The Task Force also discussed adjustments | |

| <u>Issues for Consideration</u> | <u>Fiscal Impact</u> | <u>References to Source Documents</u> | <u>Tax Principles</u> | <u>Interested Parties</u> | <u>Comments/ Other</u> | <u>Task Force Recommendations</u> |
|--|---|---|-----------------------|---|--|--|
| 3. Continued | | | | | to the current BPOL tax rates. Estimates for certain of these proposals can be found behind TAB 6 | |
| 4. Increase the threshold at which BPOL taxes apply [Morris] | | TAB 6 (Issue sheet fr. 6/26/02 mtg); TAB 8-B; Morris, p. 35-36 | | | | Wait for recommendations fr. BPOL Work Group |
| 5. Elimination of the BPOL tax [Jt. Sub.] | Fiscal cost of eliminating the BPOL tax is \$427 million in 2002-2003 | TAB 6 (Issue sheet fr. 6/26/02 mtg); TAB 7-B, "Selected Revenue Estimates"; TAB 8-B; Morris, p. 35-36 | | Virginia Chamber of Commerce, Retail Alliance, Colony Condominium, Va. Retail Merchants Association | | Wait for recommendations fr. BPOL Work Group |
| 6. Localities should be required to impose service charges on all tax-exempt property and the current restrictions of (a) basing service charges on police, fire protection, and refuse services and (b) limiting the charge to no more than one-fifth of the local real estate rate should be re-examined [Morris] | | Morris, p. 33-34 | Adequacy | | 12 cities and 8 counties impose a service charge on state owned or privately owned property that is exempt from real property taxes. | Defer |

| <u>Issues for Consideration</u> | <u>Fiscal Impact</u> | <u>References to Source Documents</u> | <u>Tax Principles</u> | <u>Interested Parties</u> | <u>Comments/ Other</u> | <u>Task Force Recommendations</u> |
|--|----------------------|---|-----------------------|---------------------------|---|--|
| 6. Continued | | | | | The service charge rate is based upon the locality's cost of furnishing police and fire protection and for collection and disposal of refuse. | |
| 7. Localities should be permitted to continue to exercise their current authority to levy merchants' capital taxes and BPOL taxes [Morris] | | TAB 6 (Issue sheet fr. 6/26/02 mtg); TAB 7-B, "Selected Revenue Estimates"; TAB 8-B; Morris, p. 35-36 | | | The merchants' capital tax rate may not be increased above the locality's rate in effect in 1978. | Wait for recommendations fr. BPOL Work Group |
| 8. Increase the service charges localities may assess for state-owned property [Jt. Sub.] | | Tab 9 (SB 479, carryover leg.) | Adequacy | | See SB 479 (carryover leg.) | Defer |
| 9. Localities should continue to designate or expand enterprise zone tax credits in both urban and rural areas [Bliley] | | Bliley, p. 31 | | | | Table |

| <u>Issues for Consideration</u> | <u>Fiscal Impact</u> | <u>References to Source Documents</u> | <u>Tax Principles</u> | <u>Interested Parties</u> | <u>Comments/ Other</u> | <u>Task Force Recommendations</u> |
|---|----------------------|---------------------------------------|-----------------------|---------------------------|--|-----------------------------------|
| OTHER | | | | | | |
| 1. Appropriate alignment of responsibility to provide services and the ability to raise revenues between the state and the localities [Morris and Jt. Sub.] | | TABS 8-D and 8-E; Morris p. 24-26 | Equity Adequacy | | Del. Hamilton and Del. Melvin to examine the issue of appropriate services for State to assume cost | Defer |
| 2. Revise Standards of Quality to accord greater recognition to (A) the number of teachers actually employed by local school divisions; (B) the salaries required by differing local conditions; (C) the necessity of continued professional development; and (D) the cost of technology. The Commonwealth should then assume a full 55% of such revised Standards of Quality [Morris] | | Morris p. 24-25; TAB 8-E p. 5-14 | Equity | | Del. Hamilton and Del. Melvin to examine the issue of appropriate services for State to assume cost | Table |
| 3. The composite index of ability-to-pay should be modified in recognition of a locality's comparative fiscal effort [Morris] | | Morris p. 24-25 | | | | Table |
| 4. The Commonwealth should develop permanent revenue sources and a distributional mechanism, apart from the Standards of Quality and other programs, to support the capital requirements of local school divisions. [Morris] | | Morris p. 25; TAB 8-E p. 5-14 | Equity Adequacy | | Outstanding debt for educational purposes for all localities as of June 30, 2001, equaled \$5.6 billion. | Table |

| <u>Issues for Consideration</u> | <u>Fiscal Impact</u> | <u>References to Source Documents</u> | <u>Tax Principles</u> | <u>Interested Parties</u> | <u>Comments/ Other</u> | <u>Task Force Recommendations</u> |
|---|--|---------------------------------------|-----------------------|---|---|--|
| 4. Continued | | | | | Del. Hamilton and Del. Melvin to examine the issue of appropriate services for State to assume cost | |
| 5. Localities should be accorded greater flexibility to address on a regional basis their economic development concerns [Morris] | | Morris p. 36 | Adequacy | | | Table |
| 6. The Commonwealth should assume the full operational costs of all mandated services provided through the Comprehensive Services Act, the public health departments, the Community Services Boards, the local and regional jails, and the social service/welfare departments [Morris] | Cost of \$400 million per year [Source: Morris p. 25] | Morris p. 25 | Equity | | Del. Hamilton and Del. Melvin to examine the issue of appropriate services for State to assume cost | Defer |
| 7. Use of special taxation districts for transportation projects [Bliley] | | Bliley p. 30-31 | | | | Defer at least until after Nov. regional referenda |
| 8. Taxpayers should not be required to pay an assessment before they are afforded an opportunity for a hearing before an independent arbiter [Bliley] | | Bliley p. 35 | Equity | VA Manufacturers' Assoc, Apt and Office Bldg Assoc of Greater Wash, VA Assoc for Commercial Real Estate, Individual | Del. Johnson to examine this issue with Ken Thorson | Thorson to examine further and report |

| <u>Issues for Consideration</u> | <u>Fiscal Impact</u> | <u>References to Source Documents</u> | <u>Tax Principles</u> | <u>Interested Parties</u> | <u>Comments/ Other</u> | <u>Task Force Recommendations</u> |
|--|----------------------|---------------------------------------|-----------------------|--|---|--|
| 8. Continued | | | | taxpayer, Commissioners of the Revenue Association, Virginia Municipal League, Virginia Association of Counties | | |
| 9. Costs of administering state taxes [Jt. Sub.] | | TAB 7-D | Efficiency | | | Defer |
| 10. Effectiveness and simplicity of administrative appeals and property tax assessment process [Jt. Sub.] | | TAB 2 p. 1-2 of 12/17/01 Summary | Equity Efficiency | Va. Manufacturers' Assoc, Apt and Office Bldg Assoc of Greater Washington, VA Assoc for Commercial Real Estate, Individual taxpayer, Commissioners of the Revenue Association, Virginia Municipal League, Virginia Association of Counties | Del. Griffith to work with the work-group of interested parties who have been meeting on this issue | Wait for recommendation by Del. Griffith |

| <u>Issues for Consideration</u> | <u>Fiscal Impact</u> | <u>References to Source Documents</u> | <u>Tax Principles</u> | <u>Interested Parties</u> | <u>Comments/ Other</u> | <u>Task Force Recommendations</u> |
|--|---|---------------------------------------|-----------------------|--|------------------------|---|
| 11. More revenue opportunities for localities (particularly for transportation and education) [Jt. Sub.] | A statewide local income tax of 1% would generate in the aggregate approximately \$1.16 bil. (See Tab 6 handout fr. 7/30/02 mtg. for revenue for each locality) | TAB 6 (Issue sheet fr. 6/26/02 mtg); | Adequacy | Virginia Municipal League, Virginia Association of Counties, Homebuilders Association of Va., Va. Interfaith Center for Public Policy, Commissioners of the Revenue Assoc. | | Bring to full committee for consideration |
| 12. Referred Legislation (see Tab 9) | | TAB 9 | | | | |

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REPORT OF THE
GOVERNOR'S COMMISSION ON
GOVERNMENT FINANCE REFORM
FOR THE 21ST CENTURY



DECEMBER 17, 2001

**REPORT OF THE
GOVERNOR'S COMMISSION ON
GOVERNMENT FINANCE REFORM
FOR THE 21ST CENTURY**

DECEMBER 17, 2001

GOVERNOR'S COMMISSION ON GOVERNMENT FINANCE REFORM FOR THE 21ST CENTURY

The Honorable Thomas J. Bliley, Jr.

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Senior Government Relations Advisor

Collier Shannon Scott, PLLC

Washington, D.C.

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Member of Congress, 7th District of Virginia; Mayor, City of Richmond;

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December 17, 2001

The Honorable James S. Gilmore, III
Governor of Virginia

The Honorable Vance S. Wilkins, Jr.
Speaker of the House of Delegates

The Honorable John H. Hager
Lieutenant Governor of Virginia

The Honorable John H. Chichester
Chairman, Senate Committee on Finance

The Honorable Vincent F. Callahan, Jr.
Chairman, House Committee on Appropriations

The Honorable Harry J. Parrish
Chairman, House Committee on Finance

The Honorable Robert F. McDonnell
Co-Chairman, Joint Subcommittee to Study and
Revise Virginia's State Tax Code

The Honorable Emmett W. Hanger
Co-Chairman, Joint Subcommittee to Study and
Revise Virginia's State Tax Code

Gentlemen:

I am pleased to transmit the final Report of the Governor's Commission on Government Finance Reform for the 21st Century. Established by Executive Order 75, the Commission was charged with developing a blueprint to modernize state and local government financial structure as the Commonwealth embarks upon a new century and a new economy.

Among the key findings and recommendations included in this Report you will discover the following ideas for modernizing state and local finances in the 21st century:

- ***A Local Income Tax:*** The Commission's core recommendation is a Constitutional amendment to cede 20 percent of the state's individual income tax revenue stream to local governments over the next decade while eliminating the personal property tax on all non-business use vehicles. Local governments need to share in the state's growing and dynamic income tax in order to adapt their revenue sources to the new economy. To date, most political discussion has bogged down over the prospect of a local income tax *in addition to* the state's income tax – that is, a tax increase on the taxpayers of Virginia – but this Commission has conceived a *revenue neutral* shift from state reimbursements to local governments for foregone car taxes to a Constitutional ceding of a fair portion of the state's individual income tax. Most importantly, the Commission recommends several viable options for ensuring that *all local governments receive more in income tax revenues than they would have received in car taxes.*
- ***Pro-Growth Tax & Regulatory Environment:*** The Commonwealth's ability to fund social program priorities over the coming decades depends critically upon economic growth to generate tax revenues to pay for those priorities. Therefore, the state should maintain a low tax burden on our businesses and our people and maintain a stable, pro-business regulatory environment as well as the Dillon Rule.

- ***BPOL Elimination:*** Virginia's struggle with the Business Professional Occupational License tax is not complete. The BPOL tax continues to inhibit economic growth, capital investment and job creation in Virginia and disproportionately burdens small start-up businesses. Therefore, localities are strongly urged to phase out the BPOL tax and replace it with either growth revenues, additional revenues from income taxes ceded to localities (per the Commission's recommendation), a fairer tax, or to spread a significantly lower BPOL tax rate across more businesses.
- ***Tax Incentives for Economic Growth:*** The state and localities should continue to target tax incentives for business expansion and job creation because the long-term revenue benefits outweigh any short-term loss in tax revenue. Where state and local tax policy provides specific incentives for business investment and job growth, the incentives should be available to new and existing businesses alike.
- ***Equal Financial Authority for Cities, Counties & Towns:*** Financial authority between cities, counties and towns should be equalized to provide all local governments the same set of financial tools to address local priorities. For decades, distinctions between the financial authority of cities and counties were based upon the historical notion that counties were primarily rural and had less need for services and revenues. The Commission concludes that the growth of the suburbs in the second half of the 20th century, and continued growth expected in the 21st century, justifies equalization of financial authority between cities and counties in the future.
- ***Special Transportation Districts:*** The funding model known as the "special transportation district" (currently codified at Virginia Code Sections 33.1-430 thru 33.1-446) should be utilized by more localities to address high priority transportation projects not funded by the state. This funding mechanism would address cost-specific transportation priorities where the people whose land value is enhanced as a result of the transportation project pay for the project after the land owners in the district approve the project and the project-specific real estate taxes in a referendum. In this context, it is important to note that the Commission considered but rejected the concept of broad-based, open-ended tax increase referenda to address local or regional transportation priorities. Instead, the Commission recommends a more tailored approach.
- ***Urban Revitalization Tax Credits:*** Targeted tax credits to promote revitalization of blighted commercial and industrial properties and brownfields, especially in urban areas, should be expanded, as should the use of enterprise zone tax credits. The Commonwealth's future depends vitally on vibrant core cities. These tax credits, as well as funding for urban renewal programs, will propel municipal and regional progress in attracting people and businesses and a high quality of living over the coming decades.
- ***No Unfunded Mandates:*** The state should not impose any new unfunded mandates on local governments.

- **Internet Tax Freedom:** The state should continue its current policy of not taxing Internet access or digital downloads of information, content and data, and should prohibit local governments from taxing the same, including the use of cable modems and DSL to access the Internet. Approximately 50 percent of the world's daily Internet traffic passes through Virginia each day. If Virginia is to remain the Internet Capital of the world and reap the economic benefits of a burgeoning technology industry, we must maintain tax and regulatory policies that encourage innovation and expansion in this industry.
- **Telecom Tax Reform:** Regarding telecommunications taxes, the Commission finds Virginia's current tax structure to be anachronistic in the information age. Virginia's state and local telecommunications taxes are overly complex. Tax rates are exorbitant and regressive at a time when every person – the elderly, the poor, college students, families – must subscribe to one or even two telephone lines to be connected in an information economy generally and to the Internet specifically. The General Assembly should enact a statewide moratorium prohibiting telecommunications tax rate increases and expansion of tax bases to new communications services. Meanwhile, the General Assembly and the Governor should establish a bi-partisan study commission charged specifically with reducing telecom tax rates in Virginia for consumers, simplifying tax structures dramatically for communications providers, eliminating discriminatory tax treatments of functionally similar communication technologies, developing limits upon multiple E-911 taxes on single residences, and identifying replacement revenues for local governments.
- **Fiscally Responsible Use of Bonds:** The state should make fiscally responsible use of its bonding capacity – consistent with maintenance of a triple-A bond rating – to address high priority construction projects. As a result of conservative fiscal leadership over the last four years, the state has issued less debt in the period from 1998 to 2001 than in any four-year period since 1986 and has accumulated significant bonding capacity – a valuable financial resource available in the new decade – which can be applied to construct the next generation of scientific laboratories on Virginia's college campuses and other modern buildings.

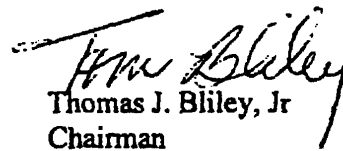
These are just some of the ideas generated by this Commission and I commend them for your review and legislative action. Considered as a comprehensive package of public policy prescriptions, I believe this Report provides the hardworking women and men of Virginia a revenue neutral blueprint for constructive and fundamental tax reform and adapts Virginia's state and local financial structure to the new economy of the 21st century.

It has been an honor to serve as this Commission's chairman and I thank Governor Gilmore for placing his confidence in me to apply nearly three decades of experience in local government, commerce and Congress to fulfill his ambitious charge. Also, it was a pleasure to

Governor & General Assembly
December 17, 2001
Page 4

work with so many distinguished leaders from the public and private sectors, from academia, as well as from local governments. The Commissioners can be satisfied that our work has indeed advanced the best interests of the people of the Commonwealth.

Sincerely,

A handwritten signature in black ink, appearing to read "Tom Bliley", written over a horizontal line.

Thomas J. Bliley, Jr
Chairman

Governor's Commission on Government
Finance Reform for the 21st Century

TJB/cgj

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THE COMMISSION

Governor Jim Gilmore established this Commission on Government Finance Reform for the 21st Century to "study and recommend fundamental reforms to the Virginia Constitution and tax and spending policies with the purpose of modernizing government finances in Virginia to meet the new and unprecedented challenges of the 21st Century." The Commission was created in June of 2001 by Executive Order No. 75, and chaired by former Congressman and Chairman of the House Commerce Committee Thomas J. Bliley, Jr., who also served as Mayor of the City of Richmond and as Chairman of the Virginia Municipal League.

The Commission has met on four occasions between July and November of 2001. The Commission has received testimony from nearly two dozen presenters representing a wide range of public and private interests. In the process, the Commission has considered over 30 policy proposals. This Report summarizes the Commission's formal findings and recommendations.

ACKNOWLEDGMENTS

The Commission gratefully acknowledges the assistance of William J. White and Stuart S. Carter of the Virginia Department of Taxation, as well as their staffs, in compiling this Report and providing the Commission invaluable economic and tax analysis, which moved this Commission's work to an articulate and sound conclusion. The Commission also wishes to thank Richard D. Brown, Acting Director of the Department of Planning & Budget, and his staff, and Asbury W. Quillen, Commissioner of the Division of Motor Vehicles, and Karen Chappell, Ralph Davis, and their staffs at the Department of Motor Vehicles. Additionally, the Commission thanks the over two dozen presenters and meeting participants whose ideas contributed significantly to this Report. The Commission also acknowledges the contributions of our Executive Director, John R. Broadway, Jr., Joseph T. Kennedy of the Governor's Office, and Lee E. Goodman, Deputy Counsel to the Governor and Deputy Director of Policy.



INTRODUCTION

"Among the many 21st century challenges facing a government designed in the 20th century is the question of how to distribute taxation authority, tax revenues, and funding responsibilities for essential services between state and local governments."

— Executive Order 75
(Issued by Governor Jim Gilmore)

Consistent with the charge of Executive Order 75, the Commission has focused most of its attention on the core question of the proper distribution of tax revenues and tax authority between the state and local governments in Virginia.

The Commission adhered to the principle that fundamental tax reforms should not disguise tax increases, but should put into place proper tax authority and structures in a revenue neutral manner. Therefore, the Commission's recommendations are intended to reform tax structures without requiring the people of Virginia to pay higher taxes.

The first order of business for the Commission was to obtain a thorough analysis of the current tax revenue raising structure in Virginia, recent tax reforms and economic growth accomplishments that have impacted growth in tax revenues, and a history of government spending over recent years. Of particular significance was a complete understanding of the Personal Property Tax Relief Act of 1998 and its implementation. This factual background information is reported below and then followed by the Commission's specific recommendations for tax reform.

COMMISSION FINDINGS:

INTRODUCTION TO GOVERNMENT FINANCE IN VIRGINIA

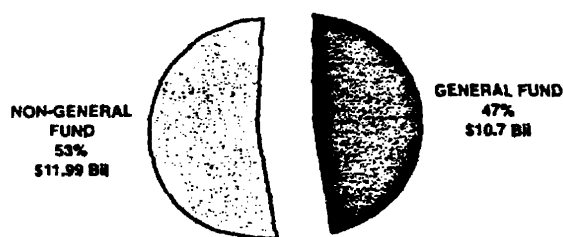
STATE TAX REVENUES

State Revenue Sources

State revenue sources are comprised of General Fund and Non-General Fund revenues. In Fiscal Year 2000, state revenues (General Fund and Non-General Fund) totaled \$22.7 billion.

General Fund revenues are those revenues which are available for unrestricted appropriation. Total general fund revenue in Fiscal Year 2000 accounted for \$10.7 billion or 47% of all revenues to the Commonwealth. In Fiscal Year 2001, general fund revenue is expected to exceed \$11 billion.

Virginia Revenue Sources Fiscal Year 2000



Non-General Fund revenues, on the other hand, are revenues earmarked for special purposes such as transportation. Examples of Non-General Fund revenues include motor fuels taxes, motor vehicle sales and use tax and federal aid. In Fiscal Year 2000, Non-General Fund revenues accounted for \$11.99 billion, or 53% of all revenues to the Commonwealth.

Major General Fund Revenues

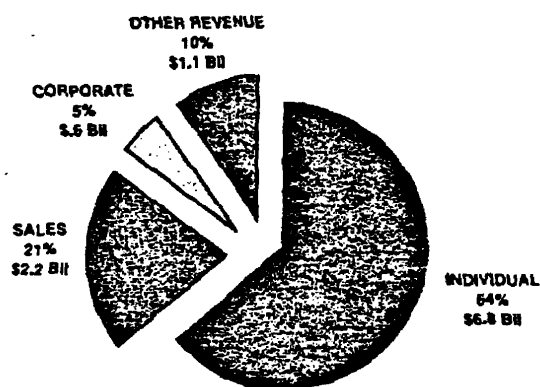
In Fiscal Year 2000, General Fund revenues, which totaled \$10.7 billion (excluding transfers to the general fund such as lottery profits), were comprised of the following:

| | | |
|-------------------------|---------------|-------|
| Individual Income Taxes | \$6.8 Billion | (64%) |
| Sales and Use Taxes | \$2.2 Billion | (21%) |
| Corporate Income Taxes | \$.6 Billion | (5%) |
| Other Revenues | \$1.1 Billion | (10%) |

Individual Income Tax

An individual Income tax has existed in Virginia since 1843. In 1972, Virginia conformed its individual income tax, in large part, to the federal income tax structure. The last major change to individual income tax came in 1987. The changes made by the Virginia Tax Reform Act of 1987 included increasing the starting point for the top tax bracket, increasing personal exemption and standard deduction amounts, and increasing the tax return filing thresholds.

Major General Fund Revenue Sources Fiscal Year 2000



Individual Income Tax Rates

The Virginia individual income tax rates currently in effect are as follows:

| Taxable Income | Tax Rate |
|--------------------|----------|
| \$0 - \$3,000 | 20% |
| \$3,001 - \$5,000 | 30% |
| \$5,001 - \$17,000 | 50% |
| Over \$17,000 | 57.5% |

There has been only one change made to the individual income tax rate schedule since 1972. The Virginia Tax Reform Act of 1987 increased the starting point for the top tax bracket from \$12,000 to \$17,000.

Under conformity, computation of Virginia taxable income begins with federal adjusted gross income. Conformity to federal income tax law can either be fixed or rolling. Virginia uses rolling conformity and automatically conforms to ongoing changes in federal tax law. States that conform to federal income tax law may "de-conform" to accomplish state specific policy by additions, subtractions and deductions that increase or decrease taxable income.

Virginia currently has 4 additions, 23 subtractions and 10 deductions for individuals.

States may also use tax credits to accomplish state specified policy objectives. Virginia has enacted numerous income tax credits over the past several years.

Individual Income Tax Collections and Growth

The individual income tax is the Commonwealth's largest source of General Fund revenues. Individual income tax has grown to \$7 billion, more than doubling since Fiscal Year 1990.

The annual rate of growth in the individual income tax has varied from a negative 0.8% in 1990 to a positive 14.3% in 1998. Annualized Growth has averaged 8% over 10 years and 11% for the past 5 years. Factors responsible for year-to-year fluctuations include changes in the strength of the economy, exercise of stock options, employment, inflation and capital gains.

Corporate Income Tax

Virginia has also had some form of a corporate income tax since 1843. Virginia currently has a flat corporate income tax rate of 6%. This rate has not changed since 1972, when it increased from 5% to the current level.

Like the individual income tax, Virginia's corporate income tax was conformed to the federal income tax structure in 1972.

The most significant recent change in the corporate income tax occurred in 1999, when the General Assembly adopted legislation that provided for a double-weighted sales factor for corporate income tax apportionment. Generally speaking, the double-weighted sales factor reduces the tax liability of corporations with a large Virginia presence in terms of employees, plant and equipment. This would mainly be corporations with headquarters and major production facilities in Virginia.

Corporate Income Tax Formula

Under conformity, the starting point for computing Virginia corporate income tax is federal taxable income. Like the individual income tax, Virginia has enacted several modifications that de-conform from the federal tax base. Virginia currently has 6 additions and 16 subtractions and deductions for corporations.

Corporations with income from business activity both within and outside of Virginia apportion their Virginia taxable income. Apportionment is a method by which a state divides the income of a multistate corporation in order to tax the income derived from within the state. Virginia currently uses a three-factor formula to divide the income of a multi-state corporation. The formula is based on the average of three factors, property, payroll and sales, with one adjustment. As noted above, the formula is adjusted by double weighting the sales factor.

Corporate Income Tax Collections

Like the individual income tax, the corporate income tax has grown over the past decade. Corporate income tax revenues have nearly doubled since the early 1990's. It is the Commonwealth's third largest source of General Fund revenues.

However, it is also the most volatile of all general fund taxes. Annual rate of growth has varied from a negative 16% in 1994 to a positive 35% in 1993 and 2000. Factors responsible for year to year fluctuations include corporate profits, changes in the level of economic activity, cost inflation and utilization of tax credits. Annualized Growth has averaged 7% over 10 years and 8.5% for the past 5 years.

Sales and Use Tax

The Virginia Retail Sales and Use Tax was enacted in 1966 as a broad-based transaction tax imposed on the sale, lease, or rental of tangible personal property or the use or consumption of tangible personal property in Virginia. The tax was enacted at a time when most personal consumption involved tangible personal property. Most services were specifically exempted from the tax. Professional and personal services are exempt; charges for rooms, lodgings and accommodations and sales of meals are considered taxable services.

In 1966, the state sales tax rate was imposed at a rate of 2%, and localities were authorized to impose an additional 1% local sales tax. The state sales tax rate has been increased only twice since 1966, increasing from 2% to 3% in 1968, and to the current 3.5% rate in 1987.

The local sales and use tax, which is imposed by all localities in Virginia, has never been increased and remains at one percent, for a combined sales tax rate of 4.5%.

The most notable change in the sales tax is the state and local Food Tax Reduction Program, which was passed by the General Assembly in 2000. It reduces the state sales and use tax rate on food purchased for human consumption. The tax rate was scheduled to decrease by $\frac{1}{4}\%$ per year over a four-year period. Each $\frac{1}{4}\%$ reduction is equal to about \$47 million annually in tax relief. The first $\frac{1}{4}\%$ rate reduction became effective January 1, 2000. Under the Program, each subsequent rate reduction is contingent upon revenue growth. If revenue growth is not sufficient, the tax rate in effect remains the same for the next 12-month period and until growth is sufficient to reach the next tax rate reduction. For the fiscal year ended June 30, 2000, revenue growth was not sufficient to go to the next level of food tax relief. Therefore, the $\frac{1}{4}\%$ rate reduction scheduled for April 1, 2001 did not become effective and is deferred to April 1, 2002. The tax rate on food is currently 4%.

Sales and Use Tax Distribution

The distribution formula for revenues generated by the state and local sales and use tax dates back to 1966. Currently, revenue generated by the 4.5% sales and use tax is allocated to the General Fund, the Transportation Trust Fund, and the localities.

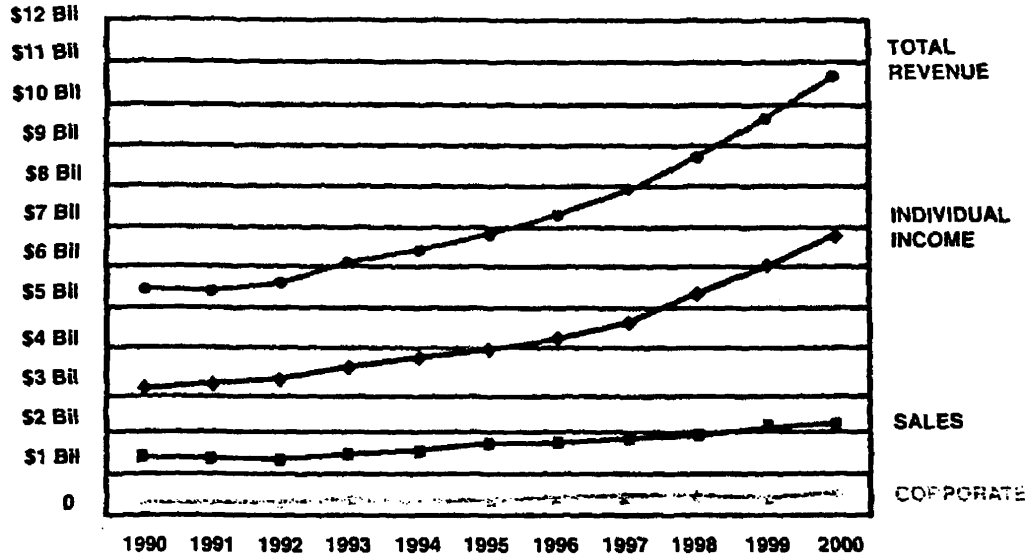
The General Fund currently retains a 2% share of the tax revenues for unrestricted use, or appropriation, by the Commonwealth. This amount is reduced to 1.5% on sales of food as a result of the Food Tax Program. An additional 1% of the sales tax revenue goes into the General Fund for educational purposes and is returned to localities based on school-age population.

The Transportation Trust Fund receives 2% of the sales tax revenues, and the remaining 1% represents the local option sales tax revenues which localities receive based on point of sale.

General Fund Sales and Use Tax Collections and Growth

The Virginia Retail Sales and Use Tax is the Commonwealth's second largest source of General Fund revenues. The general fund portion of sales and use tax totaled more than \$2 billion in Fiscal Year 2000. The annual rate of growth of the sales and use tax has varied from a negative 1.5% in 1991 to a positive 7.6% in 1999. Factors responsible for year-to-year fluctuations include changes in consumer spending and food tax relief. Annualized growth has averaged 5.1% over 10 years, and 5.8% for the past 5 years.

State General Fund Tax Revenue Collections



LOCAL TAX REVENUES

Local Revenue Sources in Fiscal Year 2000

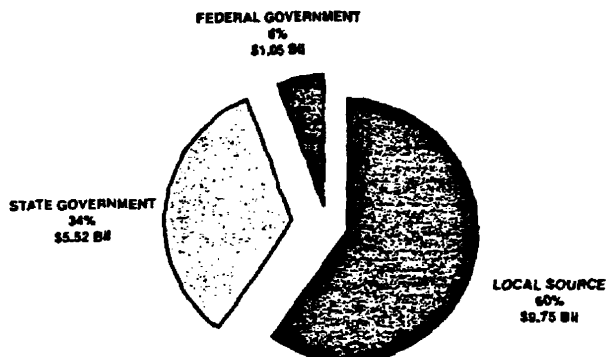
Total revenue received in Fiscal Year 2000 by localities was \$16.32 billion. Sixty percent of that total or \$9.75 billion was derived from local sources such as property taxes and the local sales tax. About one-third, or \$5.52 billion, came from the state government, primarily state aid such as local school funding and recordation taxes. Reimbursements under the Personal Property Tax Relief Act for Fiscal Year 2000 of \$320 million are included in this amount. The remaining component was revenue from the federal government, which accounted for about 6% of total local revenue, or \$1.05 billion. Included in this category are various federal grants.

Locally Generated Revenue in Fiscal Year 2000

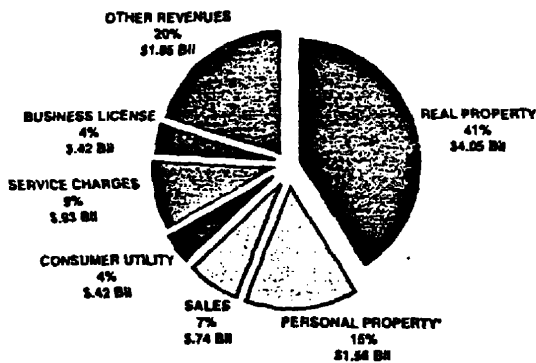
Total locally generated revenue collected in Fiscal Year 2000 was \$10.07 billion. This amount includes reimbursements under the Personal Property Tax Relief Act for Fiscal Year 2000 of \$320 million as personal property tax revenues.

The two largest sources of local revenue are property taxes on real estate and personal property taxes. Together, these revenues account for 56% of all local revenues collected in Fiscal Year 2000. Charges for services are the third largest source of local revenues, totaling 9% of all local revenues in Fiscal Year 2000. The local portion of the sales tax is the fourth largest source of local revenues. The consumer utility and BPOL tax each contribute 4% to the total. Other important local tax revenues include taxes on meals, machinery and tools, and bank franchises; permits; and fees and motor vehicle licenses.

All Local Revenue Sources Fiscal Year 2000



Local Sources of Revenue Fiscal Year 2000



Personal Property Tax Revenues

In Fiscal Year 2000, revenue from tangible personal property taxes and state reimbursements under the Personal Property Tax Relief Act of 1998 totaled \$1.56 billion. Of that total, \$1.24 billion, or 796%, was collected directly from local taxpayers. The remaining \$320 million, or 204%, was paid from the state's general fund. In Fiscal Year 2001, the year most recently completed, it is estimated that \$599 million, or 36%, will be paid by the state. In Fiscal Year 2003, when personal property tax relief is scheduled to reach 100%, it is estimated that \$1.16 billion, or 60%, of local personal property tax will be paid by the state.

Most Significant Recent Changes

A significant recent change in the area of local taxation is the reform of the Business, Professional and Occupational License tax (BPOL). The BPOL tax is a local option tax on the privilege of doing business within a locality. It has evolved over time from a state license tax to a local license fee or a gross receipts tax.

In 1996, Virginia law was amended to establish uniform ordinance provisions for the BPOL tax. The purpose of these provisions was to promote uniform application of the BPOL tax statewide. Localities levying a BPOL tax must include provisions in their local ordinances substantially similar to the uniform ordinance. This legislation also centralized the administration of the tax. The Department of Taxation has the role of issuing BPOL guidelines, which have the effect of a regulation. The Department is also authorized to issue advisory opinions and handle appeals of local BPOL assessments.

In addition, legislation passed during the 1999 General Assembly session extends the BPOL appeals and advisory opinion process to all locally assessed business taxes.

The most significant recent change in the area of local taxation in Virginia is the Personal Property Tax Relief Act of 1998, or personal property tax relief. The Act eliminates the personal property tax imposed on the first \$20,000 of value of personal use motor vehicles. The tax relief is being phased in over a five-year period. The phase-in of this tax relief is currently on schedule and is at 70% for 2001.

For calendar year 2001, it is estimated that tax relief for citizens and direct state reimbursements to localities will total \$755.5 million, which is equal to about 44% of all local personal property taxes to be collected.

STATE AND LOCAL SPENDING

This section provides an overview of spending in Virginia; specifically it focuses on overall state appropriations throughout the last decade. It also looks at the major program components that make up both the state budget and the general fund portion of the state budget, as well as the major growth trends in state spending. Finally, this section examines the growth in major programs of state aid to local governments over the last ten years.

Overall Spending

There has been significant growth in state and local government spending since Fiscal Year 1991. Total state government appropriations from all funds increased \$11.4 billion, or 89% since Fiscal Year 1991. Growth, however, was not uniform over this period. Most of the growth, \$6.5 billion, or 56%, happened in the last four years. Likewise, since Fiscal Year 1991, total local expenditures grew by over \$6.3 billion, or 61%, from \$10.3 billion in Fiscal Year 1991 to \$16.6 billion in Fiscal Year 2000. Much of the growth in state and local government spending coincided with the decade's major economic events.

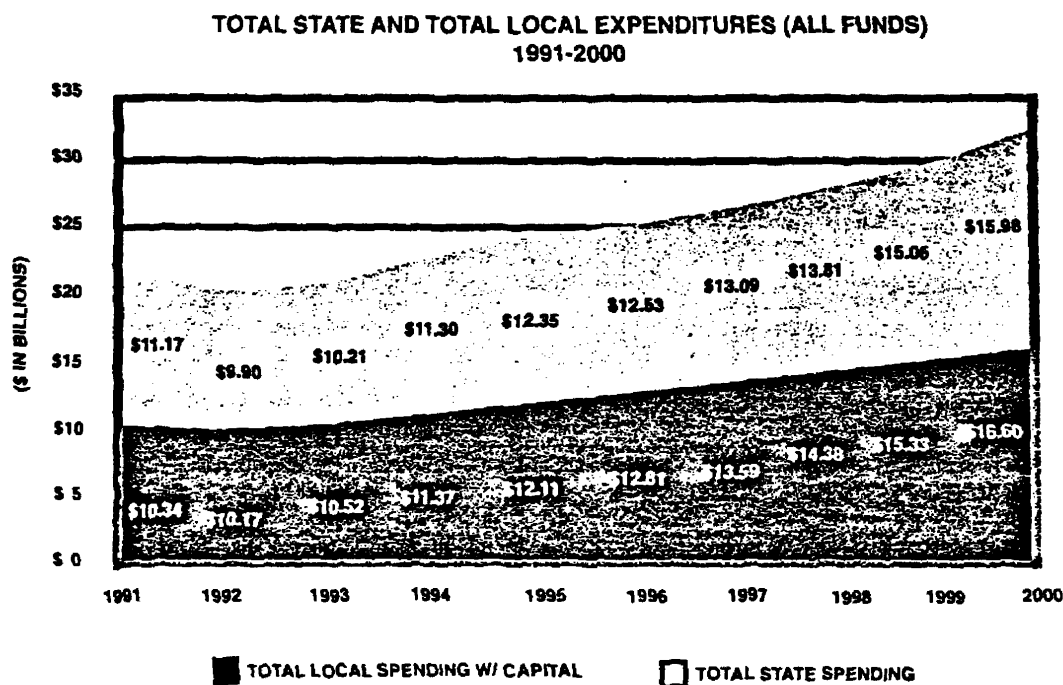
In the early 1990s, Virginia experienced a significant recession, which unlike earlier periods, included a depressed real estate market and contractions in the service sector, as well as the trade and manufacturing sectors. Growth in state and local spending in the early 1990s was limited as the economy tightened and revenues slowed.

In the latter part of the decade, Virginia enjoyed an energetic and booming economy, fueled, in part, by a surging national economy with a particular benefit from a rapidly expanding technology sector in Northern Virginia and aggressive business recruitment by Governor Allen and Governor Gilmore. The expanding economy provided the right environment for tremendous job growth in Virginia. State and local spending accelerated during the last four years with the rise in economic activity and corresponding revenue increases.

The following table illustrates the total growth in state and local spending that occurred from Fiscal Year 1991 to Fiscal Year 2001. It also segments Virginia's spending and appropriation growth into state and local components, and highlights the growth that occurred from Fiscal Year 1997 to Fiscal Year 2001:

| | PERCENT GROWTH | | | |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
| | FY 1991 TO FY 2001 | FY 1991 TO FY 2000 | FY 1997 TO FY 2001 | FY 1997 TO FY 2000 |
| TOTAL STATE AND LOCAL SPENDING (ALL FUNDS): | | | | |
| TOTAL | ... | +65.7% | ... | +22.4% |
| PER CAPITA ADJUSTED FOR INFLATION | ... | +18.2% | ... | +11.2% |
| TOTAL STATE APPROPRIATIONS: | | | | |
| TOTAL | +88.8% | ... | +36.1% | ... |
| PER CAPITA ADJUSTED FOR INFLATION | +29.3% | ... | +18.7% | ... |
| STATE GENERAL FUND APPROPRIATIONS: | | | | |
| TOTAL | +97.3% | ... | +52.7% | ... |
| PER CAPITA ADJUSTED FOR INFLATION | +35.0% | ... | +33.2% | ... |
| STATE GENERAL FUND AID TO LOCAL GOVERNMENTS | | | | |
| | +84.0% | ... | +39.9% | ... |
| TOTAL LOCAL SPENDING (ALL FUNDS): | | | | |
| TOTAL | ... | +60.5% | ... | +22.1% |
| PER CAPITA ADJUSTED FOR INFLATION | ... | +14.5% | ... | +11.1% |
| LOCAL SPENDING (LOCAL FUNDS ONLY): | | | | |
| TOTAL | ... | +52.8% | ... | +18.8% |
| PER CAPITA ADJUSTED FOR INFLATION | ... | + 9.0% | ... | + 7.9% |

Key State & Local Spending Trends



Displayed graphically, the preceding chart shows the combined annual spending, including all funds (taxes, fees, federal funds, etc.), and both capital and operating, by state and local governments in Virginia from 1991 to 2000, and reflects the growth in total combined government spending. It should be noted that a significant portion – approximately 50% – of state spending is aid to localities, which is in turn spent by local governments. Therefore, to avoid double counting of the same dollars, the state spending reflected on this graph subtracts all local aid.

This graph is particularly important for taxpayers who are more concerned with their *total* tax burdens (state and local), and the *total* cost of government services (state and local), rather than the particular division between state and local tax revenue streams and spending. The specific division between state and local tax revenue streams and cost shares for providing government services is more of a concern for government leaders and policy makers who desire a financially sound financial structure for taxing people and providing services in the most efficient and effective manner possible.

Components of the State's Budget

Every two years, Virginia's Department of Planning and Budget develops an executive budget recommending appropriation of the state's revenues and unexpended balances. Government programs are funded through both general fund (GF) and non-general fund (NGF) revenues.

General fund revenues are generally comprised of general tax dollars such as individual and corporate income taxes, and sales tax. Revenues are deposited in the state's general fund if they are not designated for a particular purpose. Because these revenues can be used for a variety of governmental programs, this is the fund that the Governor and General Assembly have the most discretion to spend.

The nongeneral funds consist of funds earmarked for a specific purpose such as transportation revenue (gas tax), federal grants, college tuition, and fee revenue.

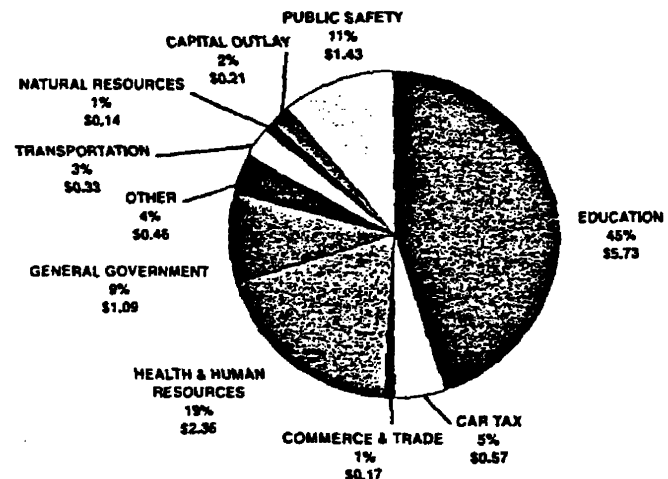
Currently, a slightly larger portion of Virginia's total state spending comes from general tax revenues than comes from earmarked and federal funds (52% and 48%, respectively).

The composition of total state spending and total state general fund spending is markedly similar. Of the \$24.2 billion appropriated from all funds by the state in Fiscal Year 2001, about three-quarters went to education, health and human resources, and transportation. Similarly, about three-quarters of the \$12.49 billion general fund spending appropriated in Fiscal Year 2001 went to education, health and human resources, and public safety programs. The major difference between all fund spending and general fund spending in Fiscal Year 2001 was that in general fund spending public safety replaced transportation as the third largest spending area.

The following graphic illustrates the composition of state general fund spending for Fiscal Year 2001. The functional areas of education, health and human resources, and public safety comprise approximately three-fourths of the total general fund budget:

Composition of State General Fund Spending

TOTAL GF BUDGET = \$12.49 BILLION



Trends

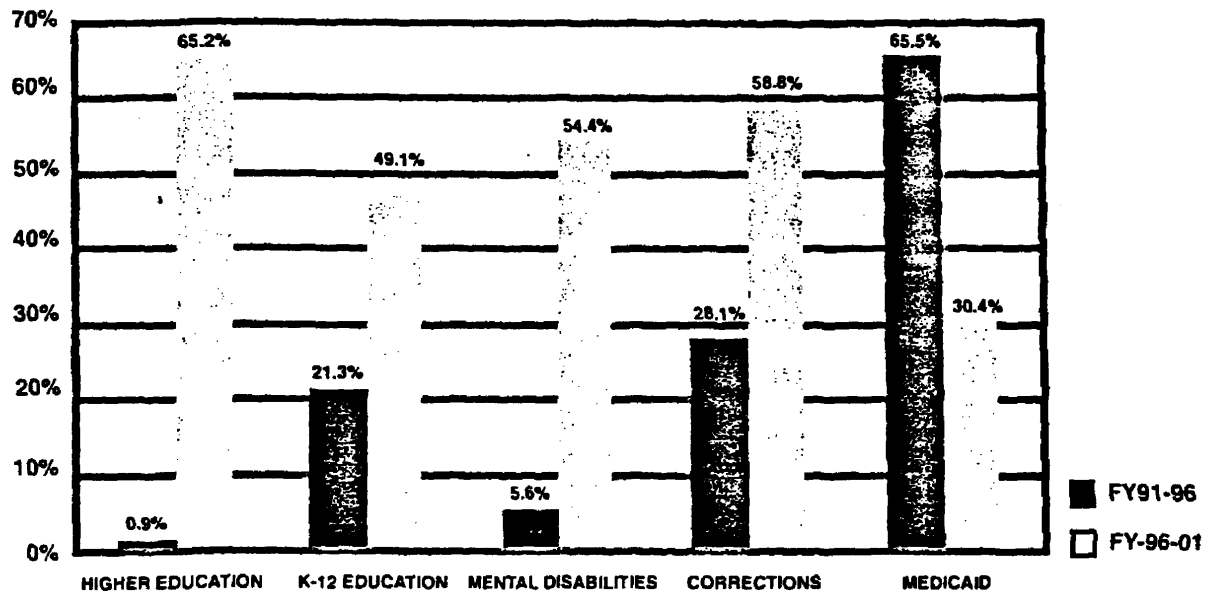
Over the Fiscal Year 1991 to Fiscal Year 2001 period, total general fund appropriations increased by 93.3%, with corrections and Medicaid driving the growth. As mentioned above, much of this growth occurred during the last four years as Virginia economy expanded and revenues increased.

When reviewing the growth trends in state spending, however, it is clear that the areas driving growth in the state's general fund spending have changed in the last 10 years:

- During the first half of this decade, major growth in spending occurred in Medicaid (+65.5%) and corrections (+28.1%)
- In the second half of the decade, growth occurred primarily in higher education (+65.2%) and mental disabilities services (+54.4%), corrections (+58.8%), and K-12 education (+49.1%)

As the following graphic illustrates, there are two distinct patterns comprising this overall trend. From Fiscal Year 1991 to 1996, overall general fund appropriations grew 21%. However, the growth in state spending for Medicaid (66%) and corrections (28%) far outpaced the overall state rate. From Fiscal Year 1996 to Fiscal Year 2001, general fund spending for higher education (65%), corrections (59%), and K-12 (49%) grew significantly, while spending for Medicaid slowed.

Shifts in General Fund Budget Drive Growth Between FY 1991-FY 1996 & FY 1996-FY 2001

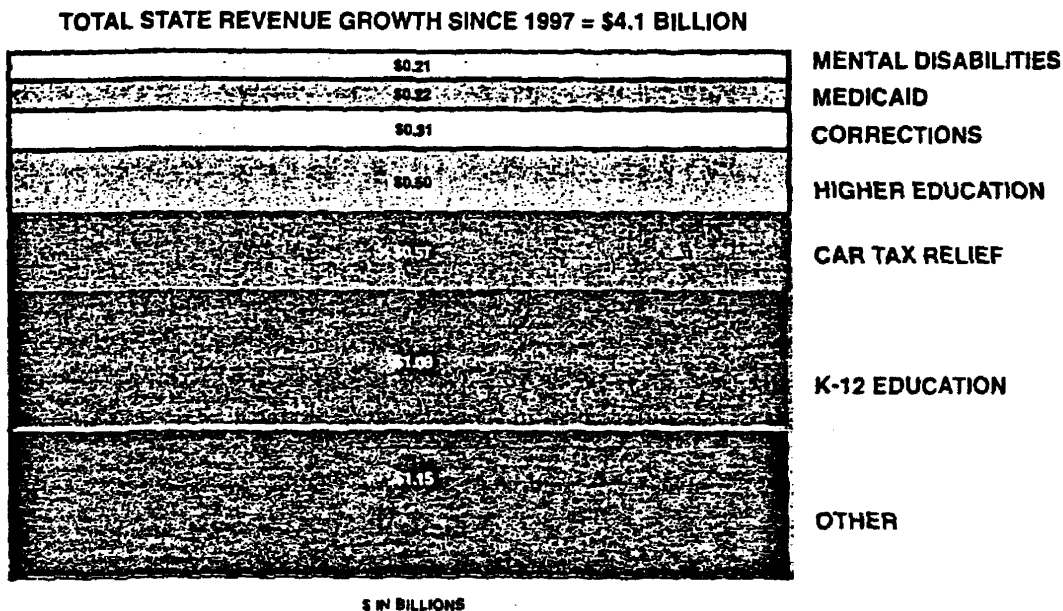


One concern raised earlier in the decade was that the abolition of parole would negatively impact spending for other state programs, such as education and health and human resources. As displayed on the graph above, however, parole abolition in 1994 did not limit spending in other areas, as some had feared. Revenue growth in the latter part of the decade was sufficient to fund increases in areas such as education, and health and human resources.

State Aid to Local Governments

As the following graphic illustrates, since Fiscal Year 1997, the growth in state general fund appropriations has been \$4.1 billion, with over a third — 39% — of that growth devoted to education. Personal property tax relief payments made up 14% of the growth during this period.

Distribution of Growth in State General Fund Spending FY 1997 TO FY 2001

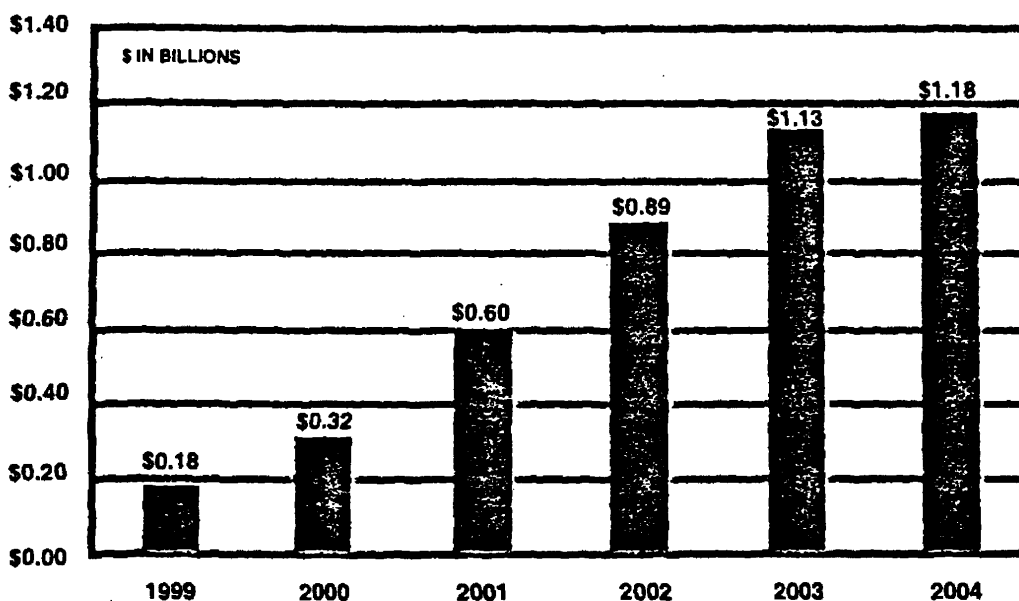


Personal property tax relief is a local revenue source that appears in Virginia's budget as an expenditure as the state pays localities for the foregone revenue of the tax relief program. As a spending item, personal property tax relief was phased in beginning in Fiscal Year 1998. The growth in personal property tax relief is expected to level off once the full phase-in of the program is achieved. The savings to taxpayers will be over \$1 billion per year.

These data confirm that Governor Gilmore fulfilled his commitment to phase out the "car tax" solely from revenue growth since 1997. Indeed, with 39% of the revenue growth devoted to

public K-12 education and 14% devoted to car tax relief, the data bear out Governor Gilmore's signature promise: "*Education first, then cut taxes*." This stated priority was again underscored when the national economy started to slow in 2001. Facing declining revenues, Governor Gilmore ordered no reductions in K-12 funding for public schools or operating funds for colleges and universities in order to maintain the gains achieved in education during the first three years of his term.

Total Personal Property Tax Relief For Virginians



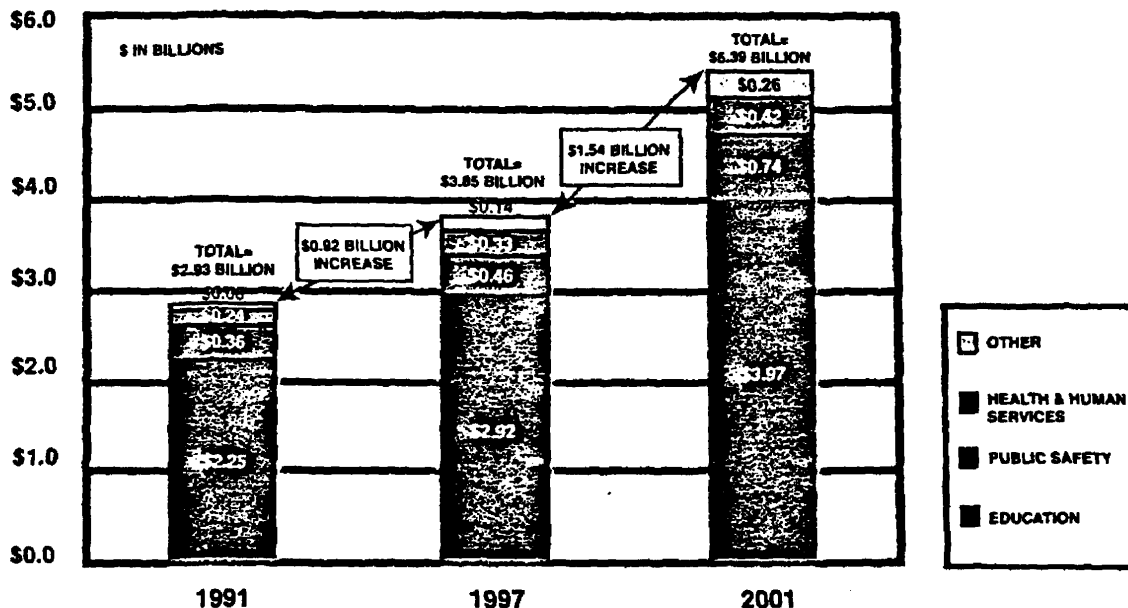
Excluding personal property tax relief payments, state aid to local governments from the general fund has almost doubled since Fiscal Year 1991. It has also increased by almost 40 percent

since 1997. Major portions of this growth occurred in traditional general fund programs: education, public safety and health and human resources.



The following graphic portrays state general fund aid to local governments, excluding personal property tax relief:

General Fund State Aid to Local Governments (Excluding Car Tax)



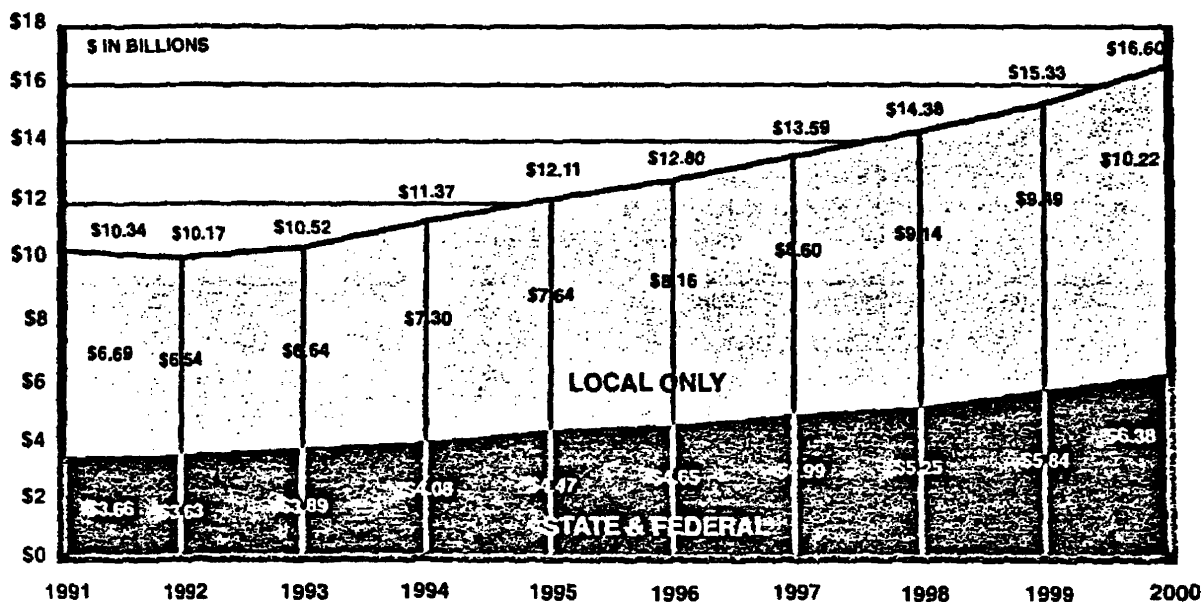
Major programs of state aid to local governments from the general fund nearly doubled from Fiscal Year 1991 to Fiscal Year 2001, from \$2.9 billion to \$5.4 billion. Growth was driven by increases in education (76%), public safety (107%), and health and human resources (75%). These three areas also account for three-quarters of all general fund spending.

State and federal grants became a more significant source of local spending over time. Spending from local-only funds has declined relative to growth in total local government expenditures. Since Fiscal Year 1991, local spending of local-only funds

increased from \$6.69 billion to \$10.22 billion, an increase of 53%. Spending of state-federal funds at the local level increased from \$366 billion to \$6.38 billion, an increase of 74% over the same period.

As the following graphic illustrates, in Fiscal Year 1991, the split between local and state-federal funding sources for local expenditures was 65/35. In Fiscal Year 2000, the local-only share had decreased to 62%, while the state-federal share rose to 38%. Clearly, state and federal grants are becoming a more significant source of local spending.

Total Local Governments Expenditures (All Funds) 1991-2000



It is evident, after reviewing Virginia's state and local spending trends over the last decade, that the past four years witnessed tremendous economic growth that generated significant additional revenues for the Commonwealth. This economic and revenue growth in Virginia made possible increased funding to both state and local government programs. In addition, personal property tax relief was entirely funded from this growth in revenue.

VIRGINIA'S BOUNTIFUL ECONOMY (1997-2001)

The old philosophy advocated impetuous tax increases to pay for the latest and shiniest government program, while the new paradigm relies upon steady economic growth to generate tax surpluses to fund our most pressing priorities.... The key to our success has been economic growth.

— Governor Jim Gilmore, Remarks to the Governor's Commission on Government Finance Reform for the 21st Century, July 25, 2001

One factor above all others explains the Commonwealth's tremendous growth of tax revenues over the past decade: economic growth. Economic growth creates new jobs and produces greater corporate profits and consumer consumption, all of which, in turn, generate additional tax revenues for government at all levels.

As a candidate for office, Jim Gilmore promised to create over 250,000 new jobs in Virginia. He has kept his promise. Under his leadership, the Commonwealth's strong economy has set new records and has led the nation. Over the last four years, Virginia has experienced extraordinary job growth and capital investment that has outpaced the nation, making major public expenditures on education, public safety and social programs possible without a tax increase.

Employment – More Jobs for the People of Virginia

Virginia's population, 7.1 million, is ranked 12th in the U.S. Virginia's population growth over the last decade, 14.4%, exceeded that of the nation, 13.2%. With a workforce of 3.6 million, more than half of our population is employed. Per capita income in Virginia is \$31,162 — 105% of the U.S. average.

In 2000, annual average unemployment rate in Virginia was 2.2%. This was the nation's lowest annual rate. Virginia's August 2001 unemployment rate of 3.1% was significantly less than the national rate of 4.9%.

From 1998 to the fall of 2001, Governor Gilmore's economic development team has created over 320,000 new jobs — including 94,800 new payroll jobs in 2000 alone. Virginia's 2.8% growth rate in 2000 outpaced the U.S. employment growth rate of 2.0%. The fastest growing sector — services — grew by 4.3% in 2000. Over the last decade, Virginia's service sector grew 54.5%, compared to a U.S. rate of 44.6%. Thus, as the nation and Virginia brace for an economic downturn following the terrorist attacks of September 11, 2001, Virginia starts with strong fundamental economic strength.

This economic growth — made possible in large part by the commitment of three consecutive governors to low taxes even in times of economic downturns — has generated the revenues which have made record expenditures in areas such as K-12 education, higher education, mental health and public safety possible during Governor Gilmore's term in office. The progress of the last four years, and indeed the last decade, should serve as a model for administrations in the next decade.

As a footnote for the future, 75% of job openings in 2008 are expected to be filled by existing workers. In order to prepare for this trend, Virginia has placed a strong emphasis on retraining. Over \$50 million in workforce training funds have been committed statewide supporting job training for almost 86,000 jobs. Virginia is clearly poised to continue its leadership in job generation over the next decade.

Capital Investment

From January 1998 through May 2001, Virginia announced 1,449 economic development projects representing 151,041 new jobs and \$13.07 billion in private investment.

In 2000, 453 companies announced new and expanding facilities in the Commonwealth, investing \$6.5 billion and creating 48,771 new jobs. Investment in 2000 broke the previous record of \$5.9 billion set in 1995.

Reasons for the Commonwealth's Success

Governor Gilmore, like Governor Allen before him, and with the assistance of the General Assembly, has cultivated an attractive business climate in Virginia. As a result of conscious policy decisions, Virginia offers a competitive cost of doing business:

- Worker compensation costs are 50% below the U.S. average.
- Unemployment insurance rates are 66% less than the U.S. average.
- Virginia's average industrial electric rates are 10% below the average for the region and 17% less than the U.S. average.
- Virginia has moderate, stable business taxes.

Virginia is also a "right to work" state with a pro-business climate, and the Dillon Rule provides businesses statewide assurance of a stable and reasonable regulatory environment.

Being "connected" is another key to success. The Commonwealth is fortunate to have a strategic location on the East Coast. The majority of the country's population is within a day and a half drive of Virginia. The Port of Hampton Roads is the 6th largest port in the nation and the 29th largest port in the world. Additionally, Virginia is connected by air, rail and highways.

Moreover, the Commonwealth is also connected by the Information Highway. Three of the nine largest Internet access and content providers, UUNet, PSINet, and America Online, are located here. More than 50% of all Internet traffic worldwide passes through Virginia each day. Virginia has over 950,000 miles of fiber optics cable.

The Commonwealth has a competent and highly skilled workforce which has allowed it to attract firms such as GIECO, Capital One, AOL, MCI WorldCom, and Intel.

Virginia is rich in intellectual capital with over 70 institutions of higher education. Twenty-five percent of Virginians have earned a college degree, more than any other state in the Southeast. Further, the Commonwealth leads the Southeast in college graduation rates. Virginia has more doctoral scientists and engineers than any other Southeastern state. Virginia has over 15,500 apprentices in more than 3,000 programs, making its apprentice program the 3rd largest in the nation.

Virginia offers a high quality of life. Money magazine has recognized several of Virginia's metropolitan regions as among the best places to live in the nation.

Virginia has a strategic plan for economic development. The Virginia Strategy has allowed us to leverage the connectivity, competent workforce, intellectual capital, and high quality of life here in the Commonwealth. Virginia has implemented many initiatives supporting this strategy:

- The Virginia Economic Development Partnership (VEDP) Business Development team established the Rural Marketing Group to review current strengths that are unique to Virginia's rural areas and to develop strategies to more effectively market these areas to VEDP prospects.
- Virginia has strengthened its International trade ties. The total cumulative export value of manufactured goods and services during the period 1998-2000 is estimated at \$46.8 billion. Virginia exports of integrated services/semiconductors increased 163% from 1998-2000, and became the number one export of manufactured goods from Virginia.
- Virginia has opened new international trade offices in Sao Paulo, Mexico City, Hong Kong and Seoul. VEDP's Frankfurt and Tokyo trade offices continued to operate. New trade offices were opened in Harrisonburg and Norfolk. VEDP's Herndon and Roanoke trade offices continued to operate. The VEDP has recruited three new staff positions to serve the most economically challenged regions of the Commonwealth: Southside, Southwest, and Eastern Shore/Northern Neck.

Virginia has made extensive investments in its economy during the past four years. Governor Gilmore aggressively has issued 93 Governor's Opportunity Fund Grants totaling \$46.63 million in an effort to attract new businesses, expansions of existing businesses, and new jobs. Eleven Virginia Investment Partnership Act Grants have been awarded, totaling \$49.15 million. Five Shell Building Loans totaling over \$5,000,000 have been approved.

Governor Gilmore's commitment to economic development has been an important element in the creation of a strong economy in the Commonwealth. A continued commitment to economic development will be an important element in the development of Virginia's economy in the New Century.

PERSONAL PROPERTY TAX RELIEF ACT OF 1998

As the Commission undertook its study of Virginia's state and local tax structure, it became apparent that the Personal Property Tax Relief Act of 1998 – Governor Gilmore's signature tax cut – would serve as the linchpin of any fundamental reform.

Elimination of the "Car Tax" in Virginia

The Personal Property Tax Relief Act (PPTRA) was enacted in 1998. The Act provides tax relief to Virginia's citizens while preserving the revenue stream of local governments. Over a five-year period, PPTRA eliminates the personal property tax on vehicles used predominantly for personal use and valued at \$20,000 or less. Reimbursements apply only to privately owned or leased passenger cars, motorcycles, and pickup or panel trucks weighing 7,500 pounds or less.

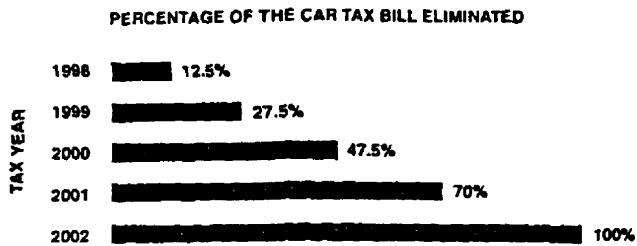
In tax year 1998, PPTRA returned \$125 million in personal property tax relief to Virginia's taxpayers. In tax year 1999, citizens received \$284 million in personal property tax relief, and in tax year 2000, citizens received \$511 million in personal property tax relief. Estimates for tax year 2001 project \$756 million in personal property tax relief. Assuming tax relief were to advance to 100% in tax year 2002, citizens would receive \$1.12 billion in personal property tax relief.

The PPTRA reimbursement process provides tax relief for individual citizens through a reimbursement mechanism whereby the state reimburses localities for the Commonwealth's portion of the tax bill. In a broad overview, the Department of Motor Vehicles provides vehicle information annually to localities. In turn, they assess and collect personal property tax and then request reimbursement from the Commonwealth. PPTRA sets forth statutory responsibilities for five state agencies as well as leasing companies and local government officials in all taxing jurisdictions.

Two state agencies, the Department of Taxation and the Department of Treasury, have statutory responsibilities which relate only to tax year 1998. All other state agencies and local governments have on-going responsibilities.

The Act began with a 12.5 percent tax reduction in 1998 and was scheduled to culminate with 100 percent reduction in 2002 so long as the state's economy and tax revenues continued to grow. If the economy will not permit a step up in tax relief, the next step is delayed a year until economic activity and tax revenue growth resume. This is an important point to note in light of the current economic recession triggered by the tragic events of September 11, 2001.

Scheduled Tax Relief Phase-In Under PPTRA

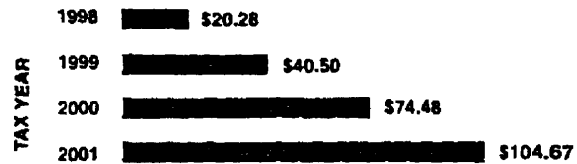


Reimbursements for tax year 1998 were made by mailing checks directly to taxpayers who had paid the required taxes on qualifying vehicles. For calendar years 1999 and beyond, local governments have deducted the prescribed tax relief from the taxpayer's personal property tax bill and then applied to the Department of Accounts for a dollar-for-dollar reimbursement of the allotted property tax reduction.

From 1998 to July 1, 2001, PPTRA has reduced personal property tax on more than 56 million vehicles and provided more than \$ 1.1 billion in tax relief to Virginia citizens. PPTRA has not resulted in revenue loss to localities. Plus, localities have received \$5 million in compensation for their administrative costs. By all accounts, PPTRA is a resounding success. For tax year 1998, the first year of the program, more than four million citizens received reimbursement checks totaling more than \$125 million. During tax year 1999, reimbursements exceeded \$283 million. During the past full tax year, 2000, the reimbursement amount exceeded \$511 million. Reimbursements for tax year 2001 are forecast to be \$756 million.

In 1998, reimbursement checks averaged \$20.28. For tax years 1999 and beyond, tax relief is reflected as a deduction on the individual's personal property tax bill. The average tax reduction per qualifying vehicle during tax year 1999 equaled \$40.50 based on the 27.5% tax relief provided under PPTRA. For tax year 2000, the average tax reduction totaled \$74.48 per vehicle, based on PPTRA's 47.5% reduction. During the first part of tax year 2001, the average tax reduction totaled \$104.67.

AVERAGE PPTRA REIMBURSEMENT PER VEHICLE



\$ AMOUNT OF TAX RELIEF PER VEHICLE

PPTRA significantly decreases the tax burden of many Virginia taxpayers. During the first biennium of the program, a typical family owning two qualifying vehicles valued at \$10,000 each received \$612.50 in tax relief.

Sales of new and used vehicles during the past three calendar years reached unprecedented levels due to Virginia's strong economy. This resulted in additional tax relief and increased revenues for local governments as well as a \$70 million revenue windfall for the Commonwealth Transportation Fund due to increased sales-and-use taxes on vehicle purchases. Further, the record vehicles sales have put newer, cleaner-burning vehicles on the road, thereby improving Virginia's air quality.

Underlying these readily apparent benefits of PPTRA are other equally important benefits:

- PPTRA provided funding for local governments to implement new computer systems or upgrade existing systems.
- Data integrity for localities as well as the State Board of Elections' voter registration files improved due to citizen address changes collected as a result of tax relief implementation.
- Thanks to PPTRA, localities have fewer delinquent tax accounts and more on-time payments, thereby increasing revenue.
- Over \$84 million in reimbursement funds were applied to past-due debts on file with the Department of Taxation as part of the State's Debt Set-off program.

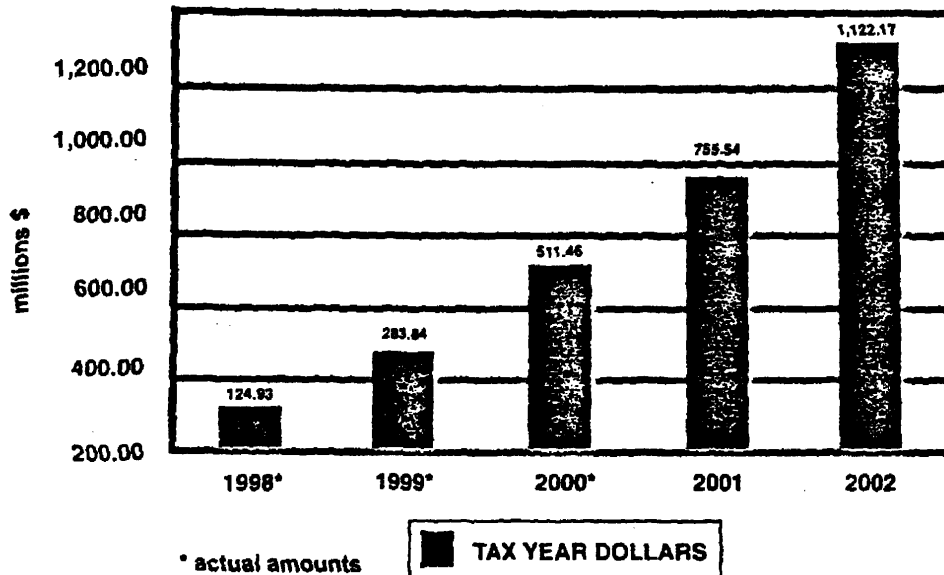
The success of PPTRA has not gone unnoticed by other state governments hoping to experience similar benefits. According to the Council of State Governments, several states, including California, Arizona and Rhode Island, have already followed in Virginia's footsteps while others watch closely. Virginia's development and implementation of PPTRA represent a model in government innovation and cooperation. And, clearly, as the five-year implementation plan evolves, PPTRA will continue to put tax dollars back in the hands of Virginia's hardworking citizens.

Projections

PPTRA legislation requires DMV to prepare a forecast each November of PPTRA reimbursements for the coming tax year. Estimates developed through the forecasting process are presented

to a consensus group consisting of representatives from the Departments of Planning and Budget, Taxation, and Accounts. This group reviews all forecasting assumptions, the methodology and results of the forecast so that a consensus can be obtained on the reasonableness of the estimates.

Tax Year Actual Reimbursements And Forecast



For the current tax year, 2001, personal property tax reimbursements are projected to be \$756 million. And, assuming that tax reimbursement reaches 100% in 2002, personal property tax reimbursements are projected to be \$1.12 billion. Once 100% relief is phased in, the growth in tax relief will level off in 2003 and 2004.

The steep increase in reimbursement amounts from 1998 to 2002 resulted from two growth factors. First, according to the PPTRA implementation plan, the tax relief percentage has increased each year, beginning at 12.5% in 1998, with step increases scheduled to culminate, economy permitting, at 100% in 2002.

The second growth factor resulted from natural growth in Virginia's vehicle fleet; both in terms of the number of qualifying vehicles and the value of the vehicles. When fully implemented, the steep increase in reimbursement growth will level off. Growth after 2002, should be between 34% and 39% annually, resulting from natural changes in the vehicle fleet.

PPTRA Infrastructure

Virginia's citizens, state and local governments have experienced and will continue to receive tangible benefits from PPTRA. However, few are aware of the complex infrastructure behind PPTRA that makes these benefits possible.

Scope

PPTRA administration involves four state agencies and the commissioners of the revenue, treasurers and directors of finance in 280 taxing jurisdictions. These taxing jurisdictions include 134 cities and counties, plus nearly 190 towns. (Citizens living in towns may pay personal property to a county and to a town.)

State Agencies

Department of Motor Vehicles
Department of Taxation
Department of Accounts
Department of Treasury

Local Government

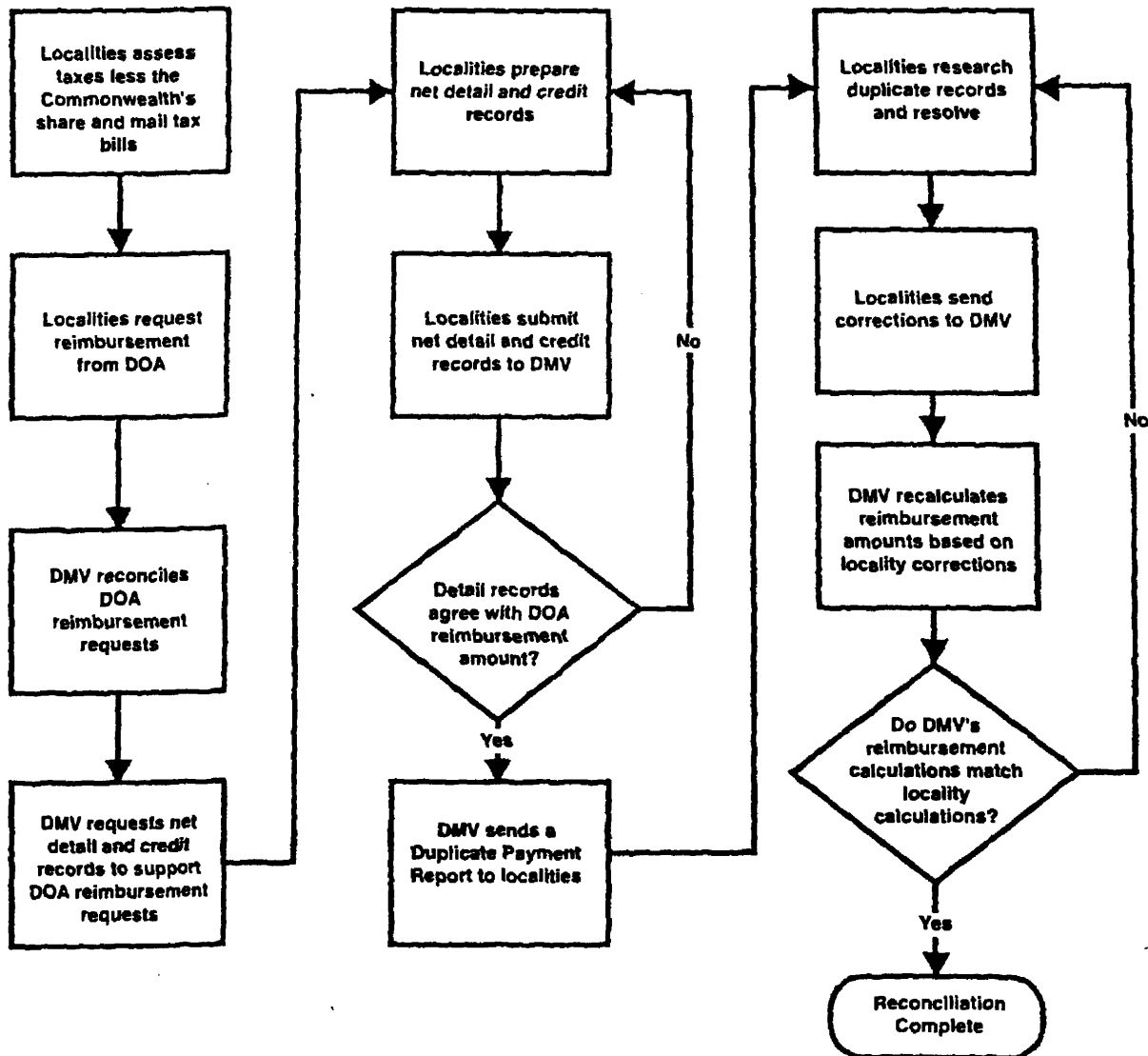
Commissioner of the Revenue
Treasurer, or
Director of Finance

There is no way to know exactly how many employees contribute to the PPTRA process in some way; however, the Compensation Board reports that personal property tax processing comprises 40% of the total workload for the commissioners of the revenue and 30% of the total workload for the treasurers. Annually, the Compensation Board reimburses commissioners of

the revenue and treasurers more than \$15 million for personal property tax processing.

The PPTRA process involves roughly 12 steps spanning several state agencies and Virginia's 280 taxing jurisdictions. This processing effort consumes not only human and financial resources, but also time, as depicted by the following chart:

PPTR Reconciliation Process



The PPTRA process begins with a locality's tax assessment, less the Commonwealth's share, to the citizen.

Localities then request reimbursement from the Department of Accounts, DOA, by keying in requests to the Commonwealth Accounting and Reporting System or by faxing requests to DOA. Using the online method guarantees localities reimbursement within two business days provided that the locality has complied with filing deadlines and submitted the required information in the correct format. Faxed reimbursement requests are promptly reimbursed; however, they are not guaranteed the two business-day turn-around.

Although two days for reimbursement is remarkably efficient, unlike the old process, localities experience a two-day delay in making their budgets whole from personal property tax collections.

Next, DMV initiates the reconciliation process by monitoring all locality reimbursement requests to DOA on a daily basis. During calendar year 2000, DMV monitored 4,711 requests from 280 taxing jurisdictions.

Once a year, DMV asks localities to submit information on all qualifying vehicles to reconcile DOA reimbursement requests for the previous calendar year.

Localities prepare net detail and credit records and have 60 days to submit the records to DMV. Each record reflects taxpayer name, social security number, vehicle identification number, vehicle value, total assessment, tax levied, reimbursed amount and tax period for the record. Additionally, these records must be submitted in a fixed format that will populate the state-wide database.

DMV received 6.9 million records for tax year 2000.

The PPTRA automated system reviews each record to verify the accuracy of the calculation based on locality tax rates in effect in July or August of 1997, whichever was higher.

Errors are resolved with a locality's treasurer. If DMV discovers that a locality cannot support its DOA requests with detailed data, DMV requests the locality to reimburse the Commonwealth. If DMV determines that a locality did not request enough based on their supporting detailed records, DMV requests DOA to reimburse the locality.

For calendar year 1999, localities repaid DOA nearly \$784,000. Although reconciliation for calendar year 2000 isn't yet complete, so far, localities have repaid DOA more than \$944,000.

If a locality is under-reimbursed, it may lose use of that revenue for as long as 14 months. Similarly, if the locality is over-reimbursed, the Commonwealth may lose use of the revenue for the same extended time period.

Once detail records agree with the DOA reimbursement amount, DMV sends a duplicate payment report to localities. Duplicate payments result from two or more localities taxing the same person and vehicle for the same tax period. Localities research and resolve duplicate records and send the corrections to DMV. DMV recalculates reimbursement amounts based on locality corrections. For calendar year 1999, localities repaid \$215,000 for duplicates. Once DMV's reimbursement calculations match locality calculations, the reconciliation process is complete.

PPTRA processing for a single tax year actually spans three years and can take as long as 26 months for completion.

For example, the annual reconciliation of locality reimbursement requests to DOA takes six months. However, a time lag of up to nine months may occur between a reimbursement request and the annual reconciliation.

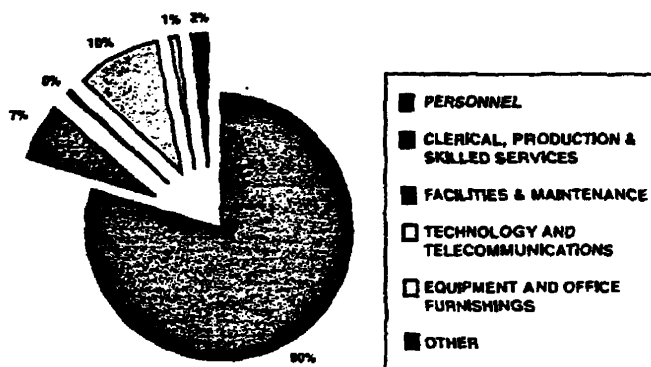
Further, duplicate payment research and settlement follow-up takes four months and does not begin until completion of the annual reconciliation process. Thus, there can be a time lag of up to 14 months between a reimbursement request and resolution of overpayments and/or underpayments related to duplicate payments. This represents time that these funds are unavailable to either the locality or the Commonwealth.

Further complicating the process, PPTRA processing turns into a multi-part harmony as new tax years begin, since processing tasks from previous tax years continue into subsequent tax years. Thus, by the third tax year, localities and state agencies are handling processing tasks for the current and two preceding tax years.

Resource Consumption

In crafting PPTRA legislation, the General Assembly anticipated the implementation costs that would fall to localities and allocated \$5 million to cover these expenditures. However, both localities and the four state agencies charged with administering PPTRA experienced ongoing administrative costs. For example, since 1998, DMV has spent more than \$38 million simply for PPTRA administrative expenditures.

PPTRA Implementation Expenditures By Type



Eighty percent of those expenditures covered personnel costs. Seven percent covered clerical, production and skilled services; less than one percent went for facilities and maintenance costs; ten percent were used for technology and telecommunications expenditures; one percent for equipment and office furnishings; and two percent for other expenditures, such as postage.

Although reimbursed for their PPTRA implementation, localities face ongoing administrative costs for processing personal property tax. Beyond the man hours used to collect, verify and

submit personal property tax data, localities annually incur roughly \$5.5 million in postage costs simply mailing tax assessment and filing materials to citizens. This cost covers only postage and does not include information technology costs or the cost of vehicle decals.

And, this doesn't begin to account for the personnel costs, information technology costs, equipment and printing costs that go into processing personal property taxes.

| | |
|----------------|---|
| 6,592,693 | = number of vehicles in Virginia's fleet as of 7/17/01 |
| x 3 | = estimated mailings to taxpayers (filing, bill, decal) |
| 19,777,989 | = estimated mailings to taxpayers by localities |
| x .28 | = estimated cost per item using 1st class |
| \$5,537,836.92 | = estimated postage cost to localities |

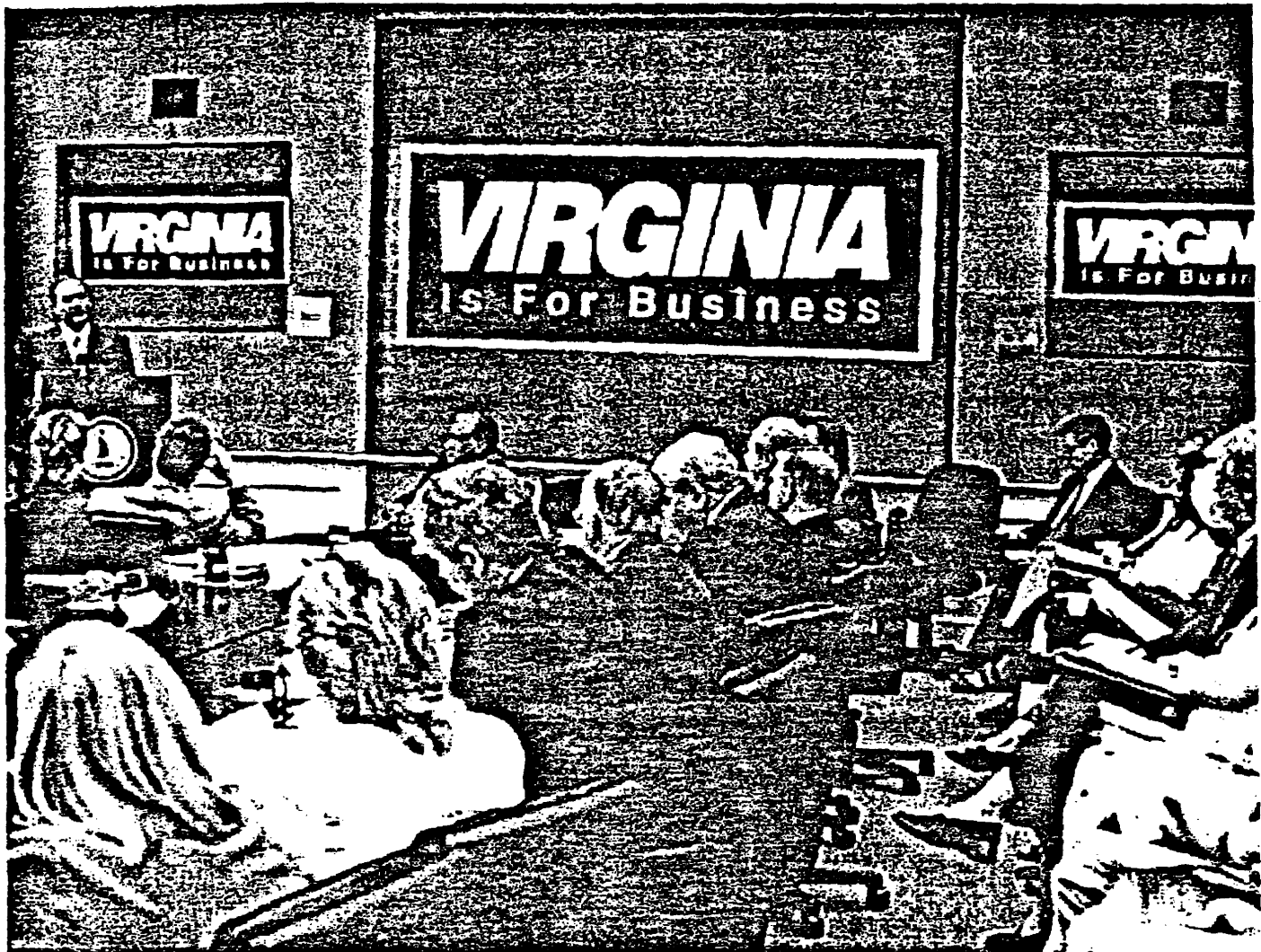
The PPTRA infrastructure has evolved during the past three years, becoming more efficient and streamlined. However, upon full implementation and 100% tax reimbursement, localities will

still be required to mail tax bills to taxpayers owning or leasing a qualifying vehicle.

PPTRA has returned \$1.1 billion in personal property taxes to Virginia's citizens with no loss of revenue to Virginia localities. We are into the fourth year of the five-year PPTRA implementation plan. By 2002, tax reimbursement is scheduled to reach 100 percent.

Successful implementation and administration of PPTRA has been achieved through partnerships between state agencies and Virginia's 280 local taxing jurisdictions. To date, localities have been reimbursed for implementation and administrative costs of PPTRA. However, even with these reimbursements, localities spend at least \$5.5 million annually on postage alone and untold amounts for personnel, information technology and printing to support the personal property tax collection process.

As the final year of PPTRA implementation approaches, taxing jurisdictions as well as the General Assembly have begun looking for effective ways to further refine the PPTRA infrastructure and the personal property tax collection process.



COMMISSION RECOMMENDATIONS

It is important for the recommendations that follow to be considered as part of a comprehensive and interdependent package of reforms. That is, the Commission has endeavored to identify a set of reforms which, taken together, represent a call to modernize the relationship between state and local financial authority and revenue sharing over the next decade, while keeping pace with the Commonwealth's important spending priorities.

GENERAL TAX REFORM PRINCIPLES

The Commission started with a general predisposition in favor of revenue neutral tax reform. Tax reform should not disguise tax increases. To the extent elected officials at the state or local level deem a tax increase necessary, they should be accountable for those decisions and any tax increase should be as transparent as possible to the people of Virginia.

Moreover, the Commission remained faithful to Governor Gilmore's philosophy, articulated in the Governor's opening address to the Commission in July, that the Commonwealth can afford new and expanded social programs – so long as economic growth funds them and they are prioritized among competing claims on the people's hard earned incomes. This philosophy may require special interest groups to wait a few years longer to permit economic growth to generate revenue surpluses sufficient to fund the next government program, but the benefits of low tax burdens outweigh the delay.

The Commission's adherence to revenue neutrality and a predisposition against tax increases was informed by several presentations. First, according to testimony received from the National Taxpayers Union, the people of Virginia bear the 18th highest combined state and local tax burden per capita in the United States. Fueled largely by high incomes and high property values in Northern Virginia and the Urban Crescent, Virginia residents pay more money to state and local government per citizen than 32 other states. The mere fact that the people of Virginia are prosperous does not automatically justify the 18th highest tax burden per capita in the United States.

Additionally, the Commission received data from the Virginia Department of Planning and Budget indicating that state government tax revenues increased a total of 50% in just four years from 1997 to 2001. The state government spent 42% more in FY 2001 than it did in FY 1997, with the remaining 8% of the growth going to cut the car tax and deposit funds into the state's Revenue Stabilization Fund (the "Rainy Day Fund") created following the recession of 1991 to soften the revenue impact of future recessions. Thus, the Commission cautions against tax increases following this tremendous increase in tax revenues over the past four years, even in the event of another recession.

In keeping with these observations and principles, the Commission recommends the following general principles to guide policy makers who wish to undertake large-scale tax reform in Virginia:

Recommendation No. 1

Revenue Neutrality, Tax Transparency & Public Accountability

Tax reform in Virginia should be revenue neutral and should not disguise tax increases. Moreover, tax reforms, tax increases and tax cuts, and tax burdens generally should be as transparent as possible to taxpayers, and elected public officials should be accountable for tax policy.

Recommendation No. 2

Pro-Economic Growth Tax Policy

Economic growth and the additional tax revenues it generates should be the primary source for additional government spending. Accordingly, Virginia should continue to promote economic growth, business expansions, new business openings, and job creation by adopting public policies consistent with the following principles:

- Virginia should maintain a low tax burden on businesses;
- Virginia should maintain a stable and pro-business regulatory environment;
- Virginia should maintain the Dillon Rule in order to promote a uniform and stable regulatory environment across the Commonwealth;
- The Commission finds that the local Business Professional Occupational License tax, or BPOL, continues to inhibit economic growth, capital investment and job creation in Virginia and disproportionately burdens small start-up businesses. The Commission encourages localities to phase out their BPOL tax during periods of revenue growth. Localities that eliminate the tax will find they are far more competitive in the hunt for businesses and jobs.
- The Commission recommends that localities devote some of the financial windfalls to be gained in the shift from car tax revenues to a 20% share of the state's personal income tax (per the Commission's recommendation) to phasing out the BPOL tax.
- The Commission also encourages localities to replace the BPOL tax with a fairer tax that more accurately taps actual economic gain and profit.
- The Commission recommends that localities continue to simplify their BPOL tax structures. However, if localities choose to continue the BPOL tax, Va. Code Section 58.1-3703 should be repealed and the BPOL tax should be dis-

tributed fairly across the business community so that all businesses share in the payment of BPOL taxes without exclusions while BPOL tax rates are reduced for all businesses by a proportionate amount.

- The Commission recommends that the state continue to target tax incentives for business expansion and job creation because the long-term revenues outweigh any short-term loss in tax revenue. Where state and local tax policy provides specific incentives for business investment and job growth, the incentives should be available to new and existing businesses alike.

A LOCAL INCOME TAX IN THE NEW ECONOMY

"Local governments that used to tax their citizens on their cars and trucks now receive dollar-for-dollar payment from the state's general fund – a windfall for taxpayers and local governments alike. As these car tax reimbursements near \$1 billion annually, revenue sharing ideas that used to sound radical – now appear quite practical and politically plausible – almost a baby step away instead of the giant leap required four years ago.... Local governments already receive about half of the state's general fund, but for years local governments have complained that they rely too heavily upon the state's generosity and real estate taxes to fund local services."

— Governor Jim Gilmore, Remarks to the
Governor's Commission on Government
Finance Reform for the 21st Century,
July 25 2001

For many years, local governments have requested the power to impose an income tax. The reason is very plain: the individual income tax is a fast-growing and stable revenue source over time. It is a dynamic revenue stream for government that accurately taps the prosperity of people in the New Economy. By comparison, the real estate tax, which constitutes local governments' largest revenue source, fluctuates with the real estate market, is prone to loss in tax base as government entities such as schools and universities expand, and can be regressive by taxing retired citizens on fixed incomes for the decades of increased value on their homes.

For years, the proposition of granting local governments the power to impose a local income tax was not deemed sound public policy because it would open the door to excessive tax burdens for the people of Virginia, would set off undesirable tax competition between localities, and would make Virginia a less desirable location for businesses and jobs. It also was unpopular with the people of Virginia and deemed politically implausible in the General Assembly. Therefore, the General Assembly was content to impose a statewide income tax and return approximately 50% of the state's tax revenues to local governments.

Then came the major tax reform known as the Personal Property Tax Relief Act of 1998, Governor Gilmore's signature tax cut initiative. The PPTRA was designed to eliminate the local car

tax on personally owned vehicles on the first \$20,000 of vehicle value. Since the elimination of the tax is a state initiative and the tax is a local tax, the state has reduced each taxpayer's car tax bill by reimbursing each locality dollar-for-dollar for the reduction. This calendar year, 2001, each taxpayer's car tax bill has been reduced 70 percent and the state is reimbursing localities a total of approximately \$755 million.

The car tax is scheduled to be phased out 100% in calendar year 2002. The people of Virginia consistently have demanded that it occur while policy leaders from both political parties consistently have committed to the complete elimination of the car tax. Regardless of the phase out schedule, the Commission's recommendation for a fundamental reform hinging on 100 percent car tax elimination by the year 2005 is practical, achievable, and has been promised by the political leadership of Virginia.

Once Virginia reaches the 100% phase out of the car tax, the state will be reimbursing localities approximately \$1.2 billion, and that figure is expected to grow to approximately \$1.31 billion by 2005. The additional cost of lifting the \$20,000 cap is estimated to be minor – approximately \$35 million.

The car tax reimbursement by 2005 is expected to total approximately 14% to 16% of the state's total receipts in individual income taxes. Whether the state sends \$1.31 billion to localities by way of car tax reimbursements or by ceding approximately 15% of its individual income tax revenue stream is inconsequential for the state government budget.

But for local governments, the financial and political benefits are significant and palpable. Consider the following advantages for localities:

First, about 50% of the state's total general fund budget already is returned to local governments but is subject to the political direction and prioritization of politicians in Richmond instead of local city councils and county boards of supervisors. Ceding the revenue stream to local governments, instead of appropriating the funds year by year, would cede this political power and autonomy to local governing bodies. They would become less dependent on the generosity of state lawmakers.

Second, the shift of revenue sources also would give to localities a faster growing revenue source – the income tax – generating additional growth revenues in future years unobtainable from the car tax. Data from the Virginia Department of Taxation indicate that the individual income tax has grown an average of 8.3% over the past 10 years, while personal property taxes on personally owned vehicles have grown only between 3.5% to 4% per year even in the most prosperous of times.

Third, the shift also would eliminate for state agencies and local governments the substantial bureaucratic overhead costs associated with the current dollar-for-dollar reimbursement system. This would save the state and local governments at least \$5 million, and perhaps as much as \$10 to \$15 million annually.

Fourth, local governments would diversify their revenue streams and thereby strengthen their bond ratings. They would retain taxing authority over 40% of the personal property tax base, primarily business vehicles and business property, but they would enhance their mix of revenues by adding the proceeds of a dynamic income tax.

Fifth, local governments would have a direct incentive to make their localities as attractive to businesses and people as possible to attract new residents and additional incomes.

Sixth, and most importantly, the shift would finally give localities an individual income tax in the New Economy. As Delegate John H. Rust, Jr., explained to the Commission, the individual income tax most accurately captures economic activity in the New Economy. In an economy where two people can sit in a room with a personal computer and with the touch of button generate \$100 million worth of economic activity, no real estate tax, sales tax on goods or car tax can tap that economic activity. *But an income tax can.* If localities are going to keep up with the New Economy, they need a revenue stream tied to personal income.

All of this can be accomplished without raising taxes on the people of Virginia. Considering the combined spending increases by state and local governments over the last decade and Virginia's position as the 18th highest state and local tax burden per capita in the United States, a tax increase is not necessary. What is needed is to shift some of the state's tax resources to the local governments, along with the political power to control the revenues. This is what Delegate Jack Rust called "shifting the tax revenues from one bucket to the other."

In short, the PPTRA has created an unprecedented opportunity to accomplish two objectives simultaneously: completely eliminate the car tax on personally owned vehicles while ceding a portion of the state's income tax to local governments. *The mechanism for accomplishing these compatible goals is an amendment to the Constitution of Virginia which abolishes the car tax and guarantees localities a definite and permanent share of the state's individual income tax.*

Of course, no fundamental shift in revenue streams of this magnitude — \$1.34 billion by 2005 — across 135 localities could perfectly correlate revenues from the personal property tax stream to the income tax stream. Some localities collect more in car taxes than they would collect from 15% of the individual income taxes paid from their localities, while others would receive far more from a 15% share of income taxes than they receive in car tax reimbursements. This lack of perfect correlation is a significant public policy issue to be resolved in order to facilitate an otherwise constructive tax reform initiative, and the Commission has endeavored to ensure that all local governments receive more in income tax revenues over the next decade than they would have received in car tax revenues.

Accordingly, the Commission requested and received analysis from the Virginia Department of Taxation comparing the distribution of individual income taxes versus personal property tax reimbursements. Assuming that a constitutional amendment would not take effect until calendar year 2005 in light of the constitutionally required process for enacting amendments, the Tax Department compared car tax reimbursements without a \$20,000 cap and individual income tax revenues, and found the following:

- A 100% car tax reimbursement without the \$20,000 cap is estimated at \$1.34 billion in calendar year 2005 (and \$1.36 billion in FY 2006).

- \$1.36 billion will equal approximately 15% of the state's total projected FY 2006 individual income tax receipts.
- For FY 2006, it is estimated that 52 localities would receive an additional \$311 million in the shift from car taxes to individual income taxes, while 83 localities would receive \$156 million less in income tax revenues than car tax revenues prior to any "hold harmless" payment. This assumes that 15% of individual income taxes would be ceded to localities in July-December 2005 and 16% in January-June 2006.
- If 20% of the state's total individual income tax stream is ceded to local governments at the point of each taxpayer's filing residence in FY 2006, a total of \$1.99 billion would be ceded to local governments.
- For FY 2006, at 20% of individual income taxes, 98 localities would receive an additional \$679 million in revenues, while 37 localities would receive approximately \$50 million less in revenues from non-capped car tax reimbursements.
- It is important to note that the \$50 million figure was estimated without accounting for the disproportionate growth rate for individual income tax revenues. Based on historic performance, the individual income tax revenues grow faster than car tax revenues. Assuming the personal income tax is ceded to local governments in 1% increments each year for five years, from 15% in 2005 to 20% in 2010, then the compounding effect of greater growth on individual income tax revenues over the next decade would eclipse and erase any loss for all localities by 2010. *Eventually, the greater growth rate would produce revenue increases for all local governments in Virginia.*

Based on this rationale and analysis, the Commission recommends the following fundamental tax reform over the next decade in Virginia:

Recommendation No. 3

Constitutional Amendment to Cede 20% of the State Income Tax to Local Governments

Between 2002 and 2005, the General Assembly and next Governor should approve legislation to amend Article X of the Constitution of Virginia to eliminate the personal property tax on all non-business use vehicles and constitutionally cede an equivalent amount of the state's individual income tax revenue stream to local governments according to the following principles:

- Beginning in 2005, the Commonwealth should cede to local governments the percentage of the state's individual income tax stream that is estimated to equal the statewide total reimbursement of car taxes. Current estimates indicate this will require the state to cede approximately 15% of the individual income tax stream to local governments;

- To further strengthen the sources of funding available to local governments and provide most localities in Virginia with a substantial windfall of tax revenues, the Commission recommends that the Commonwealth annually cede an additional 1% of the state's individual income tax each year beginning in 2006, until a total of 20% of the individual income tax revenue stream is dedicated to local governments. The additional increments of 1% each year should be dedicated from the state's overall revenue growth. Current estimates indicate this will require the Commonwealth to cede an additional 1% of the individual income tax to localities, beginning with 16% in 2006, 17% in 2007, 18% in 2008, 19% in 2009, and 20% in 2010;

- Individual income tax revenues should be distributed to localities based on each taxpayer's filing/residence location; and

- For FY 2006 (the first full year of impact), the shift from car taxes to individual income taxes is estimated to redistribute revenues among localities, creating more income tax revenues than car tax revenues for some localities (estimated \$311 million) and less income tax revenues than car tax revenues for others (estimated \$156 million). Therefore, before 20% of the individual income tax revenue stream is ceded, the State should provide a "hold harmless" mechanism to prevent any locality from receiving less in income tax revenues than it would have received in car tax revenues. Two alternative mechanisms are as follows:

- 1) The State can appropriate a special "hold harmless" fund (estimated \$156 million in FY 2006) to be distributed to localities that lose funds in the shift. The "hold harmless" fund should be phased out incrementally as the additional 1% increments of income tax revenues are ceded to localities. Once 20% is ceded to localities and all localities receive more income tax revenues than they would have received in car tax revenues, the "hold harmless" fund should be eliminated altogether.

OR

- 2) The state can withhold an appropriate amount of the additional revenues generated for local governments (estimated \$156 million of total additional revenues totaling \$311 million) in a "special redistribution fund" and redistribute the additional tax revenues to localities that lose tax revenues in the shift. The "special redistribution fund" should be incrementally eliminated as the additional 1% increments of income tax revenues are ceded to localities. Once 20 percent is ceded to localities and all localities receive more income tax revenues than they would have received in car tax revenues, the "special redistribution fund" should be eliminated altogether.

AND

- 3) Once all localities have been held harmless pursuant to "hold harmless" mechanism (1) or (2) above, the state can redistribute all remaining additional revenues generated for some local governments (estimated \$311 million in FY 2006) among all localities according to the following formula:

50% based on the point of each taxpayer's filing residence
40% based on the locality where each taxpayer works
10% distributed evenly among all localities

- In addition, regardless of which distribution formula is adopted, an additional option the Commission has identified is a mechanism to reduce the volatility of income tax revenues for localities over time. Participation in the income tax base means that Virginia localities will increase their dependence on a more volatile – and therefore less predictable – revenue source than has been traditional. The Commission urges that serious consideration be given to an appropriate mechanism for smoothing the effects of business cycle fluctuations, thus rendering more predictable the annually distributed revenue flows to localities. This purpose might be accomplished, for instance, by depositing all ceded revenues in a Trust Fund out of which the state would, based on the best available collection estimates, make pre-announced, guaranteed distributions in each year, regardless of actual collections subsequently realized. Any differences, whether positive or negative, between the pre-guaranteed distributions and the actual collections realized by the Trust Fund in any year would be amortized and recouped over the succeeding multi-year period, perhaps three to five years. Such a mechanism would, at no net additional cost to the state, provide localities a more stable and predictable revenue flow, better accommodated to efficient budgetary planning and decision-making.

MODERNIZING LOCAL GOVERNMENT FINANCIAL AUTHORITY

Before we consider altering or equalizing the taxing authority of cities and counties, we should ask why Virginia has such a unique and complete separation between cities and counties.

As a preamble to that historical discussion, a brief description of the relationship between the state and localities is useful. Often, one will hear the relationship between the state and a locality analogized to the relationship between the United States and the Commonwealth of Virginia. While this analogy may be accurate in some contexts, it is not valid from a legal point of view. In a national government based upon notions of federalism, such as that practiced in the United States, the states share power with the national government and have reserved to them all powers not specifically afforded to the national government. Such is not the case in the state-locality relationship. Localities are wholly

the creatures of the state. They are given only those powers which the state government chooses to provide to them and, in fact, exist only because the state has determined to create them. With that understood, it becomes fairly apparent how the courts have logically formulated the so-called Dillon Rule. The Dillon Rule, which holds that localities have only those powers specifically granted to them by the state and those powers necessarily implied therefrom, forms the basis for determining which powers or authority localities possess.

Since the earliest days of the Commonwealth, the powers of cities and counties have been distinct. Again, this is based on historical necessity and is a product of the ways the cities and counties have grown. Counties, traditionally more rural and sparsely populated, have in years past required fewer government services such as water, sewer and streetlights. Cities, on the other hand, have traditionally been more concentrated in their population and have had the need for those kinds of services. Consequently, the state government has provided cities with authority to engage in more activities than counties.

It is sometimes thought that the basis for Virginia's practice of city/county separation lies in a similar practice in England at the time the Virginia Colony was first settled in 1607. For several reasons, this is probably a misconception. First, it is simply historically inaccurate that the practice of city/county separation was in general use in England during Virginia's colonial period. Second, if in fact it had been an established practice from early days in Virginia, one would expect that the State of West Virginia would follow the same practice, given that its counties were part of the Commonwealth of Virginia until less than 150 years ago. Finally, and perhaps most persuasively, none of the other English colonies established in the same era follow Virginia's practice of complete city/county separation. Although a few individual cities throughout the country are completely independent of their surrounding counties, such as Baltimore and St. Louis, they are rare exceptions to the general rule.

The more likely explanation for the creation of separate cities and counties in Virginia is simply a matter of historical evolution. Early legislative acts of the colonial General Assembly indicate that as Virginia's first cities grew, particularly Williamsburg and Norfolk, they required grants of additional authority and concomitant removal of authority from the surrounding counties. Most often, this initially began as a taxing issue. As time passed, and cities felt a need for greater powers, the General Assembly obliged.

Although there is no clear line of demarcation as to when the separation practice became fixed in Virginia law, legislation enacted following the 1869 Constitution indicates the firm establishment of the policy. Probably the best example was the legislative incorporation of the City of Hopewell in 1916 that specifically declared the City of Hopewell would be "wholly separate from and independent of the remaining portion of the County of Prince George." Although the Supreme Court of Virginia has never specifically addressed the propriety of completely separating cities and counties, a number of cases over the years indicate judicial acceptance of the practice.

Notwithstanding the unique character of the Virginia system of separate cities and counties, there are several benefits to be derived from it. First, the city/county separation avoids overlapping layers of government and simplifies tax and governmental structure. Citizens and businesses know which local government is accountable when there are problems. This simplicity is particularly helpful to businesses in the area of taxation since businesses located in Virginia cities or counties receive a single tax bill, rather than several bills from different units of government for different functions. Second, city/county separation prevents duplication of offices, services and equipment. Duplication may occur if a city and county are both responsible for providing services for the same population or, in some cases, when a struggle occurs over which government should provide the service. Third, the Virginia system prevents the proliferation of local governments. Only seven states, all with small populations, have fewer units of local government than Virginia, which has the lowest number of units of local government per capita in the nation. Virginia, with a population 50% greater than Alabama's, has 230 municipal governments while Alabama has 440.

The relative simplicity of the Virginia system is a significant advantage. For example, in Hampton Roads, 1.1 million people live in seven contiguous municipalities, with no counties and no additional local government with the power to tax. In contrast, Broward County, Florida, an area of 1.2 million people, contains a county government, 28 cities, a school district, a water management district and a hospital district, each with its own taxing powers.

This following should in no way be construed as criticism of the Dillon Rule; in fact, the Commission strongly supports continued adherence to this rule because of its direct impact on maintaining a positive business climate in Virginia. The equalization of taxing authority between cities and counties is sound, provided the equalization mechanisms maintain the direct voter input on tax increases. Cities should be brought up to the level of accountability of counties by requiring cities to secure the approval of their voters prior to any imposition or increase in meals, lodging or attraction taxes.

Historically, when a referendum is put to the voters the referendum is often rejected (44 of 69 county meals tax referendums failed from November 1988 through June 1999). In fact 62% of voters in Northampton County rejected a proposed meals and beverage tax in November 2001. As a result, generally low tax rates have pervaded and helped produce a strong business climate across the state. In addition, the current hurdles to the imposition of new or increased local taxes by counties allow businesses to expand with a degree of certainty as to future tax structure.

The Commission appreciates the demands on city and county budgets. However, simply raising taxes to balance their budgets on the back of targeted industries is inequitable and results in increased costs for businesses, decreased sales revenue and fewer jobs. We believe that the referendum process forces greater deliberation on the part of elected officials and forces county government to justify to the voters the reasons behind the requested tax increase.

Finally, additional local lodging taxes should be considered as long as the tax revenue generated is earmarked to promote local travel and tourism initiatives and is supported by the local lodging establishments.

Additionally, the Commission considered what additional taxation tools local governments, especially those in Northern Virginia and the Urban Crescent, may need to address important transportation priorities. The Commission fully considered the proposal for a regional sales tax increase by referendum, but was unable to endorse the concept for several reasons:

First, the *Code of Virginia* already grants certain localities – particularly Northern Virginia localities – the power to levy a local income tax. During the 1989 session, the General Assembly approved legislation to authorize these high growth localities authority to hold a local income tax referendum, later codified at Va. Code Section 58.1-540, which enables those localities to levy a new tax and raise additional revenues. Since the enactment of this legislation in 1989, no locality has exercised its legal authority to hold a referendum. Therefore, the Commission urges a different approach.

Second, the Commission was concerned about the overbreadth of an open-ended and permanent sales tax increase on the people of Northern Virginia at a time when Governor Gilmore has budgeted unprecedented sums of public funds for road projects in Northern Virginia. A permanent sales tax increase appears to be broader than that necessary to accomplish some specific transportation projects, such as light rail to Dulles.

Third, the Commission heard testimony from Delegate Vincent F. Callahan, Jr., about a very innovative, more narrowly tailored approach to raising revenues in specific dollar amounts to pay for designated transportation projects. Delegate Callahan's approach also has the virtue of having been passed overwhelmingly by the General Assembly and signed into law by Governor Gilmore – and so it starts with the political imprimatur a broad regional sales tax increase lacks.

Fourth and most importantly, the regions of Virginia most prominently discussing a tax increase referendum – Northern Virginia – would receive a substantial windfall of additional revenues through this Commission's proposal to cede 15% to 20% of the state's individual income tax revenue stream to localities. Fairfax County in particular would receive a tremendous increase in tax revenues amounting to hundreds of millions of dollars over the next decade through a constitutional shift from car taxes to individual income taxes. This is the preferable solution because the constitutional reform would be revenue neutral for taxpayers, rather than a tax increase as has been proposed by some public leaders. The Commission favors innovative revenue neutral reform over tax increases.

Accordingly, the Commission recommends the following:

Recommendation No. 4

Equalization of Financial Authority between Cities and Counties

In order to promote and enhance economic development, public understanding and uniformity of local government financ-

ing across the Commonwealth, the Commission recommends that all counties, cities and towns have the same local government financing authorities (i.e., imposing taxes, incurring debt, service fees and user charges, etc.), such equalized authorities to be those generally and currently possessed by cities in the Commonwealth.

Changes to the *Code of Virginia*, and the Constitution of Virginia if required, necessary to implement this recommendation should be accomplished with the following principles in mind:

- Local governments should not use this equalization of local government financing authorities as a pretext for increasing taxes;
- Local governments are strongly encouraged to provide for maximum public communication and public hearings in all aspects of local government financing; and
- Any local government whose taxing authority is increased should attempt to offset any additional revenues resulting from such increased authority with a reduction by a like amount in a less equitable revenue source, such as the real estate tax, telephone tax or BPOL tax.

Recommendation No. 5

Special Taxing District for High Priority Transportation Projects

The Commission recognizes the need some localities have for specific high priority transportation projects, and further recognizes the desire of local governing bodies in such localities to seek alternative funding mechanisms. Although localities were granted considerable authority in 1989 to raise taxes upon passage of a referendum, none has done so. The Commission finds that the lack of action in this regard is significant and indicates the need for a new, more tailored approach. This new approach would focus taxation and funding authority on a particular project and raise only the amount of funds necessary to complete that project.

Unlike the approach of 1989, this funding mechanism would not constitute an open-ended taxing authority without a specific, definable objective. Rather, this mechanism would address cost-specific transportation priorities where the people whose land value is enhanced as a result of the transportation project, pay for the project after the land owners in a "special transportation district" approve the project and project-specific real estate taxes in a referendum. This funding mechanism is modeled after Delegate Vince Callahan's House Bill 2671, which was passed overwhelmingly by the General Assembly and signed by Governor Gilmore in 2001, and later codified as Virginia Code Sections 33.1-430 through 33.1-446 (Chapter 611 of the 2001 Acts of Assembly). The Callahan funding model is tailored to specific transportation projects in Northern Virginia.

Accordingly, the Commission recommends that the General Assembly, Governor and local governments utilize the "special transportation district" model for high priority transportation

projects in other regions of the Commonwealth, provided they include the following concepts:

- The special transportation district should only raise funds from those land owners whose property values will be enhanced by the transportation project;
- The special transportation district must be created by referendum and only after significant public discussion;
- The special transportation district should be created for a finite period of time; and
- The special transportation district should raise only the amount of revenue necessary to complete a specific transportation project.

Recommendation No. 6

Dillon Rule & Urban Tax Credits

The Commission recommends that Virginia maintain the Dillon Rule and the corporate distinctions between county and municipal governments. However, in the process of modernizing local government financial authority, it will be important to ameliorate some of the unintended consequences of the modern suburban trend in order to promote vibrant core cities and retain attractive regions. Tax policy can play an important role in promoting vibrant core cities, including the following tax incentives:

- The General Assembly and local governments should enact or expand targeted tax credits to redevelop blighted commercial and industrial properties and promote brownfield cleanup and development, especially in urban areas;
- The General Assembly and local governments should continue to designate or expand enterprise zone tax credits, in both urban and rural areas; and
- The General Assembly should increase funding as economic growth revenues permit, for urban renewal programs such as the Urban Public-Private Redevelopment Partnership Fund and the Housing Revitalization Zone Program.

Recommendation No. 7

No Unfunded State Mandates on Local Governments

In order to alleviate local governments' financial stress, the Commission recommends that state government impose no new unfunded mandates on local governments.

TELECOMMUNICATIONS TAXES IN THE INFORMATION ECONOMY

"[I]nformation technology is transforming the world in which we live, empowering the individual at the expense of large corporate and governmental institutions, and expanding the reach of individual citizens beyond old borders and physical limits."

– Executive Order 75

The world of telecommunications service has changed dramatically in recent years. The rise of competition has created an array of consumer choices that were unknown a generation ago. Most fundamentally, telecommunications services have emerged as the port-of-entry for the Internet and the world wide web. Increasingly, as the internet become ubiquitous, the need for affordable and reliable telecommunications services will be essential for a broad range of activities including education, commerce, and entertainment. Without such service, Virginia's status as a leader in the Internet revolution would quickly dissipate.

The emergence of new technologies, such as DSL, cable modems, wireless cellular, and satellite TV, has created the potential for a powerful convergence of communications technology. Increasingly, Virginians can reach the Internet, not only through dial up service, but through their television, their cable system or through wireless technology. As this convergence continues, the functional and commercial distinctions between these technologies will continue to narrow.

In stark contrast to the dynamic change and progress which is occurring in the world of telecommunications, our system for taxing telecommunications remains static, creating unfair burdens for consumers. Moreover, as new technologies converge, our tax system remains blind to these new functional and commercial realities, and may create a set of incentives and disincentives that are irrational.

Generally speaking, taxes on telecommunications services are very high. Nationally, taxes on telecommunications services average roughly 18%. Subtracting the federal tax bite, the average rate for all states is 13.7%. *Virginia's average rate, however, is 27.9%, more than double the average for all states, and is the second highest in the nation.* Yet Virginia's state tax on telecommunications services is only 3%, one of the lowest in the nation. The rest of non-federal taxes paid by Virginians are levied at the local level, averaging 25 percent.

All totaled, about 14% of a typical consumer's bill for telecommunications service in Virginia goes to pay taxes. By comparison, Virginians pay a general sales tax of 4.5% (food is taxed at a lower rate of 4%) and a state income tax no higher than 5.75%.

Additionally, the heavy preponderance of local taxation of telecommunications services creates a very complex patchwork of differing tax systems and jurisdictions. Nationwide, there are 37 different types of telecom taxes, and a national service provider could be required to submit a staggering 63,879 returns annually. Here in Virginia, a statewide service provider must file

3031 returns per year, compared to 12 for a typical Main Street business. That makes Virginia's tax structure the sixth most complex in the nation.

Telecom taxes are inherently regressive. The federal government began the taxation of telephone service as a temporary levy to finance the Spanish-American war. At that time, telephones were considered a toy for the wealthy. Today, they are as much a necessity as a car, a refrigerator, or heat for the home. At present, individuals with annual incomes under \$70,000 pay about 56% of telecommunications taxes. In our Internet age, these regressive taxes widen the digital divide between those in our society who have access to this new technology and those who do not.

Virginia's tax system is inconsistent in its treatment of new technologies. There is no consistent practice between localities on the taxation of DSL service, cable modem service, and wireless. The inconsistent tax treatment of new communications technology does not take into account how these new technologies are converging. Nor does it take into account how different tax treatment of technologies with narrowing differences in function and commercial application skews economic outcomes, and over time may provide an unfair advantage to less efficient technologies.

It is also clear, however, that however imperfect Virginia's system for taxing telecommunications services may be, localities are dependent on the revenue that they receive from those taxes. Any plan for reforming this system and reducing its burden on consumers and service providers must take into account the localities' need for continuing revenues. In the time that it has had to study this issue, the Commission has not been able to develop such a plan. However, the Commission has identified a clear need for a plan that would radically reform Virginia's telecommunications taxes to make them substantially less burdensome to consumers, much simpler for service providers to comply with, and neutral with respect to different technologies.

On a related topic, the Commission also recognizes that Internet tax law and policy is evolving at the national level. For three years, from 1998 to 2001, state and local governments were prohibited by the federal Internet Tax Freedom Act from imposing taxes on Internet access and multiple and discriminatory taxes on electronic commerce. The federal prohibition had little impact in Virginia because the Commonwealth does not tax Internet access or electronic transmissions of data, content, information or software. (These transmissions are defined as "services" in Virginia and, therefore, not subject to sales tax.)

Although the federal moratorium lapsed in October 2001, and Congress has not resolved the extension of the moratorium at this time, the Commission endorses Virginia's current policy against taxing Internet access and electronic transmissions of data, content, information and software. Any contrary policy would make Virginia less attractive to the technology industry – a major economic driver in Virginia – and inhibit economic growth in the New Economy, as well as exacerbate the "digital divide" by increasing the cost of Internet access for lower income citizens. Accordingly, the Commission supports continuation of tax policies that favor a free and unfettered Internet.

Recommendation No. 8

Commission to Study Telecommunication Tax Reduction & Simplification

The Commission recommends that the General Assembly and the Governor establish a bi-partisan study commission charged with the specific task of devising a telecommunications tax reform proposal to:

- Simplify and develop uniformity in the panoply of complex local telecommunications taxes in order to reduce compliance and collection costs for service providers;
- Reduce telecommunication tax rates across the Commonwealth to reduce the costs of telecommunications services for consumers;
- Identify replacement or growth revenues for local governments;
- Eliminate discriminatory tax treatments of similar telecommunications services as technologies converge; and
- Develop reasonable limits upon the imposition of E-911 taxes on multiple telephone lines into single residences.

While that commission meets, and until its recommendations are adopted, the General Assembly should enact a statewide moratorium prohibiting the following:

- Telecommunications rate increases; and
- Expansion of tax bases to new communications services.

Recommendation No. 9

Pro-Technology Tax Policy for the New Economy

The Commission recommends that the General Assembly, the Governor and the State Tax Commissioner:

- Continue Virginia's current policy of not taxing Internet access or digital downloads of information, content and data;
- Enact a Virginia-wide moratorium prohibiting local taxes on Internet access taxes or digital downloads; and
- Enact a Virginia-wide moratorium prohibiting taxation of broadband services used to access the Internet, such as cable modems and DSL.

FUNDING IMPORTANT PUBLIC INFRASTRUCTURE PRIORITIES

As we consider additional methods to fund important infrastructure priorities, we must first consider the correct state of the Commonwealth's credit rating. In this regard, we must first note that Virginia's general obligation bond rating is AAA — the highest rating assigned by the major bond rating agencies. Virginia long has enjoyed what is called a "triple AAA" rating, as each of the three major bond rating agencies has assigned that rating to Virginia's general obligation bonds. Only eight other states have a triple AAA rating.

The Commonwealth's bond ratings allow us to issue bonds at the lowest possible cost and also serve as the basis for the ratings of other, non-general obligation bonds. Virginia takes great pride in these ratings, as they reflect more about a state than just its ability to issue and service debt.

Four key factors are considered by the rating agencies in determining credit quality: control of debt burden; economic vitality and diversity; fiscal performance; and flexibility and administrative capabilities of government. The AAA rating provides an acknowledgment and endorsement of the Commonwealth's conservative financial management policies and practices and track record. The AAA ratings of the Commonwealth were reaffirmed in October 2001 in relation to an issuance of 9(c) general obligation bonds.

One example of the Commonwealth's commitment to conservative fiscal management is the role of the Debt Capacity Advisory Committee (DCAC). Virginia was one of the first states in the nation to adopt a formalized approach to analyzing the amount of debt that the Commonwealth may prudently issue. The role of the

DCAC is to review and recommend to the Governor and General Assembly the maximum amount of tax-supported debt that may be prudently authorized or issued over a biennial period. The DCAC utilizes a sophisticated debt capacity model designed to ensure that the ratio of debt service to revenues does not exceed 5%. This amount has varied between \$445 million and \$698 million annually over the past four years.

During the recent years of unprecedented prosperity, Governor Gilmore and the General Assembly have made relatively limited use of tax-supported debt, opting instead to pay for capital projects through cash appropriations. During Governor Gilmore's administration, the actual amount of tax-supported debt authorized totaled \$677 million, representing only 29% of available debt capacity. The unused capacity cannot be carried forward, but does have a positive impact on the Commonwealth's future debt capacity.

Governmental entities, including the Commonwealth, generally have two options for funding necessary capital projects, which include infrastructure, higher education, transportation, public safety, and other similar types of projects: cash and debt. Cash financing typically is referred to as "pay as you go."

Debt financing is sometimes referred to as "pay as you use," i.e., debt financing provides a match between the useful life of a project and the term of the financing. For example, a highway project or university classroom building might be financed over 20 years — considerably less than the term those projects will be used. In essence, the beneficiaries of the asset pay for it over time, rather than placing the entire cost of the project on those paying taxes or other fees at the time the asset is acquired. Particularly in times when cash is insufficient to address all major capital needs, the prudent use of debt financing allows necessary projects to go forward while preserving cash resources for other priorities.

The following chart compares the issuance of debt over the past four administrations in Virginia (Governors Baliles, Wilder, Allen and Gilmore):

Tax-Supported Debt Authorizations⁽¹⁾ By Gubernatorial Administration

| | Baliles 1986-89 | Wilder 1990-93 | Allen 1994-97 | Gilmore 1998-2001 |
|--|--------------------|------------------------|------------------|----------------------|
| Actual Dollars | \$1,539,698,000 | \$1,685,172,764 | \$1,099,893,130 | \$676,603,000 |
| Authorization as a % of General Fund Budgets | 9.36% | 7.84% | 4.25% | 1.81% |
| Average Annual Authorized Debt Per Capita ⁽²⁾ | \$ 64.82 | \$ 67.25 | \$ 41.47 | \$ 24.60 |
| Authorizations as a % of Debt Capacity ⁽³⁾ | N/A | 219.85% ⁽⁴⁾ | 110.44% | 28.86% |
| Authorizations Adjusted for Inflation | \$2,298,531,091 | \$2,125,671,391 | \$1,266,780,551 | \$703,393,965 |

(1) Net of rescinded debt authorizations and other adjustments.

(2) Population as reported in Comprehensive Annual Financial Reports (1986-2000). 2000 population figure carried forward for 2001.

(3) Debt capacity represents the amount of additional tax-supported debt that may be issued in any given year without exceeding Overall Capacity to Pay Debt Service (Debt Service < 5% of Revenue). The Debt Capacity Advisory Committee was created in September 1991, and submitted its first report to the Governor on January 1, 1992.

(4) Based on data from years 1992 and 1993. Debt Capacity Advisory Committee created in September 1991.

Recommendation No. 10

Fiscally Responsible Use of Bonds for State Infrastructure Priorities

The Commission finds that the Commonwealth has established a fiscally responsible debt capacity model and has been conservative in the authorization of debt during the last four years. Less debt has been authorized in the period from 1998 to 2001 than in any four-year period since 1986.

The bond rating agencies view control of tax-supported debt as one of several factors affecting credit quality. The Commission notes that the Commonwealth has maintained a AAA rating on general obligation debt from each of the three major bond rating agencies for more than 40 years. The ratings of the Commonwealth were confirmed in October 2001, reflecting continued confidence in Virginia's prudent debt management under Governor Gilmore's tenure.

Based upon these findings, the Commission recommends that the General Assembly and the Governor prudently utilize the Commonwealth's bonding capacity to fund high priority state infrastructure projects consistent with the following principles:

- Any debt authorized should, after taking into account issuance assumptions, be consistent with the recommendations of the Debt Capacity Advisory Committee and consistent with the Commonwealth's maintenance of a AAA rating.
- Projects should be prioritized for debt financing, giving due consideration to the impact of the project on debt capacity.
- The financing period for any project should not exceed the useful life of the project.



MISCELLANEOUS TAX REFORM PROPOSALS

During the course of this study, valuable ideas for tax reforms in other areas have been brought to the attention of the Commission. Those recommendations are listed below.

Recommendation No. 11

Reducing Death Tax Burdens in Virginia

In 2001, President George W. Bush signed into law the Economic Growth and Tax Relief Act which will phase out certain federal estate and gift taxes, also known as "death taxes." The purpose of the federal legislation was to allow families to pass their life's work – farms and small businesses and savings – to future generations without onerous and duplicative tax burdens.

In addition to reducing federal estate tax rates, this legislation phases out the credit for state death taxes paid between 2002 and 2004, when the federal credit for state death taxes is completely repealed. As a result of this federal reform, the state death tax burden for Virginia taxpayers will increase unless the General Assembly enacts legislation to prevent the increase.

For many years, Virginia Code Section 58.1-901 has set the Virginia estate tax equal to the federal credit, but not less than the credit in effect in 1978. Because the federal credit is being phased out, Virginia taxpayers will face the following changes in their state death tax burdens as follows:

- The estates of Virginia decedents dying between January 1, 2002, and December 31, 2004, would:
 - Pay Virginia estate tax at the 1978 rates; but
 - Receive a partial credit for this tax on the federal estate tax return.
- The estates of Virginia decedents dying on and after January 1, 2005, would:
 - Pay Virginia estate tax at the 1978 rates until the entire federal estate tax is repealed in 2010; but
 - Receive a deduction on the federal tax return instead of a dollar-for-dollar credit.

Thus, while the federal estate tax is being phased out, the after-tax value of the estates of Virginia decedents will be reduced by the Virginia estate tax for which a full federal credit is not allowed.

Protecting Virginia taxpayers from this death tax liability will assist families who own farms and small businesses from passing their lifetime savings – almost all of which was taxed during their lifetimes – to their children and grandchildren. Accordingly, the Commission recommends the following:

- The General Assembly should amend Virginia Code Section 58.1-901 by striking the following language which appears as the last sentence in the definition of "Federal

credit": "In no event, however, shall such amount be less than the federal credit allowable by § 2011 of the Internal Revenue Code as it existed on January 1, 1978."

Recommendation No. 12

Taxpayer Rights & Appeals Process

The fair and efficient administration of taxes by the Commonwealth and its local governments is fundamental to the ability of Virginia to maintain its position as a state that fosters a favorable business climate as well as promotes prosperity for all its citizens.

In evaluating Virginia's tax administration system, the Commonwealth scores well with respect to basic procedural elements. For example, Virginia provides several protections that must be considered, at a minimum, to be part of an even-handed and customer-focused tax administration system. These five elements are: (1) an even-handed statute of limitations with respect to assessments and refund claims; (2) equal interest rates on assessments and refunds; (3) adequate time to file a protest of an assessment; (4) an automatic extension of state return filing dates beyond the federal due date; and (5) federal audit changes do not open an entire state return. In addition, Virginia has a Taxpayer Bill of Rights.

However, the foremost element of good tax administration is a fair, efficient, and independent appeals system. Such a system permits assessments to be reviewed by an independent appeals tribunal before the taxpayer is required to pay the tax. Virginia does not presently have such an appeals process.

Currently, in Virginia, a taxpayer has the right to protest an assessment to the State Tax Commissioner. If the taxpayer receives no relief, he may file an action in circuit court but must "pay-to-play." That is, in order for the circuit court to have jurisdiction, the disputed tax assessment must be paid or a bond posted. However, the bond must be posted within 90 days of the assessment. Thus, the taxpayer may have to post the bond before the decision of the State Tax Commissioner has been rendered. As a practical matter, this provision affords the taxpayer no reasonable alternative to payment of the disputed assessment in order to maintain a court action.

According to the Committee on State Taxation, today more than half of the 50 states have an independent appeals tribunal dedicated specifically to hearing tax cases. These appeals systems afford taxpayers the opportunity to establish a record for appeal in an independent adjudicative body, before judges knowledgeable in tax law, and usually without a prepayment requirement before their day in court. Both the Virginia Chamber of Commerce and the Virginia Manufacturers Association advocate such an appeals system.

To establish a fair and efficient tax appeals system, the tax court or tribunal must be truly independent. It must not be located within, or report to, the Department of Taxation. Without independence, the appearance of objectivity will be impossible to achieve. In addition, the tax tribunal's judges must be specifically trained as tax lawyers and should be solely dedicated to resolving tax issues.

Finally, taxpayers should not be required to post bond or pay a disputed tax before a hearing before an independent tribunal. It is inherently inequitable to force a taxpayer to pay a tax assessment, often based on untested assertions of an auditor, without the benefit of a hearing before an independent trier of fact.

Establishment of an independent tax tribunal and elimination of the pay-to-play rules would benefit both the Commonwealth and its taxpayers. An independent tribunal of well-trained judges should be established to decide a broad range of disputes from less complex tax issues, such as those arising from personal income tax matters, to complex corporate tax disputes. The tremendous growth and complexity of tax law that applies to multi-jurisdictional entities, many of which have global interests, makes this approach essential to "modernizing" the appeals process.

To preserve its well-deserved reputation as good place to live and do business, the Commonwealth would be well-served to update its tax administration by replacing its current appeals process with an independent appeals system that would allow taxpayers to make prepayment challenges to disputed tax assessments. Without doubt, such changes would only enhance Virginia's business climate and reputation for providing a fair and efficient tax system. Accordingly, the Commission recommends that the General Assembly enact legislation that would establish a modern appeals procedure embracing the following principles:

- An independent tribunal, not located within or reporting to the Department of Taxation, should be authorized to hear a broad range of issues. The panel should be composed of tax lawyers and be dedicated solely to hearing tax cases.
- The new appeals procedure should be structured so as not to add another administrative layer to the current system.
- Taxpayers should not be required to prepay an assessment before they are afforded an opportunity for a hearing before an independent arbiter.



All photos: Michael White, Office of the Governor



Commonwealth of Virginia
Office of the Governor

Executive Order

NUMBER SEVENTY-FIVE (01)

Establishing the Governor's Commission on Government Finance Reform for the 21st Century

Preamble

By virtue of the authority vested in me as Governor under Article V of the *Constitution of Virginia*, including but not limited to Section 2.1-51.36 of the *Code of Virginia*, and subject to my continuing and ultimate authority and responsibility to act in such matters, I hereby establish the Governor's Commission on Government Finance Reform for the 21st Century. The Commission is classified as a gubernatorial advisory commission pursuant to Section 2.1-51.35 and Section 9-6.25 of the *Code of Virginia*.

This Commission shall study and recommend fundamental reforms to the Virginia Constitution and tax and spending policies with the purpose of modernizing government finances in Virginia to meet the new and unprecedented challenges of the 21st Century.

Challenges for Government in the 21st Century

Virginia's demographics have shifted significantly over the last three decades. Population and prosperity has increased dramatically in the "Golden Crescent" stretching from the suburbs of the northern part of the state down the I-95 corridor to the state's capitol and south to the Hampton Roads region. Inner cities have lost population to the suburbs. Rural areas have lost population to urban areas. And certain industries that once dominated the economies of regions of our state, especially in Southside and Southwest Virginia, have declined and challenged us to seek others to prosper in their place.

At the same time, information technology is transforming the world in which we live, empowering the individual at the expense of large corporate and governmental institutions, and expanding the reach of individual citizens beyond old borders and physical limits. Biotechnology and medical breakthroughs are curing people of once fatal diseases, extending life, and improving the quality of life for millions of Americans afflicted with physical or mental ailments. The technological revolution of the last decade fundamentally has transformed the American economy by making the private sector more efficient in the production of goods and delivery of services, augmenting the wealth of American citizens, and expanding economic opportunity to more citizens and places.

Such profound changes in Virginia's economy and the lives of our citizens present unprecedented challenges and opportunities for government at all levels. Governmental institutions cannot stand pat during times of cumulative and dramatic societal change. They must be flexible, innovative and reform-minded in order to harness the same efficiencies driving the private sector and deliver essential services as effectively as possible. From top to bottom, from the way government taxes its citizens in a New Economy to the way government plans its affairs for long-term continuity and funds and delivers services, all functions of government in Virginia deserve a thorough study to identify those areas in need of reform, or those areas where reform might enhance government operations and improve the lives of people.

Over the course of the last three years, I have attempted to reform numerous aspects of government in Virginia. I have worked tirelessly to eliminate an antiquated and regressive tax on the vehicles our citizens need in a mobile society. I have implemented fundamental education reforms to raise academic standards and achievement for the next generation of Virginians and prepare them for the economic and intellectual challenges of a global economy. I have initiated a long-term plan to tie, for the first time, funding in higher education to measurable results in terms of affordability and quality. I created the first Cabinet-level Secretary of Technology in the nation, launched a comprehensive e-government initiative, signed into law the first Internet policy as well as the first uniform electronic commerce statute, and took steps to close the digital divide. I have proposed fundamental reforms in the way Virginia delivers mental health services to those in need. I have signed into law major reforms for the Virginia Department of Transportation and Virginia's road building programs to build roads faster and more efficiently. And I have proposed, with some success, electoral reforms to ensure fair and honest elections for voters.

Unfortunately, each governor leaves a two-year budget for his successor who faces significant limits in his ability to engage in long-range planning for the Commonwealth during the first two years in office and one four-year term as Governor offers precious little time to undertake all of the major reforms demanded by the challenges of our times. Despite our reform efforts on so many fronts, I have been struck by how many opportunities for reform and improvement could be accomplished by a more fundamental review of how government budgets and finances services, and I have heard the voices for change expressed through many disparate and competing study commissions and interest groups.

Among the many 21st century challenges facing a government designed in the 20th century is the question of how to distribute taxation authority, tax revenues, and funding responsibilities for essential services between state and local governments. Some people have advocated tax increases at the local level, others have proposed to shift more funding responsibilities to the state, while others have proposed sharing more state tax revenues with the localities. This debate has been fueled no doubt in large measure by the comparatively disproportionate growth in state tax revenues through the income tax, the less prolific but nevertheless significant growth of real estate and personal property taxes at the local level, and the ever increasing demand by special interest groups for government services.

This debate also has been spurred by implementation of the Personal Property Tax Relief Act of 1998 which phases out the burdensome local property tax on our citizens' cars and trucks. The public outcry for relief from this onerous tax has consistently been very strong. At this time, the state reimburses each locality dollar-for-dollar for the revenues the localities once collected directly from our citizens. That approach has been functional and effective. However, the complexities of this reimbursement mechanism have prompted suggestions for alternatives and these should be explored.

Virginia's current Constitution was adopted three decades ago in 1971. It has been amended every even year since (with the exception of 1988), but no comprehensive review or overhaul has occurred since its adoption. Much has changed in thirty years, and so I believe the time is proper to compare our Constitution to the New Economy, our changed demographics, and the challenges of our time.

My goal is for this Commission to engage as thorough and perceptive a review as any in our history and make reform recommendations that advance our Commonwealth and our people into a 21st Century filled with unprecedented challenges and opportunities. Government must reform itself and adapt to change if it is to fulfill its solemn obligations to the people it serves.

Charge for the Commission

The Commission shall undertake a thorough and comprehensive review of Virginia's governmental finances, including its Constitutional structure, and advise the Governor and General Assembly, in a final report, of those reforms necessary to modernize Virginia government to meet the unique challenges and opportunities of the 21st Century.

In the course of its review, the Commission shall strive to address, and be guided by, the following issues and principles in a coordinated set of recommendations for reform:

- State and local tax structures, including elimination of the personal property tax on vehicles and other tax reforms adapted to the New Economy;
- Appropriate division between state and local governments for the provision of and funding for essential services, including education, public safety, and social services; and
- Modernization of government, including improvements to the state budget process, continuity in public policy over time, and mechanisms for long-term strategic planning for the Commonwealth.

The Commission shall consider and, where appropriate, synthesize or draw upon the findings and recommendations of other governmental study committees and commissions, including but not limited to the following:

- Commission Studying Virginia's State and Local Tax Structure in the 21st Century
- Legislative Joint Subcommittee to Study and Revise Virginia's State Tax Code
- Commission on the Future of Virginia's Cities
- Rural Virginia Prosperity Commission
- Commission on Community Services and Inpatient Services
- Special Task Force on Faith-Based Community Service Groups
- Joint Rules Committee Studying the Legislative Process

Structure and Funding

The Commission shall be composed of no more than 30 members, appointed by the Governor, and serving at his pleasure. The Governor shall designate a Commission Chairman and Vice Chairman who will direct the Commission's work. The Attorney General of Virginia, or his designee, shall serve on the Commission. Members of the Commission shall serve without compensation but shall receive reimbursement for expenses incurred in the discharge of their official duties and approved by the Chairman.

The Governor will designate staff support as necessary for the conduct of the Commission's work during the term of its existence. The Commission's staff may include, if necessary, an Executive Director appointed by the Governor and other persons furnished by the Office of the Governor, the Offices of the Governor's Cabinet Secretaries, the Department of Planning and Budget, the Department of Taxation, and other executive branch agencies and institutions as the Chairman or Vice Chairman may request.

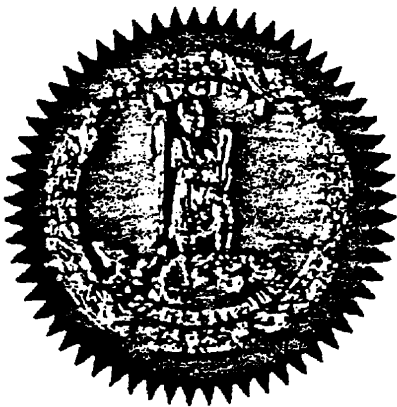
The Governor hereby directs all executive branch agencies and institutions, including institutions of higher education, to cooperate fully in assisting the Commission and Chairman in their work and to provide promptly all information requested by the Commission. An estimated 2,000 hours of staff time will be required to support the work of the Commission. Necessary funding for the term of the Commission's existence shall be provided from such sources, both state appropriations and private contributions, as authorized by Section 2.1-51.37 of the *Code of Virginia*. Direct expenditures for the Commission's work are estimated to be \$35,000.

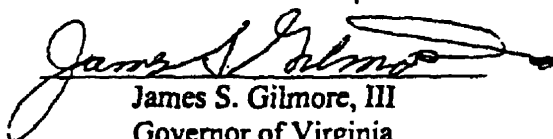
The Commission shall make a final report to the Governor and General Assembly no later than December 31, 2001. It may issue interim reports, findings, or recommendations at any time it deems appropriate.

This Executive Order shall be effective upon its signing and shall remain in force and effect until January 10, 2002, unless amended or rescinded by further executive order.

Executive Order Number Seventy-five (01)
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Given under my hand and seal of the Commonwealth of Virginia this 20th day
of June, 2001.




James S. Gilmore, III
Governor of Virginia

Attest:


Secretary of the Commonwealth

REMARKS BY GOVERNOR JIM GILMORE

Governor's Commission on Government
Finance Reform for the 21st Century
Richmond, Virginia
July 25, 2001

Welcome

Chairman Bliley, thank you for that kind introduction, and please accept my sincere appreciation for three decades of public service and leadership – as Mayor of the City of Richmond, Chairman of the Virginia Municipal League, Congressman from the 7th District, Chairman of the House Commerce Committee – and now, as the honorable Chairman of this commission.

I look around this room and I see so many distinguished leaders from the public and the private sectors, and I know that assembled here is a unique combination of experience and talent and vision to fashion meaningful reforms in the way Virginia taxes hard-working citizens and spends their money – and in the way tax revenues are divided between state and local governments.

As the Chairman just mentioned, we have indeed accomplished many important objectives on behalf of the people of Virginia, and I am proud of our accomplishments.

But four years pass quickly – and offer little time to reach the next generation of reforms implicated by a Governor's first round. Every last minute must be used effectively to push ahead on reform and progress.

When the people of Virginia entrusted me with a four-year term as their Governor, I vowed to work in their best interests from Inaugural day 1998 to Inaugural day 2002.

In fulfillment of my unswerving devotion to the people of Virginia, and with the humility that accompanies the close of a four-year term, I have asked the distinguished citizens assembled here to sustain our abiding allegiance to the best interests of the future of our great Commonwealth.

And so, to Chairman Bliley, to the distinguished commission members assembled, and to those citizens and members of the press in attendance, let me present, as clearly and concisely as I can, a statement of the common concerns and objectives that call us together.

A New Paradigm for a New Decade

During the era of the 1970s and 1980s, the prevailing political philosophy in Virginia equated "good government" with tax increases.

In an atmosphere of one-party rule and no true political competition, the old philosophy dominated without serious challenge. Nor was any rigorous public debate of the issue permitted.

Beginning in 1990, however, Virginia shifted philosophical gears and embarked upon a new paradigm for a new decade under the leadership of Governor Wilder.

Faced with a national recession and declining tax revenues, advocates of the old orthodoxy reflexively called for higher taxes. Government could not absorb the pain, they argued.

But Governor Wilder steadfastly refused. Hardworking people facing a recession and trying to pay their mortgages and

household bills should not absorb the pain, he replied. And so he opposed every tax increase the old guard sent his way.

And now I speak to you in the year 2001. Virginia has closed one decade without a tax increase – from Governor Wilder, to Governor Allen, and through my administration – we have successfully abandoned the old dogma in favor of a new paradigm ... a new paradigm that requires government to become more efficient in the way it spends the people's money, not more effective in the way it seizes their money.

The old philosophy advocated impetuous tax increases to pay for the latest and shiniest government program, while the new paradigm relies upon steady *economic growth* to generate tax surpluses to fund our most pressing priorities.

The old philosophy believed the only way to improve the quality of government services was to spend more money on them. The new paradigm relies just as fervently upon *reform* and the *application of new technologies*.

The old philosophy gave government free access and a moral right to taxpayers' wallets. The new paradigm restricts government's appetite and access to citizens' bank accounts, and presumes the principled right of each citizen to keep the product of his own labor.

The old philosophy maintained that higher taxes and expanded government programs were the price each citizen paid for collective social progress. The new paradigm does not dispute the legitimate role of government in providing beneficial schools and social programs, but it places equal value upon the power of lower taxes to empower individual citizens economically to improve their own lives rather than depending upon government.

And in times of economic downturns – like the one faced by Governor Wilder in 1991 or the one we faced in 2001 – the old philosophy put government's financial interests first, while the new paradigm puts the people first.

That is the new definition of "fiscal conservatism" in Virginia.

The New Paradigm & Four Years of Economic Growth

Distinguished commissioners, your challenge is to study the last decade of taxing and spending in Virginia, to distill some fundamental truths, and to recommend the most constructive paradigm for the next decade.

In just a few moments, I will let you proceed with that ambitious charge.

But let me raise the curtain slightly by visiting a few undeniable facts about the decade of the 1990s, with particular attention on the last four years.

Four years ago, I traveled literally to every corner of the Commonwealth to offer a vision of collective progress in government services and individual empowerment for hardworking citizens.

My vision was this: *Education first, then cut taxes*

On education, I promised to increase public spending on public schools by over \$1 billion.

And I told the people of Virginia that I would reform public education by faithfully implementing higher academic standards, insisting upon School Report Cards, enacting public Charter School legislation, putting 4,000 additional teachers into Virginia's schools to reduce class sizes and provide remedial instruction –

and raising test scores.

On taxes, I promised to phase out the car tax over five years, and to cut the car tax through revenue growth.

Ladies and gentlemen, we have faithfully kept our word to the people of Virginia.

Consider these facts:

- Since 1997, we have increased state tax support on public K-12 education by more than \$1 billion – an increase of 36 percent in just four years;
- We have increased state tax support to operate our public colleges and universities by over \$500 million – a 48 percent increase;
- And while many people have focused on our decision to delay some capital projects this year, the forgotten fact is that – counting all available funds – we have spent nearly \$1.9 billion to improve our college campuses since 1997;
- We have increased spending on mental health services by \$213 million – or 49 percent;
- When the national economy started to slump last year and revenue growth slowed, we still managed to maintain our gains: I ordered *no* reductions to K-12 education, *no* reductions to higher education operating funds, and *no* cuts to social services ... it wasn't easy, but I accepted the responsibility left to me by the General Assembly and fulfilled my Constitutional duty;
- I will leave office without touching Virginia's Revenue Stabilization Fund – in fact we will make additional deposits into the fund and leave over \$900 million in the bank for future generations – and Virginia's triple-A bond rating will be in tact; and ...
- We accomplished all of this progress *while cutting taxes!* This year we are cutting the car tax by 70 percent – and letting the people of Virginia keep \$756 million of their own money to spend on *their priorities* – whether it's an extra mortgage payment, paying off debt, investing for retirement, paying a tuition bill, or buying school clothes for children.

The key to our success has been *economic growth*. As I promised four years ago, every dollar of tax relief has come from revenue growth since 1997. In fact, the Commonwealth spent \$4.1 billion more in 2001 than it spent in 1997 – and only 14 percent of each new dollar went to car tax relief.

Our progress has validated the new paradigm that started with Governor Wilder, continued under Governor Allen, and that you are here to sustain in the new century.

Opportunity for Reform in the Next Decade

Four years ago, there were some who doubted that economic growth would produce more than a 50 percent increase in State

tax revenues – an increase of \$4.1 billion.

Others thought it was possible – but did not want to spare one dime of surpluses for hardworking taxpayers to keep. They were the old guard.

For others, car tax relief – regardless of its moral or political merits – complicates their well-intentioned spending plans for government.

The point is that – notwithstanding our tremendous progress made possible by a bountiful economy – tax relief for the people of Virginia remains a point of contention.

But where many people see impasse, I see great opportunity.

Local governments that used to tax their citizens on their cars and trucks, now receive dollar-for-dollar payment from the state's general fund – a windfall for taxpayers and local governments alike.

As these car tax reimbursements near \$1 billion annually, revenue sharing ideas that used to sound radical – now appear quite practical and politically plausible – almost a baby step away instead of the giant leap required four years ago.

I have heard the voices for change expressed through many disparate and competing study commissions and interest groups.

Local governments already receive about half of the state's general fund, but for years local governments have complained that they rely too heavily upon the State's generosity and real estate taxes to fund local services.

Charge to the Commission & Closing

So, here we are assembled to decide the Commonwealth's next step.

Your charge is outlined in Executive Order 75:

- First, how should Virginia structure state and local tax authority while eliminating the personal property tax on the cars and trucks owned by Virginia taxpayers?
- Second, how can Virginia fairly address the respective funding burdens between state and local governments?
- And third, how can Virginia modernize its state budget process to provide our citizens continuity in public policy over time and encourage long-term strategic planning for the Commonwealth?

Let us be mindful of the challenge and inspired by the opportunity we have before us to make tax relief for people and effective government services compatible goals.

Harry Truman once said: "Men [and women] make history and not the other way around. In periods where there is no leadership, society stands still. Progress occurs when courageous, skillful leaders seize the opportunity to change things for the better."

I believe that's true.

I ask *you* to embrace change and reform – to be bold and creative – and to make some history.

I thank you for your commitment to serve the people of Virginia and I wish you Godspeed in your work.

AGENDA

First Meeting of the Governor's Commission on Government Finance Reform for the 21st Century

Richmond, Virginia

July 25, 2001

- | | |
|----------------------|---|
| 10:00 – 10:15 | Call to Order & Welcoming Remarks The Honorable Thomas J. Bliley, Jr., Chairman |
| 10:15 – 10:40 | Keynote Remarks & Charge to the Commission The Honorable James S. Gilmore, III, Governor of Virginia |
| 10:40 – 10:45 | Swearing-In of Commissioners The Honorable Martha H. Kilgore, Deputy Secretary of the Commonwealth |
| 10:45 – 12:30 | Major Sources of State and Local Tax Revenues in Virginia William J. White, Executive Assistant, Office of Tax Policy, Virginia Department of Taxation |
| | State and Local Government Spending – 1991-2001 Richard D. Brown, Acting Director, Virginia Department of Planning & Budget |
| 12:30 – 1:30 | Lunch (<i>Provided for Commissioners & Presenters</i>) |
| 1:30 – 2:00 | The Personal Property Tax Relief Act of 1998 – Overview Asbury W. Quillen, Acting Commissioner, Virginia Department of Motor Vehicles |
| 2:00 – 2:30 | One Alternative to the Personal Property Tax Relief Act of 1998 The Honorable John H. Rust, Jr., Member, House of Delegates, Fairfax County |
| 2:30 – 3:00 | Open Discussion by the Commission & Closing Business |

AGENDA

Meeting of the Governor's Commission on Government Finance Reform for the 21st Century

The Rotunda
University of Virginia
Charlottesville, Virginia
September 24, 2001

- 10:00 – 10:15 **Call to Order: Ashley L. Taylor, Vice Chairman**
Welcome: John T. Casteen, III, President of the University of Virginia
- 10:15 – 10:30 **Charles E. Judd**
Virginia Leadership Council of the National Federation of Independent Business
- 10:30 – 10:45 **Sandra D. Bowen, Senior Vice President**
Government Affairs Virginia Chamber of Commerce
- 10:45 – 11:00 **Stevenson T. Walker, President and CEO**
Virginia Manufacturers Association
- 11:00 – 11:15 **Kathryn C. Falk, President**
Virginia Cable Telecommunications Association
- 11:15 – 12:00 **Jeffrey Eisenach, President**
Progress and Freedom Foundation, Washington, DC
- 12:00 – 1:30 **Lunch (Provided for Commissioners)**
Guest Speaker: R. K. Ramazani
Professor Emeritus of Government and Foreign Affairs University of Virginia
- 1:30 – 2:15 **Ellen R. Davenport, Director of Public Finance**
Virginia Association of Counties
Betty Long, Deputy Director
Virginia Municipal League
Suzette P. Denslow, Special Consultant
Virginia Association of Counties
- 2:15 – 2:30 **Connie Bawcum, Deputy City Manager, City of Richmond**
On behalf of the First Cities Coalition
- 2:30 – 2:45 **Eric V. Schlecht, Director of Congressional Relations**
National Taxpayers Union, Alexandria
- 2:45 – 3:15 **Open Discussion by the Commission and Closing Business**

AGENDA

**Meeting of the Governor's Commission on
Government Finance Reform for the 21st Century**

Marriott Dulles Suites
Herndon, Virginia
October 23, 2001

- | | |
|---------------|---|
| 10:00 – 10:10 | Call to Order: The Honorable Thomas J. Bliley, Jr. <i>Chairman</i> |
| 10:10 – 10:40 | The Honorable Barry E. DuVal <i>Secretary of Commerce and Trade</i> |
| 10:40 – 11:10 | James M. Wordsworth <i>On behalf of the Virginia Hospitality & Travel Association; Chairman, Tourism Working Group of the Virginia Post Attack Economic Response Task Force</i> |
| 11:10 – 11:40 | Frank S. Ferguson <i>Chief Deputy Attorney General Office of the Attorney General</i> |
| 11:40 – 12:00 | Open Discussion by the Commission |
| 12:00 – 1:15 | Lunch (Provided for Commissioners) |
| 1:15 – 1:30 | The Honorable Vincent F. Callahan, Jr. <i>Member, House of Delegates (Fairfax County) Co-chairman, House Committee on Appropriations</i> |
| 1:30 – 3:00 | Open Discussion by the Commission |

AGENDA

Meeting of the Governor's Commission on
Government Finance Reform for the 21st Century

Rockefeller Room
The Williamsburg Inn
Williamsburg, Virginia
November 19, 2001

- 10:00 – 10:15 **Call to Order: The Honorable Thomas J. Bliley, Jr.**
Chairman
- 10:15 – 10:45 **Stuart S. Carter**
Chief Economist – Public Finance
Office of Policy & Administration
Department of Taxation
- 10:45 – 12:00 **Discussion by the Commission:**
(1) Proposed Recommendations
(2) Additional Recommendations by Commission Members
(3) Draft of Final Report
- 12:00 – 1:00 **Lunch** (*Provided for Commissioners*)
- 1:00 – 3:00 **Continue Discussion**
Adopt Recommendations
Approve Final Report
- Closing Business**

Department of Motor Vehicles

Revenues and Costs of Administering Certain Agency Functions

| <u>Agency Functions</u> | <u>Net Revenue Collected</u> | <u>Allocated Costs</u> | <u>Costs as a Percent of Net Revenue</u> |
|---|----------------------------------|------------------------|--|
| Motor Fuels and Rental Vehicle Tax Compliance | \$804,533,608 | \$2,119,695 | 0.26% |
| Vehicle Titling/Licensing/Regulation * | \$693,840,659 | \$56,455,802 | 8.14% |
| Driver Licensing/Regulation * | \$25,053,510 | \$56,670,448 | 226.20% |
| Customer Records * | \$19,311,597 | \$9,550,257 | 49.45% |
| Dealer Services | \$572,553 | \$653,641 | 114.16% |
| Motor Carrier Licensing/Regulation | \$5,422,972 | \$2,545,216 | 46.93% |
| Transportation Safety | \$5,554,096 | \$2,863,267 | 51.55% |
| Vehicle Insurance Monitoring/Verification | \$12,148,671 | \$4,353,065 | 35.83% |
| Aid to Localities | \$33,563,531 | \$46,508 | 0.14% |
| Miscellaneous Activities | <u>\$1,203,768</u> | <u>\$2,287,959</u> | 190.07% |
| TOTALS | \$1,601,204,965 | \$137,545,858 | 8.59% |

- * The 2002 Session of the General Assembly passed a \$2 increase in the annual fee to register a vehicle, a \$.60 increase in the yearly fee charged for a driver's license, and a \$2 increase in the fee charged for customer records. As a result, the cost of administering vehicle registration, driver licensing, and customer records programs, as a percentage of net revenue, could decrease.

Notes:

Source: ACTR 1671 and ACTR 1427, Commonwealth Accounting and Reporting System, as of June 30, 1999.

DMV retains between eight and nine percent of all revenues collected for operating costs. The remainder is disbursed to other state transportation programs, other states in accordance with reciprocal licensing/taxing agreements, and to localities for locally administered taxes and fees.

State Corporation Commission

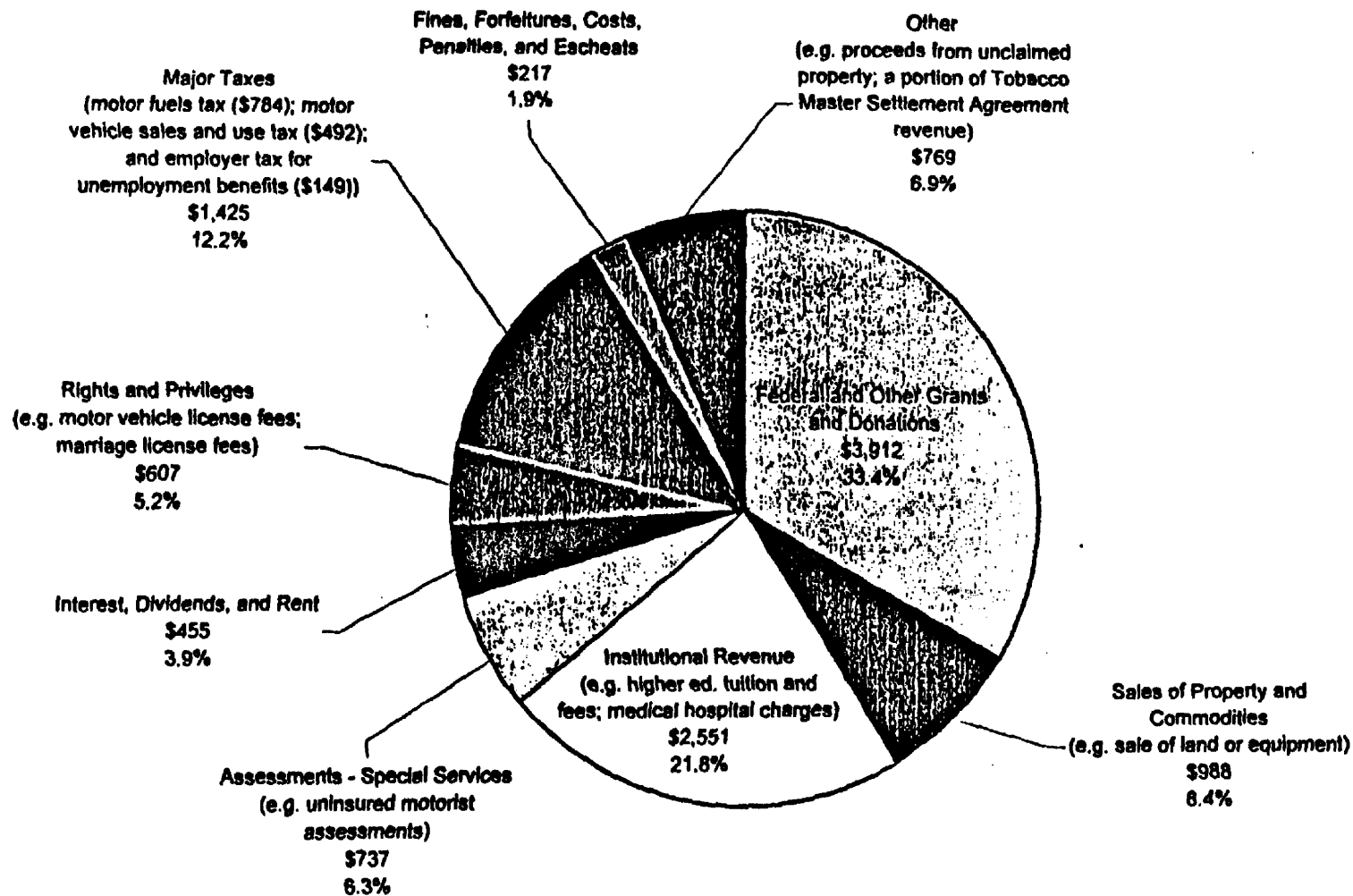
Revenues and Costs of Administering Certain Agency Functions

| <u>Agency Functions</u> | <u>Fiscal Year 2002 Revenue Estimate</u> | <u>Allocated Costs</u> | <u>Costs as a Percent of Net Revenue</u> |
|---|--|------------------------|--|
| Gross Insurance Premiums Tax | \$221,000,000 | \$315,000 | 0.14% |
| License Tax on Utilities (Water Companies)* | \$937,000 | \$6,000 | 0.64% |
| Fees Paid for Formation of Businesses, Conducting Business in Virginia, Annual Registration Fees, Providing Information from and Maintaining the Records of the Commission | \$23,150,000 | \$769,000 | 3.32% |
| Special Regulatory Revenue Tax** | \$10,702,000 | \$18,000 | 0.17% |
| Annual Assessment on Banks for Regulation and Examination of Banks | \$8,051,000 | \$15,000 | 0.19% |
| Telecommunications Relay Surcharge | \$9,280,000 | \$24,000 | 0.26% |
| Broker/Dealer Registration Fees, Securities Registration Fees, Investment Advisor Fees | \$7,234,000 | \$151,000 | 2.09% |
| Rolling Stock Tax | \$553,000 | \$10,000 | 1.81% |
| Private Payphone Fees | \$184,000 | \$2,000 | 1.09% |
| Electric Companies** | | | |
| State Consumption Tax | \$64,186,000 | | |
| Special Regulatory Tax | \$9,387,000 | \$35,000 | 0.05% |
| Gas Companies** | | | |
| State Consumption Tax | \$9,053,000 | | |
| Special Regulatory Tax | <u>\$1,341,000</u> | <u>\$25,000</u> | 0.24% |
| TOTALS | \$365,058,000 | \$1,370,000 | 0.38% |

* Beginning January 1, 2001, electricity and natural gas companies were no longer assessed with the annual license tax on utilities. Taxes on the consumption of electricity and natural gas and liability for corporate income tax replaced the annual license taxes on electricity and natural gas companies.

** The Special Regulatory Revenue Tax for electricity and natural gas companies as of 2001 is a part of a consumption tax. This is a result of deregulation of these industries.

Major Sources of Non-General Fund Revenue FY 2000 (\$ in millions)



Total Non-General Fund Revenues = \$11,704

Examples of Nongeneral Fund Taxes

DEPARTMENT OF MOTOR VEHICLES

- Total revenue collections for DMV for the past three fiscal years are as follows:

| <u>Fiscal Year</u> | <u>Revenue</u> | <u>Annual Growth</u> |
|--------------------|----------------|----------------------|
| 1998 | \$1.6 billion | |
| 1999 | \$1.7 billion | 5.3% |
| 2000 | \$1.8 billion | 6.7% |

- None of the money collected by DMV is deposited into the general fund.
- The Department of Motor Vehicles collects both the Virginia Fuels Tax and the Virginia Motor Vehicles Sales and Use Tax.
 - These taxes account for 73.8% of the \$1.8 billion in fees and taxes collected by DMV in FY 2000.

Virginia Fuels Tax

History

- The Virginia fuels tax dates back to 1923 when the tax was applied only to gasoline.
- The Virginia fuels tax is the largest source of nongeneral fund revenue collected by DMV.
 - Fuels tax revenues in FY 2000 were \$784.4 million. This is a 27.2% increase since 1991.
 - Fuels tax revenues accounted for 43.5% of all nongeneral fund revenues collected by DMV in FY 2000.

- Fuels tax revenues are distributed to the Transportation Trust Fund, the Highway Maintenance Operating Fund, and DMV.
 - Revenues attributable to the two and one-half cent rate increase enacted in 1986 are distributed to the Transportation Trust Fund. Of the remaining revenues, 99% are distributed to the Highway Maintenance Operating Fund and 1% are distributed to DMV for funding of the agency's operations.

Structure of the Tax

- Prior to January 1, 2001, the fuels tax was collected and remitted to DMV when the fuel was in the chain of distribution.
 - Fuel could be sold and purchased numerous times by distributors and jobbers before the fuels tax was actually paid to DMV. This could result in a long audit trail for purposes of determining who actually owed the tax.
- The General Assembly passed legislation during the 2000 Session that provided that the fuels tax is assessed at the point the fuel was removed from the terminal rack. The legislation was effective January 1, 2001.
 - The 'tax at the rack' legislation made licensed suppliers (i.e., oil companies and producers) responsible for collecting and submitting the tax to DMV as opposed to distributors and jobbers. Suppliers and terminal operators are required to file a \$2 million liability bond.
 - Nineteen other states impose their fuels tax 'at the rack'.
 - Licensed suppliers are required to remit the tax to DMV by the 20th day of the second month after the transaction.

- DMV expects increased fuel tax revenues from imposing the fuels tax 'at the rack'. The increase is expected to come from increased accuracy in filing fuels tax returns and an increase in matching federal funds.
- The fuels tax rates for motor fuels are as follows:

| <u>Fuel</u> | <u>Tax Rate</u> |
|---|--|
| Gasoline and gasohol | 17.5 cents per gallon |
| Diesel fuel | 16 cents per gallon |
| Aviation gasoline | 5 cents per gallon |
| Aviation jet fuel used by aviation consumers | 5 cents per gallon on the first 100,000 gallons and a half cent per gallon in excess of 100,000 gallons |

- The fuels tax rate for alternative fuels (combustible gas, liquids, and other non-motor energy sources) used to operate a highway vehicle is 16 cents per gallon.
- Federal, state, and local governments and certain nonprofit charitable organizations are exempt from Virginia's fuels taxes.

Comparison with Other States

- All 50 states impose fuels taxes on gasoline and diesel fuel.
 - Only 15 states impose a lower fuels tax on gasoline than Virginia does.

- Nine states impose a lower tax on diesel fuel, and 4 states (Hawaii, Indiana, South Carolina, and Vermont) tax diesel fuel at the same rate as Virginia does.

Virginia Motor Vehicle Sales and Use Tax

History

- The motor vehicle sales and use tax was first imposed in 1966 at a rate of 2% of the gross sales price paid for motor vehicles. It was imposed at the same rate and enacted at the same time as the retail sales and use tax.
 - The tax was last increased in 1986 to 3%.
- The motor vehicle sales and use tax is the second largest source of nongeneral fund revenue collected by DMV.
 - Sales and use tax revenues were \$492 million in FY 2000. This accounted for 30.4% of all revenue collected by DMV in FY 2000.
 - Motor vehicle sales and use tax revenues have more than doubled (116.2% increase) since FY 1991. The annual growth in these revenues has eclipsed 10% in five out of the last eight years (1993, 11.8%; 1994, 21.8%; 1995, 10.3%; 1999, 10.6%; and 2000, 12.8%).
- Revenues from the motor vehicle sales and use tax are distributed to the Transportation Trust Fund and the Highway Maintenance Operating Fund.
 - Revenues attributable to the 1% rate increase enacted in 1986 are distributed to the Transportation Trust Fund. Revenues attributable to the remaining 2% are distributed to the Highway Maintenance Operating Fund.

Structure of the Tax

- The tax is assessed on the gross sales price of motor vehicles and manufactured homes (in lieu of the retail sales and use tax). The tax is paid at the time the purchaser applies to DMV for a Certificate of Title to the vehicle. That is why it is sometimes referred to as the 'titling tax'.
- The motor vehicle sales and use tax is imposed at the following rates:

| <u>Transaction</u> | <u>Tax Rate</u> |
|---|-----------------------------|
| Sale or use of a motor vehicle | 3% of the gross sales price |
| Sale or use of a manufactured home | 3% of the gross sales price |
| Long-term rental of a motor vehicle | 4% of the gross proceeds |
| Short-term rental of a motor vehicle (daily rental vehicles) | 4% of the gross proceeds |

- - The minimum tax is \$35.
 - The sales price upon which the tax is based is not reduced for motor vehicles that are traded in.
- The tax applies both to the sale and use of motor vehicles in Virginia.
 - Vehicles purchased outside Virginia but used or stored in Virginia are subject to the tax (the tax is reduced by the amount of sales and use tax paid in the state of purchase).
- There are numerous exemptions from the tax including:
 - Sales to federal, state, and local governments;

STATE CORPORATION COMMISSION

- The State Corporation Commission, like DMV, is a nongeneral fund agency.
 - Unlike DMV, the revenues collected by the State Corporation Commission are (i) distributed to the general fund (e.g., taxes on gross premiums of insurance companies and state license taxes) and (ii) dedicated to nongeneral fund purposes (in some cases revenues are distributed to private companies as a form of reimbursement).
This outline focuses on just the nongeneral fund taxes collected by the State Corporation Commission.
- Total nongeneral fund revenue collections for the SCC for the past three fiscal years are as follows:

| <u>Fiscal Year</u> | <u>Revenue</u> | <u>Annual Growth</u> |
|--------------------|-----------------|----------------------|
| 1998 | \$ 74.6 million | |
| 1999 | \$ 94.9 million | 27.3% |
| 2000 | \$112.2 million | 18.2% |

- The special revenue regulatory tax accounts for approximately 17% of all nongeneral fund revenues collected by the SCC in FY 2000.

Special Revenue Regulatory Tax

- Regulatory tax revenues were \$11.4 million in FY 1999 and \$19.1 million in FY 2000.
 - Revenues increased 68% between FY 1999 and FY 2000. The special revenue regulatory tax was increased to provide funds for a mandated consumer education plan relating to deregulation.

- The tax equals 0.2% of gross revenue or gross income before deductions for expenses (i.e., gross receipts).
 - The tax is paid by corporations furnishing water, heat, light, or power; certain telegraph companies owning and operating a telegraph line necessary to communicate by telecommunications in the Commonwealth; telephone companies with gross receipts in excess of \$50,000; the Virginia Pilots' Association; railroads, except those exempted from state taxes under federal law; and certain common carriers of passengers.
- Revenues from the tax support the making of appraisals and assessments against public service companies, investigating the properties and services of public service corporations, and the administration of laws relating to public service companies.
 - The SCC is authorized to reduce the tax below 0.2%.
- Legislation passed by the General Assembly deregulating the electricity industry in 1999 and the natural gas industry in 2000 excludes electric suppliers, gas utilities, gas suppliers, and pipeline distribution companies from the tax.
 - Electricity and natural gas consumption taxes replace the special revenue regulatory tax paid by these corporations. A natural gas consumption tax of \$0.002 per CCF consumed monthly replaces the special revenue regulatory tax previously paid by natural gas companies. The special revenue regulatory tax previously paid by electricity companies is replaced with an electric utility consumption tax as follows:

| <u>Monthly Consumption</u> | <u>Tax Rate</u> |
|--|-----------------------------|
| 2,500 kilowatt hours or less | \$0.00015 per kilowatt hour |
| More than 2,500 but not in excess of 50,000 kilowatt hours | \$0.00010 per kilowatt hour |
| More than 50,000 kilowatt hours | \$0.00007 per kilowatt hour |

- The SCC is authorized to reduce the electricity and natural gas consumption tax rates relating to the special regulatory revenue tax.

Increasing the Personal and Dependent Exemptions

Revenue Impact (millions of dollars)

| Exemption | Fiscal Years | | | |
|-----------|--------------|---------|---------|---------|
| | 2004 | 2005 | 2006 | 2007 |
| \$900 | -14.24 | -28.48 | -28.07 | -28.11 |
| \$1,000 | -28.46 | -56.91 | -56.08 | -56.18 |
| \$1,100 | -42.65 | -85.29 | -84.06 | -84.22 |
| \$1,200 | -56.81 | -113.61 | -111.97 | -112.22 |
| \$1,300 | -70.93 | -141.87 | -139.85 | -140.17 |
| \$1,400 | -85.01 | -170.06 | -167.67 | -168.06 |
| \$1,500 | -99.05 | -198.17 | -195.44 | -195.92 |
| \$1,600 | -113.06 | -226.23 | -223.16 | -223.72 |
| \$1,700 | -127.03 | -254.21 | -250.81 | -251.48 |
| \$1,800 | -140.95 | -282.12 | -278.41 | -279.18 |
| \$1,900 | -154.84 | -309.96 | -305.94 | -306.82 |
| \$2,000 | -168.69 | -337.73 | -333.40 | -334.41 |
| \$2,100 | -182.49 | -365.40 | -360.79 | -361.94 |
| \$2,200 | -196.24 | -392.99 | -388.12 | -389.41 |
| \$2,300 | -209.95 | -420.48 | -415.38 | -416.83 |
| \$2,400 | -223.61 | -447.89 | -442.55 | -444.17 |
| \$2,500 | -237.23 | -475.20 | -469.64 | -471.45 |

* The assumed effective date is Taxable Year 2004.

* The current personal and dependent exemptions are \$800.

* These estimates do not include increases in the age and blind exemption amounts.

**A PRESENTATION TO THE
HOUSE FINANCE SPECIAL
STUDY COMMITTEE
STUDYING SALES AND USE
TAX EXEMPTIONS**

**ANALYSIS OF
SALES AND USE
TAX EXEMPTIONS
IN VIRGINIA**



**VIRGINIA DEPARTMENT
OF TAXATION**

February 27, 2002

Presented by:

**Janie E. Bowen
Executive Tax Commissioner**

**House Finance Special Study Committee
Studying Sales and Use Tax Exemptions
February 27, 2002**

Background

Original Exemptions

- There were 22 exemptions when the sales and use tax first took effect in 1966. (Code of Virginia, 1966)

Exemptions as of July 1, 2001

- As of July 1, 2001, there are 453 exemptions listed in the Code of Virginia (Sections 58.1-609.1 through 58.1-609.10). They are broken out by category in Table 1.

TABLE 1
Number of Exemptions Listed in Code of Virginia
§§ 58.1-609.1 through 58.1-609.10 as of July 1, 2001

| <u>Category</u> | <u>Number of Exemptions</u> |
|--|------------------------------------|
| 1. Government & Commodities | 16 |
| 2. Agricultural | 6 |
| 3. Commercial and Industrial | 13 |
| 4. Education | 40 |
| 5. Services | 9 |
| 6. Media-related | 7 |
| 7. Medical-related | 45 |
| 8. Nonprofit Civic & Community Service | 221 |
| 9. Nonprofit Cultural | 65 |
| 10. Miscellaneous | 31 |
| Total Exemptions | 453 |

House Finance Special Study Committee on
Sales and Use Tax Exemptions
February 27, 2002

Exemptions Added Since 1998

- There have been 152 new exemptions added to the Code of Virginia since July of 1998.
- Table 2 indicates the number of new exemptions in each category by year.
- 80 new exemptions were added in 2000, 71 new exemptions were added in 2001, and 1 new exemption was added in 1999.

TABLE 2
New Exemptions For Years 1999 through 2001 by Category

| Category | 1999 | 2000 | 2001 | TOTAL |
|-------------------------------------|-------------|-------------|-------------|--------------|
| Government and Commodities | 1 | 1 | | 2 |
| Agricultural | - | - | - | - |
| Commercial and Industrial | - | - | - | - |
| Education | - | 3 | 6 | 9 |
| Services | - | - | - | - |
| Media Related | - | - | - | - |
| Medical | | 5 | 8 | 13 |
| Nonprofit Civic & Community Service | | 51 | 35 | 86 |
| Nonprofit Cultural | | 18 | 15 | 33 |
| Miscellaneous | | 2 | 7 | 9 |
| Total Exemptions | 1 | 80 | 71 | 152 |

Trends in Exemptions Enacted Since 1998

- Of the 152 new exemptions added to the Code of Virginia since July of 1998, 86 have been granted to nonprofit organizations in the civic and community service group found in § 58.1-609.8.
- 33 of the remaining new exemptions have been granted to nonprofit organizations in the cultural group found in § 58.1-609.9.
- These two categories make up 78% of the new exemptions enacted in the last 3 years.

Administration of Exemptions by TAX

Reporting Requirement – Existing Exemptions

- The 1999 General Assembly enacted legislation which established a new reporting requirement for nonprofit organizations that were currently exempt from sales and use taxes. Churches were excluded from the new requirement.
- During 2000, all nonprofit organizations qualifying for an existing sales and use tax exemption were required to submit to TAX information relating to the operation and administration of the organization.
- The General Assembly used this information for the first time during the 2001 session when considering whether to extend the expiration, or sunset date, of all nonprofit exemptions in the exemption categories below.
- Tax Bulletin 99-9 was issued by the Department of Taxation to explain the new reporting requirement.
- The legislation created an ongoing filing requirement based on a 5-year cycle set up by exemption categories.
- After the initial filing in 2000, nonprofit organizations in five exemption categories were required to file an updated questionnaire based on a staggered schedule beginning July 1, 2001.

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- The due dates in the schedule require a nonprofit organization to submit a questionnaire in the year before a particular group of exemptions are scheduled to expire. This allows the next General Assembly session to consider extending the exemptions prior to their expiration.
- For example, the educational exemption group is scheduled to expire July 1, 2002. The filing schedule required this group to submit questionnaires by July 1, 2001.
- By law, nonprofit organizations in each exemption group must file a questionnaire by July 1 of the year shown in the schedule. The schedule was set up as follows:

| <u>Exemption Group</u> | <u>Filing Due*</u> |
|--|--------------------|
| Educational (58.1-609.4) | 2001 |
| Medical-Related (58.1-609.7) | 2002 |
| Civic and community service (first half) (58.1-609.8) | 2003 |
| Civic and community service (second half) (58.1-609.8) | 2004 |
| Cultural and Miscellaneous (58.1-609.9, 58.1-609.10) | 2005 |

- The next filing would be due five years from the year shown on the schedule.
- Failure to make a complete and timely submission of the required information constitutes grounds for revocation of an organization's exemption by the Department of Taxation.
- TAX must receive the required information and insure that an organization meets certain criteria before issuing an exemption certificate to the organization.
- The new filing requirement expanded existing requirements established by legislation enacted in 1994.

Exemption Certificates – Existing Exemptions

- 1999 legislation required TAX to issue numbered exemption certificates to organizations that had met the filing requirement and whose exemption was extended by the General Assembly.

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- TAX began issuing the exemption certificates in 2001 to be provided to vendors as documentation of the organization's exemption.
- The certificate contains an expiration date that is tied to the filing schedule and expiration date of the organization's exemption.
- For example, certificates issued to exempt organizations in the cultural and miscellaneous exemption groups currently contain an expiration date of July 1, 2006. Updated questionnaires from organizations in these groups are next due by July 1, 2005.
- The exemption certificate is renewed upon receipt of an updated questionnaire and when the sunset date of the exemption is extended by the General Assembly.

Reporting Requirement –New Exemptions

- Nonprofit organizations seeking a *new* exemption are required to submit inform concerning the operation and administration of the organization to TAX by November 1 prior to the session in which exemption legislation would be sought for the organization.

Questionnaires

- To administer the 1994 and 1999 reporting requirements, TAX uses questionnaires to gather the information required by statute.
- Separate questionnaires are used for new exemption requests and for existing exemptions.
- Both new and existing nonprofit organizations are required to provide the same information and meet the same criteria to qualify for exemption.

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- Information about nonprofit organizations' operations and administration must be provided in the questionnaires, including:
 - Estimates of annual sales and use tax savings from the exemption,
 - Beneficiaries of the exemption,
 - Charitable purposes of the organization,
 - Salary and other financial information, and
 - Names and addresses of a volunteer board of directors, etc.
- To qualify for exemption, nonprofit organizations must meet the following criteria:
 - Be exempt from federal income taxation under 501(c)(3) or 501(c)(4) of the Internal Revenue Code;
 - Spend no more than 40% of the organization's gross annual revenue on general administration, including salaries and fundraising;
 - Be in compliance with the charitable solicitation requirements of Title 57, Chapter 5; and
 - Be used only for purchases of tangible personal property by the organization.

Notification

- TAX notifies by letter those nonprofit organizations that are required to submit updated information in accordance with the filing schedule established in 1999.
 - This allows those organizations time to prepare and file the questionnaire that is provided with the letter prior to the organization's filing deadline.
- The department reviews the information for completeness and sends a follow-up letter to organizations that have not provided all the information required on the questionnaire.

Certification for New Exemptions

- General Assembly members intending to patron a bill establishing or expanding an exemption in one of the 5 exemption categories must submit the information questionnaire to TAX by the November 1 preceding the next regular session.
- By January 5 of each year, TAX certifies to the Division of Legislative Services those nonprofit organizations that will have sales tax exemption legislation introduced in the next General Assembly session and have met the information filing requirements.
- The organization and the patron of the exemption are notified by letter that the department has received and reviewed the questionnaire. The organization is also notified of any missing or incomplete information on the questionnaire.

Revenue Impact

Process for Calculating Revenue Impact

- TAX maintains a database of nonprofit organizations that benefit from sales and use tax exemptions, and which have supplied information on sales and purchases that are exempt from taxation.
- The database was used to estimate the revenue impact of repealing the exemptions for these organizations.
- Information provided by each organization includes up to three years of survey data indicating the level of purchases or sales for each organization.
- Applying the state and local sales tax rates to the average total purchases and sales yields the average sales tax for each organization.
- Since the data is centered around FY 1999, the average sales tax is inflated by the official state forecast of the Consumer Price Index to obtain FY 2003 and FY 2004 estimates.

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Revenue Impact of Nonprofit Exemptions

- Table 3 shows the estimated revenue impact of the exemption for nonprofits in each group of sales and use tax exemptions.
- For all groups, the exemptions would reduce total state and local revenue by an estimated \$64.2 million for FY 2003 and \$72.2 million for FY 2004, based on information supplied by organizations in the database.

TABLE 3

**Estimated Revenue Impact of Repealing Nonprofit
Sales and Use Tax Exemptions**

| <u>Code Section</u> | <u>Category</u> | <u>Number of Organizations</u> | <u>Millions FY 2003</u> | <u>FY2004</u> |
|---------------------|-------------------------------------|------------------------------------|-----------------------------|---------------|
| 58.1-609.4 | Educational | 190 | \$6.76 | \$7.60 |
| 58.1-609.7 | Medical-related | 234 | 49.18 | 55.31 |
| 58.1-609.8 | Nonprofit Civic and Community | 975 | 7.09 | 7.97 |
| 58.1-609.9 | Nonprofit Cultural Organizations | 85 | 0.85 | 0.96 |
| 58.1-609.10 | Miscellaneous | <u>104</u> | <u>0.31</u> | <u>0.35</u> |
| TOTALS | | 1,588 | \$64.19 | \$72.20 |

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Revenue Impact of All Exemptions

- Appendix 1 contains data from a 1998 report to the House Finance Subcommittee Studying Sales and Use Tax Exemptions.
- The Appendix provides estimates of the FY 1999 revenue impact of repealing certain sales tax exemptions.
- For most exemptions, the estimates were based on data from the sales and use tax expenditure studies completed in the early 1990's adjusted for inflation and population growth.
- Legislative fiscal impact statements were used to produce estimates for those exemptions enacted since the expenditure study process ended in 1995.
- For all categories, the revenue gain totaled \$3.6 billion for FY 1999.

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

| | Revenue Impact FY 1999 (Millions) |
|--|---|
| Group 1 Government and Commodities Exemptions | |
| Motor Vehicle Fuels | \$202.376 |
| Motor Vehicles | \$562.082 |
| Gas, Electricity and Water | \$246.646 |
| Federal, State and Local Governments | \$85.433 |
| Aircraft | \$3.329 |
| Motor Fuels for Use in Boats and Ships | \$0.042 |
| Sales of Official Flags | minimal |
| State Board of Elections | minimal |
| Watercraft | \$7.767 |
| Virginia Port Authority | \$0.555 |
| Sales of Artwork by Prisoners | minimal |
| Department of Visually Handicapped | minimal |
| Virginia Veterans Care Center | \$0.001 |
| Community Diversion Programs | unknown |
| Total | \$1,108.230 |

Although a total impact of these sales tax exemptions is reported above, the user should be cautious with this interpretation. An effort has been made to mitigate the effect of overlapping exemptions, but there is still a substantial variance associated with multiple counting of overlapping exemptions. The actual revenue gained by repealing all of these exemptions together is likely to be lower than the estimate reported above, and possibly substantially lower.

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

**Revenue Impact
FY 1999
(Millions)**

Group 2 Agricultural Exemptions

| | |
|---|------------------|
| Property Used in Agricultural Production | \$515.926 |
| Processing of Agricultural Commodities | \$0.000 |
| Products Consumed by Farmers | \$0.777 |
| Commercial Watermen | \$1.110 |
| Feed Making | \$0.000 |
| Harvesting of Forest Products | \$2.552 |
| Total | \$520.364 |

Although a total impact of these sales tax exemptions is reported above, the user should be cautious with this interpretation. An effort has been made to mitigate the effect of overlapping exemptions, but there is still a substantial variance associated with multiple counting of overlapping exemptions. The actual revenue gained by repealing all of these exemptions together is likely to be lower than the estimate reported above, and possibly substantially lower.

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Revenue Impact of Repealing Certain Sales Tax Exemptions

| | Revenue Impact FY 1999 (Millions) |
|---|---|
| Group 3 Commercial and Industrial Exemptions | |
| Contractor's Temporary Storage | \$0.078 |
| Manufacturing | \$315.067 |
| Public Service Corporations | \$153.467 |
| Ships and Vessels | \$8.776 |
| Research and Development | \$12.093 |
| Airlines | \$39.169 |
| Meals Furnished to Employees | \$6.742 |
| Laundry and Linen Processors | \$1.712 |
| Pollution Control Equipment | \$5.244 |
| Taxicab Parts | \$0.533 |
| Electrostatic Duplicators | \$0.265 |
| Gas and Oil Production | \$0.000 |
| Virginia Commercial Space Flight Authority | \$0.359 |
| Expand to Transport Vessels | \$0.026 |
| Total | \$543.531 |

Although a total impact of these sales tax exemptions is reported above, the user should be cautious with this interpretation. An effort has been made to mitigate the effect of overlapping exemptions, but there is still a substantial variance associated with multiple counting of overlapping exemptions. The actual revenue gained by repealing all of these exemptions together is likely to be lower than the estimate reported above, and possibly substantially lower.

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

| | Revenue Impact FY 1999 (Millions) |
|---|---|
| Group 4 Educational Exemptions | |
| School Lunches and Textbooks | \$9.632 |
| Institutions of Learning | \$31.036 |
| Education for Persons With Mental retardation | \$0.050 |
| Face-to-face Educational Programs | \$0.268 |
| Reading is Fundamental Programs | unknown |
| Boarding/Day School for the Handicapped | \$0.000 |
| Law Enforcement Educational Programs | minimal |
| School Fund Raising Activities | \$10.916 |
| Specific Day care Centers | \$0.032 |
| County Public Libraries and Recreational Centers | minimal |
| Public Library Associations | \$0.007 |
| Free Enterprise Educational Programs | minimal |
| Art Education Organizations | \$0.004 |
| City Public Library "Friends" Organizations | minimal |
| Organizations Combating Illiteracy | \$0.001 |
| Fund Raising Organizations Assisting Public Libraries | minimal |
| Services for At-Risk Youth | \$0.002 |
| Advocacy Organizations for the Hearing Impaired | minimal |
| Organizations Promoting Highway Safety | \$0.032 |
| | |
| Organization operating a school for Christian Studies | \$0.001 |
| Organization in Tidewater region providing preschool education to children of parents pursuing self-sufficiency | \$0.000 |
| Organization to develop pool of data processing professionals, training, and college scholarships | \$0.001 |
| | |
| An organization that conducts & publishes research for public school improvement | unknown |
| Telecommunications networks & classrooms in Va schools | \$0.010 |
| Organizations with reading education programs | \$0.001 |
| Organizations in the Tenth Planning District with Annual Science Fair and Scientific Investigation | minimal |
| Organizations that Provide Residential & Educational Services for Abused Children, and Head Start | \$0.005 |
| Organizations that Educate About Animal Agriculture | \$0.001 |
| Organizations Promoting Vocational-Technical Education in the Public Schools | \$0.004 |

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

| | Revenue Impact FY 1999 (Millions) |
|--|--|
| Group 4 Educational Exemptions (Continued) | |
| Include all Illiteracy Programs | \$0.023 |
| Expand to include food purchased for free distribution | \$0.483 |
| Consortium of black colleges | \$0.002 |
| Total | \$52.510 |

Although a total impact of these sales tax exemptions is reported above, the user should be cautious with this interpretation. An effort has been made to mitigate the effect of overlapping exemptions, but there is still a substantial variance associated with multiple counting of overlapping exemptions. The actual revenue gained by repealing all of these exemptions together is likely to be lower than the estimate reported above, and possibly substantially lower.

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

**Revenue Impact
FY 1999
(Millions)**

Group 5 Selected Service Exemptions

| | |
|--|-----------|
| Accountants | \$23.600 |
| Engineers | \$108.400 |
| Health Professionals | \$253.500 |
| Land Surveying | \$7.900 |
| Legal | \$71.300 |
| Bank Service Charges | \$18.300 |
| Nonbank Service Charges | \$0.400 |
| Safe Deposit Box Rentals | \$0.500 |
| Insurance Premiums | \$244.200 |
| Barber/Beauty Shops | \$19.800 |
| Carpet and Upholstery Cleaning | \$1.400 |
| Funeral Services | \$9.100 |
| Laundry and Dry Cleaning | |
| Coin Operated | \$2.600 |
| Non-Coin Operated | \$13.200 |
| Horse Boarding | \$0.400 |
| Pet Grooming and Training | \$0.900 |
| Tax return Preparation (for individuals) | \$1.800 |
| Armored Car/Detective Services | \$12.400 |
| Collection Services | \$2.300 |
| Credit reporting | \$2.300 |
| Janitorial and Building Maintenance | \$26.200 |
| Landscaping and Lawn Care | \$20.300 |
| Parking | \$6.900 |
| Pest Control/Disinfecting | \$5.200 |
| Security System Services | \$4.400 |
| Telephone Answering Services | \$1.800 |
| Appliance Repair | \$0.000 |
| Automotive Repair | \$0.000 |
| Auto Washing | \$0.000 |
| Shoe Repair | \$0.000 |
| Watch, Clock and Jewelry Repair | \$0.000 |
| 800 Number Service | \$0.800 |
| Cable and Other Pay TV | \$25.100 |

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

| | Revenue Impact FY 1999 (Millions) |
|--|---|
| Group 5 Selected Service Exemptions (Continued) | |
| Cellular Telephone | \$7.300 |
| Interstate Calls | \$64.900 |
| Intrastate Calls | \$71.700 |
| Household Goods Storage | \$0.400 |
| Travel Arrangements/Services | \$3.100 |
| Cold Storage | \$1.600 |
| Amusement Parks | \$4.900 |
| Auto Racing Events | \$0.500 |
| Movie Theaters | \$5.100 |
| Bowling Alleys | \$2.600 |
| Labor Charges | minimal |
| Transportation Charges | \$0.647 |
| Alteration Charges | \$0.013 |
| Gift Wrapping | minimal |
| Computer Software Modifications and Custom Programs | \$68.889 |
| Transient Accommodations | minimal |
| Repair & Replacement Parts in Maintenance Contracts | |
| Total | \$1,116.649 |

Although a total impact of these sales tax exemptions is reported above, the user should be cautious with this interpretation. An effort has been made to mitigate the effect of overlapping exemptions, but there is still a substantial variance associated with multiple counting of overlapping exemptions. The actual revenue gained by repealing all of these exemptions together is likely to be lower than the estimate reported above, and possibly substantially lower.

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

**Revenue Impact
FY 1999
(Millions)**

Group 6 Media Related Exemptions

| | |
|---|-----------------|
| Motion Picture Film Leasing | \$2.201 |
| Broadcast Equipment | \$3.108 |
| Publications | \$10.618 |
| Catalogs | \$3.237 |
| Advertising | minimal |
| Book publishing facility that distributes books free of charge to educators | \$0.107 |
| Delete video dialtone systems, add open video, wireless cable | unknown |
| Tapes/Production Svcs/AudioVisual | \$0.323 |
| Common Carrier Broadcasting Equipment | unknown |
| Advertising Definition | unknown |
| Back Copy Sales | minimal |
| out-of-state business purchases of printed materials | unknown |
| Total | \$19.595 |

Although a total impact of these sales tax exemptions is reported above, the user should be cautious with this interpretation. An effort has been made to mitigate the effect of overlapping exemptions, but there is still a substantial variance associated with multiple counting of overlapping exemptions. The actual revenue gained by repealing all of these exemptions together is likely to be lower than the estimate reported above, and possibly substantially lower.

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

Revenue Impact
FY 1999
(Millions)

Group 7 Medical Related Exemptions

| | |
|---|----------|
| Prescription and Controlled Drugs | \$77.312 |
| Nonprescription Drugs* | \$17.500 |
| Medical Equipment | \$5.089 |
| Dialysis Equipment and Supplies | \$0.973 |
| Motor Vehicle Equipment for the Disabled | \$0.007 |
| Typewriters/Computers for the Disabled | unknown |
| Hospitals and Nursing Homes | \$58.316 |
| Community Health Centers | \$0.067 |
| HMOs | \$0.091 |
| Free Health Clinics | \$0.012 |
| Hospital Cooperatives | \$0.117 |
| Ronald McDonald Houses | \$0.006 |
| Easter Seal Society | \$0.024 |
| Blood Pressure Centers | minimal |
| Tissue Banks | \$0.300 |
| Organization that provides cancer education, screenings | \$0.013 |
| Organization to assist primary and secondary victims of Alzheimer's disease | \$0.000 |
| Organization to provide breast cancer support and outreach for medically underserved | \$0.000 |
| Organization for citizen's research, prevention detection, diagnosis & treatment of kidney disease | \$0.004 |
| Organizations Facilitating Health Services to Children in Poverty | \$0.003 |
| Organizations Researching Treatment & Prevention of Birth Defects | \$0.005 |
| Organizations Promoting Health Care & Health Care Education in Roanoke Valley | \$0.001 |
| Organization to Provide Dental Services with the Eighth Planning District | \$0.001 |
| Increased health care established at the initiative of the General Assembly & Joint Commission on Health Care | \$0.001 |

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

**Revenue Impact
FY 1999
(Millions)**

Group 7 Medical Related Exemptions (Continued)

| | |
|--|------------------|
| Include Samples of non-prescription drugs & medicines distributed free of charge by the manufacturer | unknown |
| Faculty Services at Medical Colleges | \$0.093 |
| Prescription drug samples | unknown |
| Medical Airlift | \$0.010 |
| Free Medical Clinic | \$0.020 |
| Organization for Services to Child Abuse Victims | unknown |
| Organization for Medical & Psycho-Social treatment in the Fifteenth Planning District | \$0.007 |
| Medicaid Recipient Supplies | \$0.152 |
| Practitioner/Assistant Prescriptions | \$0.000 |
| Volunteer medical services orgs. | \$0.011 |
| Leukemia | unknown |
| Tissue Bank | unknown |
| Controlled drugs used in corporation physician practice | unknown |
| Total | \$160.137 |

Although a total impact of these sales tax exemptions is reported above, the user should be cautious with this interpretation. An effort has been made to mitigate the effect of overlapping exemptions, but there is still a substantial variance associated with multiple counting of overlapping exemptions. The actual revenue gained by repealing all of these exemptions together is likely to be lower than the estimate reported above, and possibly substantially lower.

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

Revenue Impact
FY 1999
(Millions)

Group 8 Nonprofit Civic and Community Service Exemptions

| | |
|--|---------|
| Churches | \$6.790 |
| Volunteer Fire and Rescue Squads | \$1.103 |
| REACT Teams | minimal |
| Nutrition Programs | \$0.240 |
| Food Banks | \$0.032 |
| Humane Societies | \$0.047 |
| Wildlife Federation | minimal |
| Donated Property | \$0.013 |
| Homeless Shelters | \$0.106 |
| Christmas Mothers | \$0.004 |
| Group Homes for Children | \$0.055 |
| Foster Care Associations | \$0.068 |
| Head Start Programs | \$0.013 |
| Community Action Agencies | \$0.658 |
| Homes for Adults | \$0.740 |
| Women's Centers | \$0.008 |
| Physical Education Programs | \$0.006 |
| Youth Programs | minimal |
| Traveler's Guide Society | minimal |
| Traveler's Aid | \$0.008 |
| Homeless Aid | \$0.018 |
| Assistance to the Mentally Retarded | \$0.002 |
| Girl and Boy Scout Organizations | \$0.429 |
| Heart Organizations | \$0.054 |
| Lung Organizations | \$0.010 |
| Diabetes Organizations | \$0.031 |
| Cancer Organizations | \$0.079 |
| Lions Club | \$0.114 |
| | |
| The Garden Club of Virginia | \$0.006 |
| Community Centers | minimal |
| Kiwanis Clubs | \$0.000 |
| Rehabilitation of Adolescent Substance Abusers | \$0.011 |
| Conservation of Marine Resources | \$0.000 |
| Robotics Education and Technology | \$0.000 |
| Therapeutic Horseback Riding | \$0.000 |
| Prevention and Treatment of Addictive Diseases | \$0.001 |
| Community Service to Children | \$0.000 |
| Education of Disabled | minimal |
| Housing for Low Income Families | \$0.001 |
| Training in Christian Character | \$0.000 |

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

Revenue Impact
FY 1999
(Millions)

Group 8 Nonprofit Civic and Community Service Exemptions (Continued)

| | |
|--|---------|
| Charitable Foundation | \$0.020 |
| Support for Virginia Rehabilitation Center for the Blind | \$0.000 |
| Domestic Violence Task Forces | \$0.000 |
| Mental Retardation Organizations | \$0.001 |
| Desert Storm Veterans | \$0.000 |
| Legal Assistance to Low Income Taxpayers | \$0.000 |
| Education on James River Watershed | minimal |
| Advocacy of Traffic Safety | \$0.001 |
| 4-H Educational Centers | \$0.011 |
| Treatment of Substance Abuse | \$0.003 |
| Emergency Assistance to Children | \$0.003 |
| Promotion of Downtown Areas | minimal |
| Missionary Outreach to West Africa | \$0.000 |
| Protection of Chesapeake Bay | \$0.003 |
| English Speaking Union | \$0.000 |
| Care of Low Income Children | \$0.001 |
| Improvement of Employment Opportunities for the Blind | \$0.009 |
| Promotion of Central Business District | minimal |
| Baseball Boosters | \$0.001 |
| Recreational Opportunities for Youth | \$0.003 |
| Chapel Foundation | \$0.015 |
| Provision of Low Income Housing | \$0.000 |
| Crisis Intervention Hotline | \$0.001 |
| Environmental Education | \$0.003 |
| Treatment of Substance Abuse | \$0.005 |
| Mutual Aid and Service Organizations | \$0.000 |
| Military-Related Toy Distribution Organizations | \$0.006 |
| Youth Development Programs | \$0.003 |
| Half-Way Houses for Non-Violent Offenders | \$0.003 |
| Shenandoah River Education and Preservation | \$0.001 |
| Eighth District Home Rehabilitation Programs | \$0.002 |
| Public Library Support | \$0.003 |
| Community Residences | \$0.015 |
| Emergency Financial Assistance Organizations | minimal |
| Community Bible Study | \$0.014 |
| State River and National Forest Road Maintenance | \$0.001 |
| Residential Youth Substance Abuse Centers | \$0.001 |
| Jewish Community and Service Organizations | \$0.002 |
| Fund Raisers for Residential Special Needs Centers | minimal |
| Swamp Wilderness Protection Organizations | minimal |

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

Revenue Impact
FY 1999
(Millions)

Group 8 Nonprofit Civic and Community Service Exemptions (Continued)

| | |
|---|----------------|
| Support for Families of Autistic Children | minimal |
| Sixteenth District Mental Retardation Support Organizations | \$0.000 |
| Clothing Donation Organizations | \$0.000 |
| Amateur Hockey Promotion | \$0.000 |
| Providers of Day Care to Low-Income Children | \$0.002 |
| Support for Individuals with Physical, Mental or Social Needs | minimal |
| Providers of Cash Rewards for Crime Tips | minimal |
| Free Camps for Disadvantaged Children | \$0.002 |
| United Jewish Appeal Support Organizations | \$0.001 |
| Environmental Promotion and Education Organizations | \$0.001 |
| Housing and Support Services for the Low-Income Disabled | \$0.001 |
| Organizations Granting Wishes to Ill Children | \$0.009 |
| Financial and Social Support Services for the Poor | \$0.001 |
| Support Services for Low-Income Families | \$0.000 |
| Personal Development Programs for School Age Girls | \$0.002 |
| Support Services for the Disabled | \$0.001 |
| Providers of Alcohol Education and Al-Anon Support | \$0.009 |
| Fundraising for nonprofit member agencies | \$0.033 |
| Tenth District Child Care Scholarship Organizations | minimal |
| Twenty-third District Drug, Alcohol, and Crime Programs | \$0.006 |
| Providers of Food in Exchange for Community Service | \$0.074 |
| Volunteer Community Improvement Groups | \$0.000 |
| Family Service Organizations | \$0.020 |
| Athletic Programs for the Mentally Retarded | \$0.045 |
| Fifteenth District Youth Athletic Organizations | \$0.000 |
| Twenty-third District Technology Access for the Disabled | \$0.000 |
| Advocates for Abused and Neglect Children in Court | \$0.001 |
| Nineteenth District Assistance Programs for Needy | \$0.001 |
| Organizations that Fund Nonprofit Member Organizations | included above |
| HUD Approved and Financed Meal Programs | \$0.017 |
| Mentoring Programs for At-Risk Youth | \$0.007 |
| Assistance to Elementary and Secondary Schools | \$0.005 |
| Wheelchair Athletic Programs | minimal |
| Independent Living Services for the Disabled | \$0.007 |
| Non-Denominational Religious Outreach Programs | \$0.002 |
| Fifth District Youth Softball Leagues | \$0.001 |
| Eighteenth District Housing Assistance Programs | \$0.002 |
| Eighteenth District Home Repair Assistance Programs | included above |
| Programs Preparing Students for Agricultural Careers | \$0.265 |

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

Revenue Impact
FY 1999
(Millions)

Group 8 Nonprofit Civic and Community Service Exemptions (Continued)

| | |
|--|--------------|
| Fundraising Receptions for Charities | \$0.001 |
| Multiple Sclerosis Research and Patient Assistance | \$0.012 |
| Organizations Providing Free Meals in Lynchburg | minimal |
| Third District Independent Living Programs | \$0.001 |
| Eleventh District Summer Camps for Mentally Handicapped | \$0.005 |
| Environmental Restoration Programs | unknown |
| Eleventh District Family Counseling Services | \$0.001 |
| Eighth District Housing for Low-income, Elderly & Disabled | \$0.005 |
| Twenty-third District Employment and Training Programs | \$0.009 |
| Twenty-third District Child Care for Lower Income Families | \$0.014 |
| Eighth District Community Service Organizations | \$0.000 |
| Twenty-first District Counseling and Education Programs | \$0.007 |
| Eighth District Housing and Services for the Mentally Ill | \$0.004 |
| Organizations Providing Food, Clothing & Shelter | \$0.017 |
| Fifteenth District Family Services | \$0.046 |
| Expand fire dept., rescue squad, auxiliary | \$0.001 |
| All IRC Section 501(c)(4) | \$0.000 |
| Total | \$11.414 |

Although a total impact of these sales tax exemptions is reported above, the user should be cautious with this interpretation. An effort has been made to mitigate the effect of overlapping exemptions, but there is still a substantial variance associated with multiple counting of overlapping exemptions. The actual revenue gained by repealing all of these exemptions together is likely to be lower than the estimate reported above, and possibly substantially lower.

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

| | Revenue Impact FY 1999 (Millions) |
|---|---|
| Group 9 Nonprofit Cultural Organization Exemptions | |
| Historical Society | \$0.002 |
| Fine Arts/Science-Technology Museum | \$0.045 |
| Public Park and Museum | \$0.012 |
| American Indian Heritage Foundation | minimal |
| Chief Justice Memorial | minimal |
| Black History Museum | minimal |
| Live Music Performance Group | minimal |
| Children's Museum | minimal |
| Ecological Associations | \$0.063 |
| Botanical Garden | \$0.022 |
| Roanoke Valley Art Organizations | \$0.005 |
| Community Concert Associations | minimal |
| Fredericksburg Area Museum | \$0.002 |
| Arts and Activities Centers | \$0.000 |
| City History Museum | \$0.000 |
| International Arts Festival | \$0.006 |
| Hampton Roads Area Museum | \$0.001 |
| Museum Association | \$0.003 |
| Virginia Holocaust Museum | minimal |
| Youth Symphony Orchestras | \$0.000 |
| Fine and Performing Arts Promotion Organizations | \$0.020 |
| Performing Arts Organizations | \$0.008 |
| Historic Building Reconstruction and Preservation | \$0.002 |
| Renovation and Operation of Civil War Site and Museum | \$0.003 |
| Israeli-U S Physician Exchange Program | \$0.003 |

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

**Revenue Impact
FY 1999
(Millions)**

Group 9 Nonprofit Cultural Organization Exemptions (Continued)

| | |
|--|----------------|
| Jewish Community Organizations | \$0.017 |
| Commemoration of Virginia's Statute for Religious Freedom | \$0.001 |
| Contemporary American and English Theater Production | \$0.000 |
| Genealogical and Historical Research Organizations | \$0.004 |
| Fourth District Summer Musical Production | \$0.001 |
| Organization to Operate and Preserve Mount Vernon | \$0.029 |
| Total | \$0.248 |

Although a total impact of these sales tax exemptions is reported above, the user should be cautious with this interpretation. An effort has been made to mitigate the effect of overlapping exemptions, but there is still a substantial variance associated with multiple counting of overlapping exemptions. The actual revenue gained by repealing all of these exemptions together is likely to be lower than the estimate reported above, and possibly substantially lower.

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

**Revenue Impact
FY 1999
(Millions)**

Group 10 Miscellaneous Exemptions

| | |
|--|----------|
| Heating Fuels | \$17.198 |
| Occasional Sales | unknown |
| Leasebacks | \$3.748 |
| Interstate Commerce/Export Factor | unknown |
| Boy Scout Jamboree | \$0.000 |
| Food Stamps/WIC Vouchers | \$25.411 |
| Organization operating a nonprofit swim team | minimal |
| Organization promoting long-distance running | \$0.000 |
| Organization for boys' baseball | \$0.000 |
| Organization promoting sportsmanship through soccer | \$0.000 |
| Organization to promote region of Civil War activities | minimal |
| Organization receiving fund from specified government sources, fostering economic development | \$0.003 |
| Expand exemption for little-league type baseball-softball and remove exemption for tangible personal property sold by such organizations | \$0.140 |
| Promote private sector development of Romania and carry out Support for East European Democracy Act 1989 | \$0.003 |
| Organization for Social Welfare and Defend Human Rights of Persons Born and Unborn | \$0.016 |
| Livestock auction sales proceeds distributed to contestants | \$0.002 |
| Little league type baseball & softball in the Second Planning District | unknown |
| Professional's Provision of original, revised, edited, Reformatted or Copied documents to clients or third parties | unknown |
| Veterans Associations Providing Scholarships, Life Insurance, and Loans to Coast Guard members who have lost their jobs | \$0.000 |

APPENDIX 1

Revenue Impact of Repealing Certain Sales Tax Exemptions

| | Revenue Impact FY 1999 (Millions) |
|--|--|
| Group 10 Miscellaneous Exemptions (Continued) | |
| Electronic Securities Information | \$0.020 |
| Construction Property | \$0.109 |
| Medical Records Copies | unknown |
| Property for Disaster Victims | unknown |
| Total | \$46.652 |
| Total for all Categories | \$3,579.331 |

* Nonprescription Drug exemption went into effect July 1, 1998.

Although a total impact of these sales tax exemptions is reported above, the user should be cautious with this interpretation. An effort has been made to mitigate the effect of overlapping exemptions, but there is still a substantial variance associated with multiple counting of overlapping exemptions. The actual revenue gained by repealing all of these exemptions together is likely to be lower than the estimate reported above, and possibly substantially lower.

APPENDIX 2

Filing Procedures for New Exemptions and Extending Existing Exemptions

Tax Bulletins 94-13 & 99-9

Virginia Tax Bulletin

Virginia Department of Taxation

June 18, 1999

99-9

RETAIL SALES AND USE TAX: NEW FILING REQUIREMENT FOR NONPROFIT ORGANIZATIONS EXEMPT FROM THE TAX

The 1999 General Assembly passed legislation (Senate Bill 829, Chapter 762, 1999 Acts of Assembly and House Bill 1571, Chapter 776, 1999 Acts of Assembly) which establishes a new reporting requirement for nonprofit organizations exempt from the sales and use tax. Churches are excluded from the new requirement. The legislation also establishes a June 30, 2001, sunset date for existing nonprofit organization exemptions that currently do not have a sunset date.

Filing Requirement - Nonprofit Organizations Exempt From Sales and Use Tax

By July 1, 2000, all nonprofit organizations that have qualified for a sales and use tax exemption, except churches, are required to submit to the Department of Taxation updated information relating to the operation and admission of the organization. The General Assembly will use this information when considering whether to extend the exemptions due to expire in a particular year.

Information to be Filed With the Department of Taxation:

- An estimate of the annual state and local tax savings as a result of the exemption.
- Beneficiaries of the exemption.
- Direct or indirect local, state or federal government assistance received by the organization.
- Extent to which the organization is exempt from the retail sales and use tax in other states.
- Any external statutory constitutional or judicial mandates in favor of the exemption.
- Other state taxes to which the organization is subject.
- Similar organizations which are not entitled to the sales and use tax exemption.
- Certification of exemption from federal income taxation under either § 501 (c)(3) or § 501 (c)(4) of the Internal Revenue Code.
- The purpose or purposes for which the entity is organized and operated and the charitable functions and services it offers to Virginia citizens, along with an explanation of such services.

- Proof that no more than forty percent of the organization's gross annual revenue, under general accepted accounting principles, is spent on general administration and fundraising (e.g., Form 990).
- The location of the organization's detailed financial records available for public inspection and certification that the records are true, accurate, and complete. Salaries, including all benefits, or the five most highly compensated employees.
- Proof of compliance with Chapter 5 of Title 57 (relating to solicitation of contributions) from organizations subject to it; and
- Names and addresses of a volunteer board of directors.

Questionnaire to Assist Nonprofit Organizations in Complying with Filing Requirement

The department plans to develop a questionnaire and instructions for use by nonprofit organizations to fulfill the new filing requirement:

After the initial July 1, 2000 filing, the Department of Taxation will issue a numbered exemption certificate to organizations that have met the filing requirements discussed above and whose exemption has been extended by the 2001 General Assembly. The exemption certificate will be issued prior to June 30, 2001. Qualifying organizations will then provide the exemption number to vendors when making purchases exempt from sales and use tax. The exemption certificate will expire in accordance with the filing schedule below, and each organization's exemption certificate will be renewed when the updated information is filed and the exemption statute is extended by the General Assembly.

Ongoing Filing Requirement

After the initial filing on July 1, 2000, exempt nonprofit organizations will be required to file updated information with the Department of Taxation on a five-year cycle using the following schedule.

| <u>Exemption Group</u> | <u>Filing Due</u> | <u>Next Filing Due</u> |
|--|--------------------------|-------------------------------|
| Educational; (§ 58.1-609.4) | July 1, 2001 | July 1, 2006 |
| Medical-related (§ 58.1-609.7) | July 1, 2002 | July 1, 2007 |
| Civic and community service (§ 58.1-609 Subsections 1-80) | July 1, 2003 | July 1, 2008 |
| Civic and community service (§ 58.1-609 Subsections 81 and higher) | July 1, 2004 | July 1, 2009 |
| Cultural (§ 58.1-609) and Miscellaneous (§ 58.1-609.10) | July 1, 2005 | July 1, 2010 |

Failure to Comply with New Reporting Requirement

The law provides that failure to file complete information with the Department in a timely manner will result in loss of the organization's sales and use tax exemption.

If you have any questions concerning the new filing requirement or related issues, please contact the department's Office of Tax Policy at (804) 367-8010.

Virginia Tax Bulletin

Virginia Department of Taxation

September 30, 1994

94-13

RETAIL SALES AND USE TAX: LEGISLATIVE CONSIDERATION OF EXEMPTION REQUEST

The 1994 General Assembly passed legislation (Senate Bill 148, Chapter 222, 1994 Acts of Assembly establishing new standards and procedures which must be satisfied and followed by organizations seeking exemptions from the sales and use tax. The legislation, effective July 1, 1994, was recommended by the Joint Subcommittee of the Senate and House Finance Committees to Develop Criteria For Evaluating Sales and Use Tax Exemption Requests (SJR 249, 1993 General Assembly).

Information Requirements - Organizations Seeking an Exemption

Formerly, the patron of any legislation seeking a sales and use tax exemption was required to submit information based on various statutory criteria to the Division of Legislative Services prior to consideration of the legislation by the committee.

Under the new law, the patron must submit information to the Department of Taxation (TAX) by November 1 prior to the session in which the exemption is sought.

Nonprofit Organizations

The new law also requires organizations seeking an exemption under the educational (§ 58.1-609.4), medical-related (§ 58.1-609.7), civic and community services (§ 58.1-609.8) and cultural (§ 58.1-609.9) groupings to submit the following additional information relating specifically to the operation and administration of the organization:

1. Documentation indicating exemption from federal income taxation under either § 501 (c)(3) or (4) of the Internal Revenue Code;
2. The charitable purpose of the entry and how those functions or services are provided to Virginia citizens;
3. Documentation that no more than one-third of the organization's gross annual revenue is spent on general administration and fundraising;
4. The location of the organization's financial records and the salaries, including benefits, of the five most highly compensated employees;

5. Proof of compliance with Chapter 5 of Title 57 (Solicitation of Contributions) of the Code of Virginia from organizations subject to it; and
6. The names and addresses of a volunteer board of directors.

For any nonprofit organization granted an exemption under the new information requirements set forth above, Item 3 (relating to general administration and fundraising expenses) constitutes a continued obligation and condition for maintaining tax exempt status. Failure to comply with this requirement to constitute grounds for the revocation of the organization's sales and use tax exemption.

New Questionnaire for Exemption Requests

TAX has developed a questionnaire to assist organizations in satisfying the information requirements set forth above. An organization seeking an exemption should obtain the questionnaire from TAX, complete it, and forward it and the required information to the legislator who will sponsor the bill for exemption. The legislator must sign the questionnaire and submit it and the accompanying documentation to TAX by November 1.

Questionnaires ("Request for Sales and Use Tax Exemption") may be obtained from TAX by calling (804) 367-8010 or by writing to the Department of Taxation, Office of Tax Policy, P. O. Box 1880, Richmond, Virginia 23282-1880. Legislators should forward completed and signed questionnaires to the department's Office of Tax Policy at the above address.

Upon receipt, TAX will review the questionnaire and issue a preliminary determination to the legislator and to the Division of Legislative Services, by January 5, that the organization has furnished all the required information. The Division of Legislative Services may not draft a bill providing for a sales and use tax exemption unless the drafting request is accompanied by TAX's preliminary determination.

Penalty For Failing to Comply with New Reporting Requirements

Effective July 1, 1994, organizations must remain in compliance with all the information requirements noted above. Failure to do so may constitute grounds for revocation of exempt status.

Study of Existing Exemptions - New Information Requirements for Exempt Organizations

Under Va. Code § 30-19.05, the Secretary of Finance is required to investigate and analyze, on an ongoing basis, each category of exemptions set out in Va. Code §§ 58.1-609.1 through 58.1-609.10. A report is due to the House and Senate Finance Committees each year by December 1. Senate Bill 148 requires that the information and questionnaire be updated every five years by the organizations being studied. The information is due to TAX by July 1 prior to the December 1 deadline for the report.

For additional information: Contact the Office of Taxpayer Services, Virginia Department of Taxation, P. O. Box 1115, Richmond, Virginia 23208-1115, (804) 367-8037.

APPENDIX 3

Notification To All Registered Sales Tax Dealers Regarding Exemption Certificates Of Nonprofit Organizations

Issued March 2001

**Notification Statement placed in the March 2001
coupon booklets mailed to registered retailers**

"Effective July 1, 2001, registered dealers should not accept Form ST-13, Sales and Use Tax Certificate of Exemption from exempt nonprofit organizations. In addition, exemption letters previously issued by the department to exempt nonprofit organizations will no longer be valid. The Department of Taxation will issued a numbered exemption certificate to each nonprofit organization exempt from the Virginia retail sales and use tax. In order to make purchases exempt of the sales tax, nonprofit organizations must present a numbered exemption certificate. If the organization does not have a numbered exemption certificate, please advise then to contact the Virginia Department of Taxation, Office of Tax Policy at (804) 367-1530. Additional information regarding this process will be made available on the Virginia Department of Taxation's Web Site at <http://www.tax.state.va.us> by June 15, 2001."

APPENDIX 4

Questionnaire for New Exemptions

VIRGINIA DEPARTMENT OF TAXATION REQUEST FOR SALES AND USE TAX EXEMPTION

Instructions: Sections A, B, C and D must be completed by all organizations seeking an exemption under the educational (§ 58.1-609.4), medical-related (§ 58.1-609.7), civic and community service (§ 58.1-609.8), cultural (§ 58.1-609.9), or miscellaneous (§ 58.1-609.10) categories. If necessary, attach supplemental information to completely answer any question. If you have any questions, please contact the Department of Taxation at (804) 367-1530. The sales and use tax exemption request is applicable only to purchases of tangible personal property by the organization. This is in accordance with Code of Virginia § 30-19.05.

PLEASE PRINT OR TYPE THIS APPLICATION

SECTION A: BUSINESS / ORGANIZATION NAME AND ADDRESS

1. Enter the Legal Business/Organization Name: _____

2. Enter the Physical Address: (the actual physical location of the business/organization)
Street _____
City _____ State _____ Zip _____
3. Enter the name and mailing address of a contact person:
Name _____ Phone _____
Title _____
Street _____
City _____ State _____ Zip _____
***Optional: Please print your electronic mail address and/or fax number, if available:

4. Enter the name of the city or county of the business/organization's physical address: _____
5. Enter the Federal Employer Identification Number (FEIN): _____
6. If registered for other Virginia taxes, enter the Virginia account number and taxes registered for:
Account Number _____ Tax Types _____

Please report address changes to the Department of Taxation. Mail changes to the address appearing on Page 4.

SECTION B: EXEMPTION INFORMATION

1. Please indicate the dollar amount, excluding sales tax, of the taxpayer's purchases of tangible personal property over the last three (3) years. Estimates are acceptable. (Exclude goods for resale, motor vehicles and fuel, services, salaries, insurance, utilities, postage/shipping, rent/mortgage payments, depreciation, and interest charges).

| Year / Period | Annual Purchases Subject to Sales and Use Tax |
|---------------|---|
| | |
| | |
| | |

Please note: if the information is not available for the years shown, please indicate time periods for which this information is available and provide available information. You can include necessary brief clarifications, such as fiscal year end dates, etc.

2. Do you expect purchases to change significantly in the future from what they have been in the recent past? YES___ NO___
If yes, please provide your good faith numeric estimate of such purchases. Remember, this is just your best numeric estimate, your actual future purchases may turn out to be significantly different.

| Year / Period | Annual Purchases Subject to Sales and Use Tax |
|---------------|---|
| | |
| | |
| | |

You can include necessary brief clarifications, such as fiscal year end dates, etc.

3. To your knowledge, are there other organizations that perform a similar function requesting or receiving this exemption? YES___ NO___ DON'T KNOW___ If YES, please list the names of the similar organizations.
4. Please list other states that allow a similar exemption.

5. Do you qualify for other direct or indirect federal, state, or local government grants, subsidies, or appropriations? YES___ NO___ DON'T KNOW___ If YES, please list the source, amount, and time period for the assistance received.

| SOURCE/ TYPE OF FUNDING | AMOUNT | DATE RECEIVED |
|-------------------------|--------|---------------|
| | | |
| | | |

6. Please check the state and local taxes to which you are currently subject. ☐ Corporation/ Individual Income ☐ SCC Gross Receipts ☐ Local Property ☐ Local Business License: List other state and local taxes you are subject to.
7. Are there other criteria, circumstances, or factors, including external statutory, constitutional, or judicial mandates, that should be considered when evaluating this exemption request?

SECTION C: BUSINESS / ORGANIZATION STRUCTURE

YOU MUST ATTACH THE RULING OR OTHER DOCUMENTATION FROM THE INTERNAL REVENUE SERVICE TO INDICATE THAT THE ORGANIZATION IS EXEMPT FROM FEDERAL INCOME TAX UNDER § 501 (c) OF THE INTERNAL REVENUE CODE.

1. Describe the charitable purpose(s) for which the business/organization is organized and operated. Include the charitable functions, organization's activities, and services provided to Virginia citizens. Attach the Articles of Incorporation, Mission Statement, Statement of Purpose or any other appropriate documentation.

2. Is more than 40 percent of the business/organization's gross annual revenue, using generally accepted accounting principles, spent on general administration, including salaries, and fundraising? YES____ NO____ (Attach a financial statement or other proof to verify the 40 percent cost.)

3. List the address, if different from the physical address, where the business/organization's financial records are available for public inspection.

4. List the salaries, including ALL benefits, for the five employees of the business/organization that receive the highest compensation. You do not have to provide the names of the employees.
A. _____
B. _____
C. _____
D. _____
E. _____

5. Is the business/organization's gross annual revenue \$250,000 or greater? YES____ NO____ If YES, you **MUST** attach the most recent financial audit that was performed by an independent Certified Public Accountant.

6. Is the business/organization subject to Chapter 5 (§ 57-48 *et seq.*) of Title 57 of the Code of Virginia, relating to solicitation of contributions? YES____ NO____

If YES, provide proof of compliance with this chapter. Proof of compliance shall be documentation which reflects registration with the Virginia Department of Agriculture and Consumer Services. Charitable organizations that intend to solicit contributions within the Commonwealth may be required to register. Please call 804-371-0392 for information.

7. Does the organization have a volunteer Board of Directors? YES____ NO____ If YES, list the names and addresses of the Directors below.

NAME

ADDRESS

| | |
|-------|-------|
| _____ | _____ |
| _____ | _____ |
| _____ | _____ |
| _____ | _____ |
| _____ | _____ |
| _____ | _____ |
| _____ | _____ |

SECTION D: SIGNATURES

This form must be completed with all required documentation attached, and timely filed in accordance with Code of Virginia § 30-19.05.

WAIVER: The information provided in this request for Sales and Use Tax exemption shall NOT be subject to the secrecy of information provisions of Code of Virginia § 30-28.18 or 58.1-9, or any other secrecy of information provisions thereof, and shall become a part of the public legislative record. However, this information may not be used for any purpose other than as part of the legislative record.

Signature of Delegate/Senator Sponsoring Exemption

Date

Print name of Delegate/Senator Sponsoring Exemption

Date

The undersigned certifies that this organization's financial records are true, accurate, and complete.

Organization's Authorized Representative*

Date

* Required only if exemption applies to one nonprofit organization

MAILING INFORMATION

Send completed form with attachments or change of address to:

Virginia Department of Taxation

Office of Tax Policy

P. O. Box 1880

Richmond, Virginia 23218-1880

or

Virginia Department of Taxation

Office of Tax Policy

2220 West Broad Street

Richmond, Virginia 23220

APPENDIX 5

Questionnaire for Extending Existing Exemptions

VIRGINIA DEPARTMENT OF TAXATION

REQUEST FOR EXTENSION OF SALES AND USE TAX EXEMPTION

Instructions: This form must be completed by all applicants that wish to extend an existing retail sales and use tax exemption under the educational (§ 58.1-609.4), medical-related (§ 58.1-609.7), civic and community service (§ 58.1-609.8), cultural (§ 58.1-609.9), or miscellaneous (§ 58.1-609.10) categories. If necessary, attach supplemental information to completely answer any question. The law provides that failure to file complete and timely information with the department could result in loss of the exemption. If you have any questions, please contact the Department of Taxation at (804) 367-1530.

PLEASE PRINT OR TYPE THIS APPLICATION

SECTION A: BUSINESS / ORGANIZATION NAME AND ADDRESS

1. Enter the Legal Business/Organization Name: _____

2. Enter the Physical Address: (the actual physical location of the business/organization)

Street _____

City _____ State _____ Zip _____

3. Enter the name and mailing address of a contact person:

Name _____ Phone _____

Title _____

Street _____

City _____ State _____ Zip _____

***Optional: Please print your electronic mail address and /or fax number, if available:

4. Enter the name of the city or county of the business/organization's physical address: _____

5. Enter the Federal Employer Identification Number (FEIN): _____

6. If registered for other Virginia taxes, enter the Virginia account number and taxes registered for:

Account Number _____ Tax Types _____

Please report address changes to the Department of Taxation. Use the mailing address on Page 4.

SECTION B: EXEMPTION INFORMATION

1. If the exemption has been granted for purchases, what was the dollar amount, excluding sales tax, of the taxpayer's purchases of tangible personal property over the last three (3) years? Include taxable services, if applicable. Estimates are acceptable. Exclude goods for resale, motor vehicles and fuel, services, salaries, insurance, utilities, postage/shipping, rent/mortgage payments, depreciation, and interest charges.

| Year / Period | Annual Purchases Subject to Sales and Use Tax |
|---------------|---|
| | |
| | |
| | |

Please note: If the information is not available for the years shown, please indicate time periods for which this information is available and provide available information. You can include necessary brief clarifications, such as fiscal year end dates, etc.

2. Do you expect purchases to change significantly in the future from what they have been in the recent past? YES _____ NO _____

3. If the exemption has been granted for sales, what was the dollar amount, excluding sales tax, of the taxpayer's sales of tangible personal property over the last three (3) years? Exclude goods sold for resale, motor vehicles and fuel, services, salaries, insurance, utilities, postage/shipping, rent/mortgage payments, depreciation, and interest charges.

| Year / Period | Annual Sales Subject to Sales and Use Tax |
|---------------|---|
| | |
| | |
| | |

Please note: if the information is not available for the years shown, please indicate time periods for which this information is available and provide available information. You can include necessary brief clarifications, such as fiscal year end dates, etc.

4. Do you expect a significant change to occur to your sales volume? YES _____ NO _____
5. To your knowledge, are there other businesses that perform a similar function requesting or receiving this exemption? YES _____ NO _____ DON'T KNOW _____ If YES, please list the names of the similar businesses.
6. Please list other states that allow a similar exemption.
7. Do you qualify for other direct or indirect federal, state, or local government grants, subsidies, or appropriations? YES _____ NO _____ DON'T KNOW _____ If YES, please list the source, amount, and time period for the assistance received

SOURCE / TYPE OF FUNDING

AMOUNT

DATE RECEIVED

8. Please check the state and local taxes to which you are currently subject. ☐ Corporation: Individual Income ☐ SCC Gross Receipts ☐ Local Property ☐ Local Business License : List other state and local taxes you are subject to.
9. Are there other criteria, circumstances, or factors, including external statutory, constitutional, or judicial mandates, that should be considered when evaluating this exemption request?

SECTION C: BUSINESS / ORGANIZATION STRUCTURE

YOU MUST ATTACH THE RULING OR OTHER DOCUMENTATION TO INDICATE THAT THE BUSINESS IS EXEMPT FROM FEDERAL INCOME TAX UNDER §501 (c) OF THE INTERNAL REVENUE CODE.

1. Describe the charitable purpose(s) for which the business/organization is organized and operated. Include the charitable functions, business activities, and services provided to Virginia citizens. ~~Attach~~ the Articles of Incorporation, Mission Statement, Statement of Purpose or any other appropriate documentation.

2. Is more than 40 percent of the business/organization's gross annual revenue, using generally accepted accounting principles, spent on general administration, including salaries, and fund raising? YES____ NO____ (Attach a financial statement or other proof to verify the 40 percent cost.)

3. List the address, if different from the physical address, where the business/organization's financial records are available for public inspection.

4. List the salaries, including ALL benefits, for the five employees of the business/organization that receive the highest compensation. You do not have to provide the names of the employees.
 - A. _____
 - B. _____
 - C. _____
 - D. _____
 - E. _____

5. Is the business/organization's gross annual revenue \$250,000 or greater? YES____ NO____ If YES, you MUST attach the most recent financial audit that was performed by an independent Certified Public Accountant.

6. Is the business/organization subject to Chapter 5 (§ 57-48 et seq.) of Title 57 of the Code of Virginia, relating to solicitation of contributions? YES____ NO____

If YES, provide proof of compliance with this chapter. (Proof of compliance includes documentation which reflects registration with the Virginia Department of Agriculture and Consumer Services. Charitable organizations which intend to solicit contributions within the Commonwealth may be required to register. Please call 804-371-0392 for information)

7. Does the business/organization have a volunteer Board of Directors? YES____ NO____ If YES, list the names and home addresses of the Directors below.

NAME

ADDRESS

| | |
|-------|-------|
| _____ | _____ |
| _____ | _____ |
| _____ | _____ |
| _____ | _____ |
| _____ | _____ |
| _____ | _____ |

SECTION D: SIGNATURES

This form must be completed with all required documentation attached, and timely filed in accordance with Code of Virginia § 30-19.05.

WAIVER: *The information provided in this request for Sales and Use Tax exemption shall NOT be subject to the secrecy of information provisions of Code of Virginia §§ 30-28.18 or 58.1-3, or any other secrecy of information provisions thereof, and shall become a part of the public legislative record. However, this information may not be used for any purpose other than as part of the legislative record.*

Signature of Delegate/Senator Sponsoring Exemption

Date

Print Name of Delegate/Senator Sponsoring Exemption

The undersigned certifies that this organization's financial records are true, accurate, and complete.

Business Authorized Representative*

Date

*Required only if exemption applies to one business/organization

MAILING INFORMATION

Send completed form with attachments or change of address to:

Virginia Department of Taxation
Office of Tax Policy
P. O. Box 1880
Richmond, Virginia 23218-1880

or

Virginia Department of Taxation
Office of Tax Policy
2220 West Broad Street
Richmond, Virginia 23220



ACCELERATED SALES TAX PAYMENTS

By

Virginia Retail Merchants Association

Budget Language passed in the 2002 session of the General Assembly required dealers who reported taxable sales of \$1.3 million or more for the twelve-month period ending June 30, 2001 to make an accelerated tax payment. Approximately 6,800 dealers reported sales in this range last year.

The new requirement calls for those dealers to make an accelerated payment of their June 2002 tax, in an amount equal to 90% of the tax liability they reported for June 2001. The payment was due on June 25, 2002 for dealers paying by mail and June 30 for dealers who pay electronically. All dealers then filed their June returns on the normal due date, July 22, 2002, and reconciled the accelerated payment with the actual June liability. Accelerated payments not made by the required date were subject to a 6% penalty.

The same language is found in the 2002 – 2004 Budget, therefore dealers have to make similar accelerated payments in June 2003 and June 2004. Similar provisions are expected to be authorized in future General Assembly sessions for each June due to the hole created in the next year's budget. There is no formal phase out in place for this provision only legislative intent to hopefully phase this out beginning in 2006 and to be completed by June 2012.

The acceleration of the sale tax payments generated approximately 118 Million dollars for Fiscal Year 02.

Any questions please contact Laurie Peterson at VRMA 804-649-0789.

CAMPAIGN for TOBACCO-FREE Kids®

RAISING STATE CIGARETTE TAXES ALWAYS INCREASES STATE REVENUES AND ALWAYS REDUCES SMOKING

Over the past decade, many states have raised their cigarette tax rates and, as the economic research predicts, in each of these states the tax increases reduced cigarette consumption below what it would otherwise have been. Every single one of these states also enjoyed increased cigarette tax revenues, despite the related reductions in smoking and cigarette sales. In every state the revenue losses from fewer cigarette sales were more than made up for by the increased state revenues per pack.

Recent State Experiences With Cigarette Tax Increases

| State | Date | Tax Increase Amount (per pack) | New State Tax (per pack) | State Consumption Decline | Nationwide Consumption Decline | Revenue Increase (percent) | New Revenues (millions) |
|---------------|-------|--------------------------------|--------------------------|---------------------------|--------------------------------|----------------------------|-------------------------|
| Alaska | 10/97 | 71¢ | \$1.00 | -13.5% | -4.7% | +202% | \$28.7 |
| California | 1/99 | 50¢ | 87¢ | -18.9% | -6.6% | +90.7% | \$555.4 |
| Hawaii | 7/98 | 20¢ | \$1.00 | -8.1% | -3.4% | +19.9% | \$6.4 |
| Illinois | 12/97 | 14¢ | 58¢ | -8.9% | -4.7% | +19.0% | \$77.4 |
| Maine | 11/97 | 37¢ | 74¢ | -15.5% | -4.7% | +66.7% | \$30.8 |
| Maryland | 7/99 | 30¢ | 66¢ | -16.3% | -3.2% | +52.5% | \$68.0 |
| Massachusetts | 10/96 | 25¢ | 76¢ | -14.3% | -0.9% | +28.0% | \$64.1 |
| Michigan | 5/94 | 50¢ | 75¢ | -20.8% | -0.5% | +139.9% | \$341.0 |
| New Hampshire | 7/99 | 15¢ | 52¢ | -10.4% | -3.2% | +27.1% | \$19.6 |
| New Jersey | 1/98 | 40¢ | 80¢ | -16.8% | -4.7% | +68.5% | \$166.6 |
| New York | 3/00 | 55¢ | \$1.11 | -20.2% | -5.7% | +57.4% | +\$365.4 |
| Oregon | 2/97 | 30¢ | 78¢ | -8.3% | -0.9% | +77.0% | \$79.8 |
| Rhode Island | 7/97 | 10¢ | 71¢ | -1.5% | -1.3% | +16.2% | \$8.6 |
| South Dakota | 7/95 | 10¢ | 33¢ | -5.6% | -1.2% | +40.4% | \$6.1 |
| Utah | 7/97 | 25¢ | 51.5¢ | -25.7% | -1.3% | +71.0% | \$17.6 |
| Vermont | 7/95 | 24¢ | 44¢ | -16.3% | -1.2% | +84.2% | \$11.7 |
| Wisconsin | 11/97 | 15¢ | 59¢ | -6.5% | -4.7% | +25.8% | \$52.9 |

Sources: Orzechowski & Walker, *Tax Burden on Tobacco* (2002) [tobacco-industry funded volume of state tobacco tax data]; state revenue offices. Consumption declines and revenue increases calculated from the last full fiscal year (7/1 to 6/30) before the tax increase to the first full year after the increase. Nationwide consumption declines are for all 50 states and Washington, DC. The power of state tax increases to reduce consumption beyond nationwide trends would be even more apparent if each tax-increase state's declines were compared to the decline (or increase) in consumption among all other states not including the state, itself, and any other state with a concurrent cigarette tax increase. State increases in 2002 by New York, Washington State, Connecticut, Utah, Maryland, Nebraska, Ohio, Illinois, Rhode Island, Louisiana, and Vermont; and in 2001 by Rhode Island, Wisconsin, Arkansas, and Maine are not included above because there is not yet sufficient data to calculate the year-to-year changes.

Cigarette Company False Arguments Against State Tobacco Tax Increases

For over 15 years, economic research studies have consistently documented the fact that cigarette price increases reduce smoking, especially among kids. These studies currently conclude that every 10 percent increase in the real price of cigarettes will reduce the total amount of adult smoking by about four percent and reduce teen smoking by roughly seven percent.¹ In addition, internal tobacco industry documents revealed through the various lawsuits against the cigarette companies show that since at least the early 1980s the

Raising State Cigarette Taxes Always Increases State Revenues

companies have fully understood that cigarette tax increases reduce their sales, especially among kids (their replacement customers).² In fact, the cigarette companies regularly admit that cigarette tax increases reduce cigarette sales in their official filings with the U.S. Securities and Exchange Commission.³ Accordingly, it is not surprising that the companies spend millions of dollars to oppose state cigarette tax increases. But it is surprising that the companies and their allies continue to argue, falsely, that cigarette tax increases will not reduce smoking.

The cigarette companies also falsely argue that cigarette tax increases will not produce substantial amounts of new revenue because they will prompt enormous surges in cigarette smuggling and smoker efforts to evade the higher taxes through cross-border or internet cigarette purchases. Again, it is amazing that the companies and their allies make this argument when (as shown above) *every single state that has significantly increased its cigarette taxes has significantly increased its revenues – despite the lost sales caused by the related smoking declines and despite any associated increases in cigarette smuggling or other tax-avoidance*. Moreover, research shows the cigarette smuggling and tax avoidance are relatively minor problems.

For example, the one of the most recently published scientific research studies on cigarette smuggling found that cigarette smuggling and cross-border cigarette purchases account for no more than about five percent of all cigarette sales.⁴ Similarly, a California study found that soon after the state's 50-cent cigarette-tax increase went into effect in 1999 no more than five percent of all continuing smokers were purchasing cigarettes in nearby states, from Indian reservations or military bases, or via the internet, or were otherwise avoiding the state's cigarette tax.⁵ It also appears that many smokers who initially try to avoid large state cigarette tax increases soon use up their stockpile of cigarettes purchased right before the increase or tire of driving across state border or going to the internet to buy cheaper cigarettes and return to the convenience of normal full-tax purchases in their own state.⁶ Indeed, the vast majority of smokers prefer to buy cigarettes by the pack, but cross-border and internet purchases involve multiple cartons. Depleted pre-increase stockpiles, tax-avoidance fatigue, and the strong appeal of convenient single-pack purchases explain while New York state's taxable pack sales decreased sharply in the year after the state's 55-cent tax increase in March 2000, beyond what consumption declines might explain, they then increased in the following year (despite new consumption-reducing price increases by the cigarette companies).

National Center for Tobacco-Free Kids, June 21, 2002 / Eric Lindblom

For more on tobacco taxes, see the Campaign website at <http://tobaccofreekids.org/reports/prices>

For information on cigarette company involvement in cigarette smuggling, see <http://www.tobaccofreekids.org/research/factsheets/pdf/0044.pdf>

¹ See, e.g., Chaloupka, F., "Macro-Social Influences: The Effects of Prices and Tobacco Control Policies on the Demand for Tobacco Products," *Nicotine & Tobacco Research*, 1999, and other studies at www.tigger.uic.edu/~fjc.

² See, e.g., Philip Morris Executive Jon Zoler, "Handling An Excise Tax Increase," September 3, 1987, PM Bates Number: 2058122240/2241; R.J. Reynolds Executive D. S. Burrows, "Estimated Change In Industry Trend Following Federal Excise Tax Increase," September 20, 1982, RJR Bates Number 500045052/5132; Philip Morris Research Executive Myron Johnston, "Teenage Smoking and the Federal Excise Tax on Cigarettes," September 17, 1981, PM Bates Number: 2001255224/5227.

³ See, e.g., Philip Morris 10-Q SEC report, May 11, 2001; RJR 10-Q report, August 1, 2001; Loews (parent corporation of the Lorillard cigarette company) 10-K Report, March 31, 1999.

⁴ It is also worth noting that any real or imagined problems with smuggling and tax avoidance from New York's tax increase in 2000 were not significant enough to stop the state from increasing its cigarette tax again, by 39 cents, in 2002, to \$1.50 per pack, the highest rate in the country.

Raising State Cigarette Taxes Always Increases State Revenues

⁴ Yurekli, A. & P. Zhang, "The Impact of Clean Indoor-Air Laws and Cigarette Smuggling on Demand for Cigarettes: An Empirical Model," *Health Economics* 9:159-170, 2000.

⁵ Emery, S et al., "Was there significant tax evasion after the 1999 50 cent per pack cigarette tax increase in California?," *Tobacco Control* 11: 130-34, June 2002, <http://tc.bmjournals.com/cgi/reprint/11/2/130.pdf>.

⁶ See, e.g., Spencer, M., "Incensed Smokers Stock Up Before Tax Rises," *Hartford Courant*, April 3, 2002.

CAMPAIGN for TOBACCO-FREE Kids®

STATE CIGARETTE EXCISE TAX RATES & RANKINGS

Major Tobacco States' Average: 8.2 cents per pack

Other States' Average: 65.5 cents per pack

Overall All States' Average: 58.8 cents per pack

| State | Tax | Rank |
|---------------------|------|------|
| Alabama | 16.5 | 45th |
| Alaska | 100 | 9th |
| Arizona | 58 | 22nd |
| Arkansas | 34 | 32nd |
| California | 87 | 15th |
| Colorado | 20 | 39th |
| Connecticut | 111 | 8th |
| Delaware | 24 | 36th |
| DC | 65 | 20th |
| Florida | 33.9 | 33rd |
| Georgia | 12 | 46th |
| Hawaii ¹ | 120 | 7th |
| Idaho | 28 | 35th |
| Illinois | 98 | 13th |
| Indiana | 55.5 | 23rd |
| Iowa | 36 | 29th |
| Kansas ² | 70 | 17th |
| Kentucky | 3 | 50th |

| State | Tax | Rank |
|-----------------------|-----|------|
| Louisiana | 36 | 29th |
| Maine | 100 | 9th |
| Maryland | 100 | 9th |
| Massachusetts | 151 | 1st |
| Michigan ³ | 125 | 6th |
| Minnesota | 48 | 26th |
| Mississippi | 18 | 41st |
| Missouri | 17 | 43rd |
| Montana | 18 | 41st |
| Nebraska ⁴ | 64 | 21st |
| Nevada | 35 | 31st |
| New Hampshire | 52 | 25th |
| New Jersey | 150 | 2nd |
| New Mexico | 21 | 38th |
| New York | 150 | 2nd |
| North Carolina | 5 | 49th |
| North Dakota | 44 | 27th |
| Ohio | 55 | 24th |

| State | Tax | Rank |
|---------------------------|-------|------|
| Oklahoma | 23 | 37th |
| Oregon | 68 | 19th |
| Pennsylvania | 100 | 9th |
| Rhode Island ⁵ | 132 | 5th |
| South Carolina | 7 | 48th |
| South Dakota | 33 | 34th |
| Tennessee | 20 | 39th |
| Texas | 41 | 28th |
| Utah | 69.5 | 18th |
| Vermont ⁶ | 93 | 14th |
| Virginia | 2.5 | 51st |
| Washington | 142.5 | 4th |
| West Virginia | 17 | 43rd |
| Wisconsin | 77 | 16th |
| Wyoming | 12 | 46th |
| Puerto Rico | 123 | NA |

¹ Effective 10/1/02 with 10-cents added 7/1/03 & 7/1/04, & return to \$1 per pack 7/1/06.

² Goes up to 79 cents on 1/1/03.

³ As of 8/1/02

⁴ As of 10/1/02. Reverts to 34 cents 10/1/04.

⁵ Goes up to \$1.50 7/1/03 with 10-cent increases on 7/1 in each of next five years.

⁶ Goes up to \$1.19 on 1/1/03.

The 18 states and Puerto Rico that have passed new cigarette increases in 2002 are in bold type. In November 2001, voters in Washington State overwhelming passed a 60-cent cigarette tax increase that went into effect 1/1/2002. New York City increased its local cigarette tax from eight cents to \$1.50 per pack, effective 7/1/02.

State averages include all increases scheduled to occur in 2002. Tobacco States are KY, VA, NC, SC, GA, TN. State averages do not include Puerto Rico. Including Puerto Rico (which is larger than more than 20 states and DC, based on population), raises the average state cigarette tax to 60.0 cents per pack and the non-tobacco state average to 66.8 cents. Federal cigarette tax is 39 cents per pack. Since the beginning of 1998, the major cigarette companies have increased the prices they charge by more than \$1.25 per pack.

The average price for a pack of cigarettes nationwide is roughly \$3.80 (including statewide sales taxes but not including local cigarette or local sales taxes), with considerable state-to-state differences because of the different state cigarette rates, different state sales tax rates and rules, and different manufacturer, wholesaler, and retailer pricing and discounting practices. AK, DE, MT, NH & OR have no state sales tax at all; CO has a state sales tax but it does not apply to cigarettes; and AL, GA & MO do not apply their state sales tax to that portion of retail cigarette prices that represents the state's cigarette excise tax.

Sources: Orzechowski & Walker, *Tax Burden on Tobacco*, 2002; media reports; Economic Research Service, U.S. Department of Agriculture, *Tobacco Briefing Room Website*, <http://www.ers.usda.gov/Briefing/tobacco>.

For additional information on state cigarette taxes and the many benefits from increasing them, see the Campaign's website at <http://tobaccofreekids.org/reports/prices>.

The National Center for Tobacco-Free Kids, July 27, 2002 / Eric Lindblom

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Sources

Youth smoking. Virginia is currently completing its first survey of youth tobacco use in the state. Current smoking = smoked in past month. Most recent National Youth Tobacco Surveillance (YTS), with a different methodology than the YRBS, found that in 2000 28.0% of high school kids smoked and 11.8% of high school males use spit tobacco. **Male Youth smokeless.** No Virginia data currently available. Female smokeless use is much lower. **New youth smokers.** Estimate based on U.S. Dept of Health and Human Services (HHS), "Summary Findings from the 2000 National Household Survey on Drug Abuse" (2001), <http://www.samhsa.gov/oas/nhsda.htm>, with the state share of the national initiation number allocated through the formula in CDC, "Projected Smoking-Related Deaths Among Youth – United States," *Morbidity and Mortality Weekly Report (MMWR)* 45(44): 971-974 (November 8, 1996) [as updated with most current population and smoking data available]. **Smokefree workplaces.** Shopland, D., et al., "State-Specific Trends in Smoke-Free Workplace Policy Coverage: The Current Population Survey Tobacco Use Supplement, 1993 to 1999," *Journal of Occupational and Environmental Medicine* 43(8): 680-686 (August 2001). **Kids exposed to secondhand smoke.** CDC, "State-Specific Prevalence of Cigarette Smoking Among Adults, and Children's and Adolescents' Exposure to Environmental Tobacco Smoke – United States, 1996," *MMWR* 46(44): 1038-1043 (November 7, 1997). **Packs consumed by kids.** Estimated from DiFranza, J. & J. Librett, "State and Federal Revenues from Tobacco Consumed by Minors," *American Journal of Public Health (AJPH)* 89(7): 1106-1108 (July 1999); & Cummings, et al., "The Illegal Sale of Cigarettes to US Minors: Estimates by State," *AJPH* 84(2): 300-302 (February 1994), and Virginia's youth population and smoking rates. **Adult smoking.** 2000 Behavioral Risk Factor Surveillance System (BRFSS).

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Related Campaign for Tobacco-Free Kids Fact Sheets, available at <http://www.tobaccofreekids.org> or <http://tobaccofreekids.org/research/factsheets>:

- Toll of Tobacco in the USA
- Comprehensive State Tobacco Prevention Programs Effectively Reduce Tobacco Use; and State Tobacco Prevention Programs Save Money
- Raising State Tobacco Taxes Always Increases State Revenues and Reduces Tobacco Use

National Center for Tobacco-Free Kids, July 28, 2002, www.tobaccofreekids.org/ Eric Lindblom

CAMPAIGN For TOBACCO-FREE Kids®

BENEFITS FROM A CIGARETTE TAX INCREASE IN VIRGINIA

Current State Cigarette Tax: 2.5 Cents Per Pack (51st among all states)

Average retail price per pack: \$3.20 (including state cigarette and sales taxes totaling 16 cents).

Smoking-caused costs in state per taxed pack sold in state: \$5.57

Cigarette tax revenue (2001): \$15.1 million. Medicaid Program smoking costs: \$313 million/year.

Last Virginia Cigarette Tax Increase: 9/1/66

- Inflation since then: +454.9% Cigarette price increases since then: +1065.4%
- Today's inflation-adjusted tax rate would be: 14 cents per pack

Projected Benefits From Increasing State Cigarette Taxes By 50 Cents Per Pack

- New state cigarette tax revenues each year: \$310.3 million
- New state sales tax revenues: \$8.0 million
- Fewer packs of cigarettes smoked each year: 43.5 million
- Percent decrease in youth smoking: 10.6%
- Increase in total number of kids alive today who will not become smokers: 44,500
- Number of current adult smokers in the state who would quit: 36,300
- Number of smoking-affected births avoided over next five years: 4,900
- Number of current adult smokers saved from smoking-caused death: 7,900
- Number of kids alive today saved from premature smoking-caused death: 14,200
- 5-Year healthcare savings from fewer smoking-affected pregnancies & births: \$5.6 million
- 5-year healthcare savings from fewer smoking-caused heart attacks & strokes: \$12.7 million
- Long-term healthcare savings in state from adult & youth smoking declines: \$833.4 million

Cigarette tax increases both reduce smoking levels and increase state revenues because the increased tax per pack brings in more new revenue than is lost from the decrease in the number of packs sold. Sales tax revenues from cigarette sales similarly increase, despite fewer pack sales, because the state sales tax percentage applies to the total retail price of a cigarette pack, including the increased state cigarette tax amount.

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See, also, the Campaign fact sheets, *Raising State Tobacco Taxes Always Reduces Tobacco Use (& Always Increases State Revenues)*; and *Toll of Tobacco in Virginia*, www.tobaccofreekids.org/research/factsheets.

National Center for Tobacco-Free Kids, June 5, 2002 / Eric Lindblom 7/29/02

CAMPAIGN for TOBACCO-FREE Kids®

STATE CIGARETTE TAX INCREASES WILL NOT HARM VIRGINIA'S TOBACCO FARMERS

Virginia's cigarette tax rate is currently 2.5 cents per pack (and the average among all the states is a bit more than 57 cents per pack). Increasing the State's cigarette tax would bring in new state revenues while also reducing smoking, especially among children. By prompting these declines in smoking, increasing the cigarette tax would also reduce the number of people in Virginia who suffer and die from smoking-caused lung cancer, heart disease, and other illnesses – thereby reducing related public and private healthcare costs, as well.¹

At the same time, Virginia has a long and proud tradition of tobacco farming, and many of the state's tobacco farmers, and their communities, are dependent on tobacco farming for their economic well being. Indeed, many tobacco-farming families are currently finding it hard to make ends meet. Accordingly, people and policymakers in Virginia may worry that any increase to the State's cigarette tax will, by reducing smoking, end up hurting the State's tobacco farmers and tobacco-farming communities, and perhaps even harm the State's economy. Fortunately, these worries are groundless.

Smoking in Virginia is responsible for only a tiny fraction of the overall demand for the burley and flue-cured cigarette tobacco grown in Virginia or elsewhere in the United States. Even if all cigarette sales in the State were totally eliminated, that would reduce the total annual sales of American-grown burley and flue-cured leaf by less than two percent. By reducing cigarette consumption in Virginia by about 6.5%, a State cigarette tax increase of 50 cents per pack would reduce the overall demand for American-grown burley and flue-cured leaf by only about one-tenth of one percent.

The Calculations. Of all the American-grown burley and flue-cured tobacco sold last year, 26.6% of the burley and 40 percent of the flue-cured was sold to foreign buyers for use in overseas cigarette manufacturing and consumption. The rest of the burley and flue-cured was used for American-made cigarettes, but only 70% of all the cigarettes made in the United States were actually smoked in the United States. The rest were exported for sale and consumption overseas. Accordingly, smoking in the entire United States accounts for only about 52% of the total demand for burley tobacco and 45% of the total demand for flue-cured leaf.² In addition, cigarette sales in Virginia account for only about 3.1% of all sales of cigarettes in the United States.³ That means that smoking in Virginia accounts for only about 1.6% of the total demand for American-grown burley leaf and 1.4% of the total demand for flue-cured. Accordingly, reducing cigarette consumption in Virginia by about 6.5% through a tax increase of 50 cents per pack would only reduce the overall demand for American-grown burley and flue cured by approximately 0.11% and 0.09%, respectively.⁴

National Center for Tobacco-Free Kids, July 18, 2002 / Eric Lindblom

¹ See, e.g., Campaign For Tobacco-Free Kids fact sheet, *Raising State Tobacco Taxes Always Increases State Revenues and Always Reduces Tobacco Use*, and others at <http://tobaccofreekids.org/reports/prices>.

² Capehart, T., Economic Research Service, U.S. Department of Agriculture, *Tobacco Situation and Outlook* (December 2000), Tables 18, 17, 1; USDA, Tobacco Briefing Room, www.ers.usda.gov/Briefing/tobacco.

³ Orzechowski & Walker, *Tax Burden on Tobacco* (2002) [annual compilation of state tobacco tax data].

⁴ The rough consensus from numerous research studies is that a 10% increase in cigarette prices will reduce overall cigarette consumption by 4% and reduce the number of kids who smoke by 6.5%. See, e.g., Chaloupka, F., "Macro-Social Influences: The Effects of Prices and Tobacco Control Policies on the Demand for Tobacco Products," *Nicotine and Tobacco Research* (1999) and other studies at <http://tigger.uic.edu/~fjc> & www.uic.edu/orgs/impactteen.

CAMPAIGN for TOBACCO-FREE Kids®

THE TOLL OF TOBACCO IN VIRGINIA

Tobacco Use in Virginia

- High school students who smoke: NA [Girls: NA Boys: NA]
- High school males who use smokeless tobacco: NA
- Kids (under 18) who try cigarettes for the first time each year: 37,600
- Additional Kids (under 18) who become new regular, daily smokers each year: 16,500
- Packs of cigarettes bought or smoked by kids in Virginia each year: 21.7 million
- Kids exposed to second hand smoke at home: 336,000
- Percentage of workplaces that have smoke-free policies: 70.0%
- Adults in Virginia who smoke: 21.4% [Men: 24.2% Women: 18.8%]

National youth smoking rates have declined somewhat since 1997, but remain at historically high levels. The 2001 National Youth Risk Behavioral Surveillance found that 28.5% of all U.S. high school kids smoke and 14.8% of high school males use spit tobacco. U.S. adult smoking rates have decreased gradually since the 1980s, and 23.3% of U.S. adults currently smoke.

Deaths in Virginia From Smoking

- Adults who die each year in Virginia from their own smoking: 9,100
- Annual deaths in state from others' smoking (secondhand smoke & pregnancy smoking): 890 to 1,590
- Virginia kids who have lost at least one parent to a smoking-caused death: 6,900
- Kids alive in state today who will ultimately die from smoking: 134,000 (given current smoking levels)

Smoking kills more people each year than alcohol, AIDS, car crashes, illegal drugs, murders, and suicides combined – and thousands more die from other tobacco-related causes, such as secondhand smoke or spit-tobacco use. No good state-specific estimates are currently available, however, for the number of Virginia citizens who die from these other tobacco causes, or for the massive numbers who suffer from tobacco-caused health problems each year without actually dying.

Tobacco-Related Monetary Costs in Virginia

- Annual health care expenditures in the state directly caused by tobacco use: \$1.62 billion
- State Medicaid program payments caused by tobacco use: \$313 million
- Citizens' state/federal taxes to cover smoking-caused gov't costs: \$1.31 billion (\$508 per household)
- Smoking-caused productivity losses in Virginia: \$2.08 billion
- State smoking-caused health costs and productivity losses per pack sold in Virginia: \$5.57

Other non-health costs caused by tobacco use include direct residential and commercial property losses from smoking-caused fires (more than \$500 million nationwide); the costs of the extra cleaning and maintenance made necessary by tobacco smoke and tobacco-related litter (about \$4+ billion per year for commercial establishments alone); and additional work productivity losses from smoking-caused work absences, on-the-job performance declines, and disability during otherwise productive work lives (in the tens of billions nationwide) [productivity loss amount above is from smoking-death-shortened work lives, alone].

Tobacco Industry Advertising and Other Product Promotion

- Annual tobacco industry marketing expenditures nationwide: \$9.7 billion (\$26+ million per day)
- Estimated portion spent in Virginia each year: \$242.4 million

Published research studies have found that kids are three times more sensitive to tobacco advertising than adults and are more likely to be influenced to smoke by cigarette marketing than by peer pressure, and that one-third of underage experimentation with smoking is attributable to tobacco company marketing.

State Government Policies Affecting The Toll of Tobacco in Virginia

- State per-capita 2002/2003 tobacco prevention spending: \$3.09 (National rank: 16th)
- State cigarette tax per pack: 2.5¢ (National rank: 51st) [States' average is 58.8¢ per pack]

CAMPAIGN for TOBACCO-FREE Kids®

RAISING CIGARETTE TAXES REDUCES SMOKING, ESPECIALLY AMONG KIDS (AND THE CIGARETTE COMPANIES KNOW IT)

The cigarette companies have opposed tobacco tax increases by arguing that raising cigarette prices would not reduce adult or youth smoking. But the companies' internal documents, disclosed in the tobacco lawsuits, show that they know very well that raising cigarette prices is one of the most effective ways to prevent and reduce smoking, especially among kids.

- **RJ Reynolds:** *If prices were 10% higher, 12-17 incidence [the percentage of kids who smoke] would be 11.9% lower.¹*
- **Philip Morris:** *It is clear that price has a pronounced effect on the smoking prevalence of teenagers, and that the goals of reducing teenage smoking and balancing the budget would both be served by increasing the Federal excise tax on cigarettes.²*
- **Philip Morris:** *Jeffrey Harris of MIT calculated . . . that the 1982-83 round of price increases caused two million adults to quit smoking and prevented 600,000 teenagers from starting to smoke. . . . We don't need to have that happen again.³*
- **Philip Morris:** *A high cigarette price, more than any other cigarette attribute, has the most dramatic impact on the share of the quitting population. . . . price, not tar level, is the main driving force for quitting.⁴*

The companies have even publicly admitted the effectiveness of tax increases to deter smoking in their required filings with the U.S. Securities and Exchange Commission.

- **Philip Morris:** *[I]ncreases in excise and similar taxes have had an adverse impact on sales of cigarettes. Any future increases, the extent of which cannot be predicted, could result in volume declines for the cigarette industry. [10-Q Report, May 11, 2001.]*
- **Loews/Lorillard Tobacco:** *Significant increases in federal and state excise taxes on cigarettes . . . have, and are likely to continue to have, an adverse effect on cigarette sales. [Loews (parent corporation of the Lorillard cigarette company) 10-K Report, March 31, 1999.]*
- **R.J. Reynolds:** *[S]ubstantial increases in state and federal excise taxes on cigarettes. . . have had and will likely continue to have an adverse effect on cigarette sales. [10-Q Report, August 1, 2001.]*

Economic Research On Cigarette Tax Increases Reducing Smoking

Numerous economic studies in peer-reviewed journals have documented that cigarette tax or price increases reduce both adult and underage smoking. The general consensus is that every 10 percent increase in the real price of cigarettes will reduce overall cigarette consumption by approximately three to five percent and reduce the number of kids who smoke by about six or seven percent.⁵ Research studies have also made the following related findings:

- Among all adults or all youths, cigarette price increases work even more effectively to prevent and reduce smoking among males, Blacks, Hispanics, and lower-income persons.⁶

Raising Cigarette Taxes Reduces Smoking, Especially Among Kids

- Higher taxes on spit tobacco reduce its use, particularly among young males.⁷
- Kids do not smoke more marijuana if they reduce their cigarette smoking. In fact, cigarette price increases not only reduce youth smoking but also reduce both the number of kids who smoke marijuana and the amount of marijuana consumed by continuing regular users.⁸

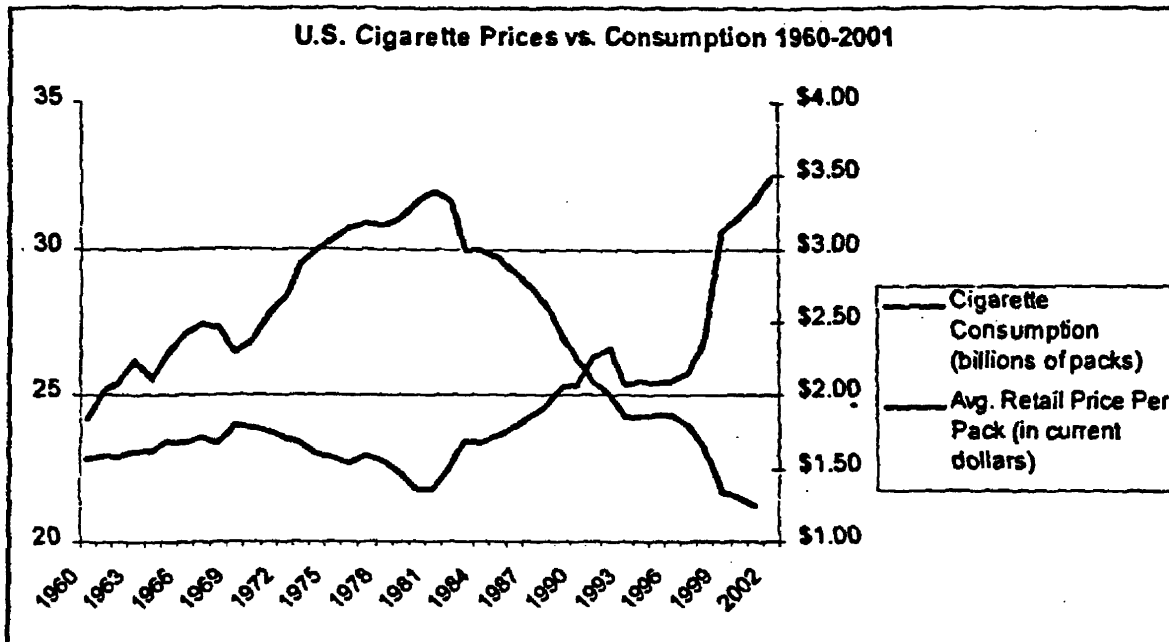
Expert Conclusions on Cigarette Prices and Smoking Levels

- The 2000 U.S. Surgeon General's Report, *Reducing Tobacco Use*, found that increasing the price of tobacco products would decrease the prevalence of tobacco use, particularly among kids and young adults, and that tobacco tax increases would lead to "substantial long-term improvements in health." From its review of existing research, the report concluded that raising tobacco taxes is one of the most effective tobacco prevention and control strategies.⁹
- The 1999 World Bank report *Curbing The Tobacco Epidemic: Governments and the Economics of Tobacco Control* carefully evaluated existing research and data, worldwide, and concluded that "the most effective way to deter children from taking up smoking is to increase taxes on tobacco. High prices prevent some children and adolescents from starting and encourage those who already smoke to reduce their consumption."¹⁰
- Wall Street tobacco industry analysts have long recognized the powerful role increased cigarette taxes and rising cigarette prices play in reducing U.S. smoking levels. For example, a December 1998 "Sensitivity Analysis on Cigarette Price Elasticity" by Credit Suisse First Boston Corporation settled on a "conservative" estimate that cigarette consumption will decline by four percent for every 10 percent increase in price.
- In its 1998 report, *Taking Action to Reduce Tobacco Use*, the National Academy of Sciences' Institute of Medicine concluded that "the single most direct and reliable method for reducing consumption is to increase the price of tobacco products, thus encouraging the cessation and reducing the level of initiation of tobacco use."¹¹
- A National Cancer Institute Expert Panel reported in 1993 that "a substantial increase in tobacco excise taxes may be the single most effective measure for decreasing tobacco consumption," and "an excise tax reduces consumption by children and teenagers at least as much as it reduces consumption by adults."

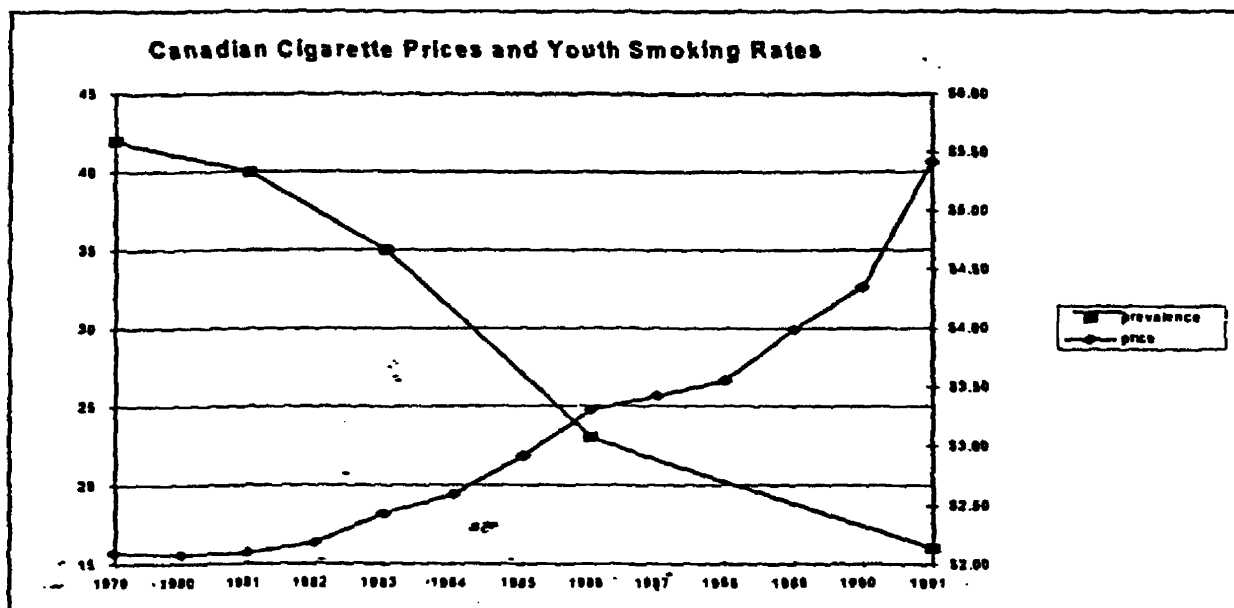
Increasing U.S. Cigarette Prices and Declining Consumption

Although there are many other factors involved, comparing the trends in cigarette prices and overall U.S. cigarette consumption from 1970 to 2001 shows that there is a strong correlation between increasing prices and decreasing consumption (see chart below). While U.S. cigarette prices are largely controlled by the cigarette companies' price-setting decisions, from 1970 to 2002, the federal tax on cigarettes also increased from eight cents to 39 cents per pack and the average state cigarette tax increased from 11 to 45 cents per pack. Without these federal and state tax increases, U.S. cigarette prices would be much lower and U.S. smoking levels would be much higher.

Raising Cigarette Taxes Reduces Smoking, Especially Among Kids



The Canadian Experience. From 1979 to 1991 real prices in Canada increased from \$2.09 to \$5.42 and smoking among 15 to 19 year olds fell from 42 to 16 percent. As the President of the Canadian Tobacco Manufacturers Council then admitted to a legislative committee, "there is no question that consumption is down measurably over the last five years, and there is no question in our minds that taxes have been a significant factor."¹² But when Canada subsequently reduced its cigarette taxes (to reduce tax-avoidance smuggling supported by the cigarette companies), youth smoking immediately increased for the first time in nearly fifteen years.¹³



For more information, please go to the Campaign's special website page on tobacco taxes at <http://tobaccofreekids.org/reports/prices>

National Center for Tobacco-Free Kids, January 3, 2002, Eric Lindblom

¹ R.J. Reynolds Executive D. S. Burrows, "Estimated Change In Industry Trend Following Federal Excise Tax Increase" RJR Document No. 501988846 -8849, September 20, 1982, www.rjtdocs.com.

² Philip Morris Research Executive Myron Johnston, "Teenage Smoking and the Federal Excise Tax on Cigarettes," PM Document No. 2001255224, September 17, 1981, www.pmdocs.com.

³ Philip Morris Executive Jon Zoler, "Handling An Excise Tax Increase," PM Document No. 2022216179, September 3, 1987, www.pmdocs.com.

⁴ Philip Morris Executive Claude Schwab, "Cigarette Attributes and Quitting," PM Doc. 2045447810, March 4, 1993, www.pmdocs.com.

⁵ See, e.g., Tauras, J., et al., "Effects of Price and Access Laws on Teenage Smoking Initiation: A National Longitudinal Analysis," Bridging the Gap Research, ImpacTeen, April 24, 2001, and other price studies at www.impacteen.org; Chaloupka, F., "Macro-Social Influences: The Effects of Prices and Tobacco Control Policies on the Demand for Tobacco Products," *Nicotine and Tobacco Research*, 1999, and other price studies at <http://tigger.uic.edu/~fjc>; Chaloupka, F. & R. Pacula, *An Examination of Gender and Race Differences in Youth Smoking Responsiveness to Price and Tobacco Control Policies*, National Bureau of Economic Research, Working Paper 6541, April 1998, <http://tigger.uic.edu/~fjc>; Emery, S., et al., "Does Cigarette Price Influence Adolescent Experimentation?," *Journal of Health Economics* 20:261-270, 2001; Evans, W. & L. Huang, *Cigarette Taxes and Teen Smoking: New Evidence from Panels of Repeated Cross-Sections*, working paper, April 15, 1998, www.bsos.umd.edu/econ/evans/wrkpap.htm.

Harris, J. & S. Chan, "The Continuum-of-Addiction: Cigarette Smoking in Relation to Price Among Americans Aged 15-29," *Health Economics Letters* 2(2) 3-12, February 1998, www.mit.edu/people/jeffrey.

⁶ See, e.g., U.S. Centers for Disease Control and Prevention (CDC), "Responses to Cigarette Prices By Race/Ethnicity, Income, and Age Groups – United States 1976-1993," *Morbidity and Mortality Weekly Report (MMWR)* 47(29): 605-609 July 31, 1998, www.cdc.gov/mmwr; Chaloupka & Pacula, April 1998.

⁷ Chaloupka, F., J. Tauras & M. Grossman, "Public Policy and Youth Smokeless Tobacco Use," *Southern Economic Journal* 64(2): 503-16, October 1997, <http://tigger.uic.edu/~fjc>.

⁸ Chaloupka, F., et al., *Do Higher Cigarette Prices Encourage Youth to Use Marijuana?*, National Bureau of Economic Research, Working Paper No. 6939, February 1999, <http://tigger.uic.edu/~fjc>; Farrelly, M., et al., "The Joint Demand for Cigarettes and Marijuana: Evidence from the National Household Surveys on Drug Abuse," *Journal of Health Economics* 20: 51-68, 2001. See, also, Campaign for Tobacco Free Kids fact sheet, *Smoking and Other Drug Use*, <http://tobaccofreekids.org/research/factsheets/pdf/0106.pdf>.

⁹ Available at www.cdc.gov/tobacco/sqrpage.htm.

¹⁰ Available at <http://www1.worldbank.org/tobacco/reports.htm>.

¹¹ Available at www.nap.edu/books/0309060389/html/index.html.

¹² Bill Neville, President, Canadian Tobacco Manufacturers Council, testifying before Legislative Committee F on Bill C-10, *An Act to Amend the Excise Tax Act and the Excise Act*, September 26, 1991.

¹³ Canadian Cancer Society, et al., *Surveying the Damage: Cut Rate Tobacco Products and Public Health in the 1990s*, October 1999, www.nsra-adnf.ca/english/oct99taxrep.html.

Voters Support Significant Increases in State Tobacco Taxes

- Seven out of ten Kansas voters (71%) want the Governor and state legislature to increase the cigarette tax to help balance the state budget. No other potential revenue source received support from even half of Kansas voters (including increasing the state sales tax and introducing slot machines to racetracks).

Voters clearly want some of the revenue from tobacco-tax increases to be used to fund tobacco prevention efforts – and support using tobacco-tax revenues for tobacco prevention more than for any other purpose. In nearly every state in which the question was asked, voters expressed the strongest support for cigarette tax increases that directed some of the new revenue to support programs to reduce tobacco use among kids. For example:

- Eighty-three percent of Minnesota voters favored dedicating cigarette tax revenues to programs to reduce tobacco use, ahead of funding for public schools (77%), providing health care to the uninsured (77%) and funding to prevent bioterrorism (61%).
- Nearly 9 out of 10 Wisconsin voters (86%) favor dedicating new cigarette tax revenue to youth smoking prevention. Other options for using the revenue received less support, including long-term care for seniors (84%), smaller class sizes for Kindergarten through third grade (74%), and helping balance the state budget (60%).
- 68 percent of Connecticut voters prefer a 72-cent tobacco tax increase that addresses the budget deficit and fully funds a tobacco prevention program over a 61-cent increase used only for the budget deficit (19%). [12 percent said that they prefer neither tax increase.]

Large majorities of low-income persons strongly support tobacco tax increases. In Indiana, 77 percent of voters with family incomes less than \$25,000 per year support a 50-cent increase (to 65.5 cents per pack). In Kansas, 76 percent of voters with family incomes less than \$30,000 per year support a 75-cent increase (to 99 cents per pack). In Vermont, 71 percent of voters with family incomes of less than \$30,000 per year support a \$1.06 cigarette tax increase (to \$1.50 per pack). In all the other states with this data, at least 57 percent of voters in families with low incomes support substantial cigarette tax increases.

Both men and women support tobacco-tax increases. In New Hampshire, 72 percent of men and 74 percent of women support a 50-cent increase in the state tax (to \$1.02 per pack). In all the other states, substantial majorities of men and women supported the tax increase.

Support for tobacco-tax increases comes from all age groups. In Minnesota, more than 60 percent of voters in every age bracket support a \$1.00 increase (to \$1.48 per pack), including 62 percent of those under age 30 and 67 percent over age 65. In the other states, at least 60 percent every age group support the cigarette tax increases.

Minority Support for tobacco-tax increases is strong. In Massachusetts, 64 percent of minority voters and 70 percent of white voters support a 50-cent increase (to \$1.26 per pack). In Maryland, 86 percent of African-American voters and 75 percent of white voters support a 70-cent increase (to \$1.36 per pack).

Significant numbers of smokers support tobacco-tax increases. In New Jersey, a majority of current tobacco users (54 percent) support a 50-cent increase in the tobacco tax (to \$1.30 per pack). In Maryland, 45 percent of current tobacco users support a 70-cent increase in the cigarette tax (to \$1.36 per pack), with 42 percent supporting a tax increase in Iowa (to 86 cents per pack) and 36 percent of current tobacco users supporting a tax increase in Vermont (to \$1.11 per pack). In the 12 other polls with this data, from 22 to 39 percent of current tobacco users support increasing the state cigarette tax.

For more information on state tobacco-tax increases, see the Campaign's website at www.tobaccofreekids.org/reports/prices and www.tobaccofreekids.org/research/factsheets/index18.shtml

*This factsheet is based on all the state polls on state tobacco-tax increases done in the past year for which the Campaign for Tobacco-Free Kids was able to obtain comprehensive information regarding the questions asked and the answers received. Numerous other state polls have also been done that, according to press reports and available summaries, show equally strong voter support for tobacco tax increases. For example:

- Two separate polls of Connecticut voters in February 2002 found that more than 70 percent of voters support raising the state cigarette tax by 61-cents, to \$1.11 per pack (polls done by the Center for Survey Research and Analysis at the University of Connecticut and by Quinnipiac University).
- An Oklahoma poll by the *Tulsa World* newspaper in January 2002 found that 63 percent of Oklahoma adults support a \$1.00 cigarette tax increase (to \$1.23 per pack) to fund health care for the state's indigent population.
- In the tobacco state of South Carolina, 68 percent of adults support increasing the cigarette tax by 44-cents (to 51 cents per pack) to fund health care (AARP survey conducted by the Southeastern Institute of Research in February 2002).
- A survey in North Carolina found that 70 percent of adults would support an additional state cigarette tax if the money was dedicated to youth tobacco prevention (40% supported an increase up to \$1 and another 30% support an increase of more than \$1 – North Carolina Public Health Awareness Survey, December 2001).
- In Texas, 76 percent support a tobacco-tax increase to help balance the budget (March 2001 poll, Center for Health Promotion & Prevention Research, Univ. of Texas Health Science Center).
- A poll taken after New York state raised its cigarette tax to \$1.50 per pack found that New York City voters support an additional \$1.42 per-pack increase within the city – as Mayor Michael Bloomberg (R) has proposed – 68% to 27%. Among all NY state voters, support for applying the new \$1.42 increase statewide was 59% to 38%. [Quinnipiac University, February 19-25, 2002.] A subsequent poll conducted for the Coalition for a Smoke-Free city found that 73 percent of New York City voters favored the Mayor's proposed tobacco tax increase (Global Strategy Group, Inc., March 2002).

Strong support for tobacco-tax increases is also shown by the November 2001 ballot initiative in Washington State, where more than 65 percent of those who cast ballots voted to raise the state cigarette tax by 60-cents per pack (to a total tax of \$1.42.5 per pack). Ballot initiatives have also raised state cigarette tax rates in California (11/98 & 11/88), Oregon (11/96), Arizona (11/94), and Massachusetts (11/92), despite the fact that spending by the major cigarette companies to defeat the proposed tobacco-tax increases far exceeded the expenditures in favor of the increases.

State Polls Summarized In This Factsheet

Connecticut – Market Strategies, Inc. and The Mellman Group, Inc. (May 2001); Mellman Group, Inc. (February 2002)
Illinois – Market Strategies, Inc. and The Mellman Group, Inc. (January 2002)
Indiana – Massie, Inc. (April and December 2001)
Iowa – Market Strategies, Inc. (March 2002)
Kansas – Market Strategies, Inc. (December 2001)
Kentucky – QEV Analytics (December 2001)
Maine – Market Strategies, Inc. and The Mellman Group, Inc. (May 2001)
Maryland – The Mellman Group, Inc. (February 2002)
Massachusetts – Market Strategies, Inc. and The Mellman Group, Inc. (May 2001 and March 2002)
Minnesota – Market Strategies, Inc. and The Mellman Group, Inc. (January 2002)
Nebraska – Market Strategies, Inc. (January 2002)
New Hampshire – Market Strategies, Inc. and The Mellman Group, Inc. (May 2001)
New Jersey – Validata Research. (March 2002)
Oregon – Davis, Hibbitts and McCaig (January 2002)
Rhode Island – Market Strategies, Inc. and The Mellman Group, Inc. (May 2001)
Vermont – Market Strategies, Inc. and The Mellman Group, Inc. (May 2001 and March 2002)
Wisconsin – Market Strategies, Inc. and The Mellman Group, Inc. (January 2002)

The Mellman Group is a prominent Democratic polling firm, and Market Strategies is a well known Republican firm. For more information about the polls they have conducted, contact Mark Mellman of the Mellman Group at 202-625-0370 or Dimitri Pantazopoulos of Market Strategies at 613-722-3322.

National Center for Tobacco-Free Kids, April 2, 2002

Cigarette Tax Rates for 2002*
Virginia's Cities, Counties and Selected Towns
Where Cigarette Tax Is Applicable

| Locality | Cigarette Tax (\$ per 20-count Pack) |
|-----------------|---|
| Cities | |
| Alexandria | \$0.30 |
| Bedford | \$0.20 |
| Bristol | \$0.04 |
| Charlottesville | \$0.12 |
| Chesapeake | \$0.50 |
| Fairfax | \$0.30 |
| Falls Church | \$0.25 |
| Franklin | \$0.25 |
| Fredericksburg | \$0.05 |
| Hampton | \$0.40 |
| Lynchburg | \$0.15 |
| Manassas | \$0.15 |
| Manassas Park | \$0.15 |
| Newport News | \$0.45 |
| Norfolk | \$0.30 |
| Petersburg | \$0.10 |
| Roanoke | \$0.27 |
| Suffolk | \$0.30 |
| Virginia Beach | \$0.32 |
| Waynesboro | \$0.04 |
| Winchester | \$0.10 |
| | |
| Counties | |
| Arlington** | \$0.05 |
| Fairfax** | \$0.05 |
| | |
| Towns | |
| Blacksburg | \$0.10 |
| Bluefield | \$0.03 |
| Chilhowie | \$0.02 |
| Culpeper | \$0.10 |
| Herndon | \$0.20 |
| Kilmarnock | \$0.05 |
| Leesburg | \$0.25 |
| Marion | \$0.02 |
| Mount Jackson | \$0.05 |
| Pulaski | \$0.10 |
| Purcellville | \$0.20 |
| Vienna | \$0.30 |
| Warrenton | \$0.15 |
| Wytheville | \$0.045 |

Gross County and City Tobacco Taxes*
For Fiscal Year 2001

| | Number of Places Taxing Tobacco | Tobacco Revenue |
|----------|------------------------------------|------------------------|
| Virginia | | |
| Cities** | 29 | \$30,796,738.00 |
| Counties | 2 | \$2,780,772.00 |
| | Total | \$33,577,510.00 |

*These figures are according to Tax Burden on Tobacco, Historical
 Compilation, Volume 36, 2001.

**Estimate

**Comparison of Total Number of Counties, Cities, Towns
 and Total Taxing Cigarettes**

| | Number of Places Taxing Cigarettes | Total Number of Localities |
|----------|---------------------------------------|-------------------------------|
| Cities | 21 | 40 |
| Counties | 2 | 135 |
| Towns | 14 | 182 |

* These figures are based on the 20th Annual Edition of Tax Rates 2001; data collected by the University of Virginia's
 Weldon Cooper Center of Public Service.

** Arlington and Fairfax are the only counties that have the ability to tax with a limit of \$0.05. All cities and towns have
 taxing authority with no limit.

CAMPAIGN FOR TOBACCO-FREE KIDS®

STATE EXCISE TAX RATES FOR NON-CIGARETTE TOBACCO PRODUCTS

Forty-seven of the 50 states have at least some tax on non-cigarette tobacco products. Kentucky, Pennsylvania, and Virginia do not. Georgia taxes only cigars, and Florida does not tax on cigars but does tax pipe or other loose smoking tobacco, chewing tobacco, and snuff tobacco. Washington State, Alaska, and Oregon have the highest taxes of 129.42%, 75%, and 65% of wholesale price, respectively. North Carolina, South Carolina, Tennessee, and West Virginia have the lowest taxes of 2%, 5%, 6%, and 7% of wholesale price, respectively. Tennessee (24.3%) and West Virginia (28.6%) also have two of the highest rates of smokeless tobacco use (chewing tobacco and snuff) by high school males. Nationwide, 14.2% of all high school boys and 1.3% of high school girls use smokeless tobacco.¹ For more information, see the Campaign factsheet *Spit (Smokeless) Tobacco and Kids*, www.tobaccofreekids.org/research/factsheets/pdf/0003.pdf.

| State | Cigar Tax | Smoking Tob. Tax | Chewing Tob. Tax | Snuff Tax | Cigarette Tax (cents/pack) | Cigarette Tax (as % mfr. price) |
|----------------------|-------------------------------|------------------------|------------------------|------------------------|-------------------------------|------------------------------------|
| Alabama | 1.5 to 20.25 cents/10 cigars | 0.6-4.4 cents/ounce | .75 cents/ounce | 0.6-4.4 cents/ounce | 16.5 | 6.7% |
| Alaska | 75% Wholesale price | 75% Wholesale price | 75% Wholesale price | 75% Wholesale price | 100 | 40.5% |
| Arizona | 6.5 to 64 cents/10 cigars | 6.5 cents/ounce | 6.5 cents/ounce | 6.5 cents/ounce | 58 | 23.5% |
| Arkansas | 23% Manufactures price | 23% Manufactures price | 23% Manufactures price | 23% Manufactures price | 34 | 13.8% |
| California | 56.65% Wholesale price | 56.65% Wholesale price | 56.65% Wholesale price | 56.65% Wholesale price | 87 | 35.2% |
| Colorado | 20% Manufactures price | 20% Manufactures price | 20% Manufactures price | 20% Manufactures price | 20 | 8.1% |
| Connecticut | 20% Wholesale price | 40 cents/ounce | 40 cents/ounce | 40 cents/ounce | 111 | 44.9% |
| Delaware | 15% Wholesale price | 15% Wholesale price | 15% Wholesale price | 15% Wholesale price | 24 | 9.7% |
| District of Columbia | 5.75% Wholesale price | 5.75% Wholesale price | 5.75% Wholesale price | 5.75% Wholesale price | 65 | 26.3% |
| Florida | None | 25% Wholesale price | 25% Wholesale price | 25% Wholesale price | 33.9 | 13.7% |
| Georgia | 2¢/10 cigars or 13% Wholesale | None | None | None | 12 | 4.8% |
| Hawaii | 40% Wholesale price | 40% Wholesale price | 40% Wholesale price | 40% Wholesale price | 120 | 48.6% |
| Idaho | 40% Wholesale price | 40% Wholesale price | 40% Wholesale price | 40% Wholesale price | 28 | 11.3% |
| Illinois | 18% Wholesale price | 18% Wholesale price | 18% Wholesale price | 18% Wholesale price | 98 | 39.7% |
| Indiana | 18% Wholesale price | 18% Wholesale price | 18% Wholesale price | 18% Wholesale price | 55.5 | 22.5% |
| Iowa | 22% Wholesale price | 22% Wholesale price | 22% Wholesale price | 22% Wholesale price | 36 | 14.6% |
| Kansas | 10% Manufactures price | 10% Manufactures price | 10% Manufactures price | 10% Manufactures price | 70 | 28.3% |
| Kentucky | None | None | None | None | 3 | 1.2% |
| Louisiana | 8%-20% Manufactures price | 33% Manufactures price | 20% Manufactures price | 33% Manufactures price | 36 | 14.6% |
| Maine | 16% Wholesale price | 16% Wholesale price | 62% Wholesale price | 62% Wholesale price | 100 | 40.5% |
| Maryland | 15% Wholesale price | 15% Wholesale price | 15% Wholesale price | 15% Wholesale price | 100 | 40.5% |
| Massachusetts | 15% Wholesale price | 15% Wholesale price | 75% Wholesale price | 75% Wholesale price | 76 | 30.6% |
| Michigan | 20% Wholesale price | 20% Wholesale price | 20% Wholesale price | 20% Wholesale price | 125 | 50.6% |
| Minnesota | 35% Wholesale price | 35% Wholesale price | 35% Wholesale price | 35% Wholesale price | 48 | 19.4% |

State Excise Tax Rates for Non-Cigarette Tobacco Products

| State | Cigar Tax | Smoking Tob. Tax | Chewing Tob. Tax | Snuff Tax | Cigarette Tax (cents/pack) | Cigarette Tax (as % mfr. price) |
|----------------|-------------------------|-------------------------|-------------------------|-------------------------|---------------------------------------|--|
| Mississippi | 15% Manufactures price | 15% Manufactures price | 15% Manufacture's price | 15% Manufactures price | 18 | 7.3% |
| Missouri | 10% Manufactures price | 10% Manufactures price | 10% Manufactures price | 10% Manufactures price | 17 | 6.9% |
| Montana | 12.5% Wholesale price | 12.5% Wholesale price | 12.5% Wholesale price | 12.5% Wholesale price | 18 | 7.3% |
| Nebraska | 20% Wholesale price | 20% Wholesale price | 20% Wholesale price | 20% Wholesale price | 64 | 25.9% |
| Nevada | 30% Wholesale price | 30% Wholesale price | 30% Wholesale price | 30% Wholesale price | 35 | 14.2% |
| New Hampshire | 21.6% Wholesale price | 21.6% Wholesale price | 21.6% Wholesale price | 21.6% Wholesale price | 52 | 21.1% |
| New Jersey | 30% Wholesale price | 30% Wholesale price | 30% Wholesale price | 30% Wholesale price | 150 | 60.7% |
| New Mexico | 25% Manufactures price | 25% Manufactures price | 25% Manufactures price | 25% Manufactures price | 21 | 8.5% |
| New York | 35% Wholesale price | 35% Wholesale price | 35% Wholesale price | 35% Wholesale price | 150 | 60.7% |
| North Carolina | 2% Wholesale price | 2% Wholesale price | 2% Wholesale price | 2% Wholesale price | 5 | 2.0% |
| North Dakota | 28% Wholesale price | 28% Wholesale price | 16 cents/ounce | 60 cents/ounce | 44 | 17.8% |
| Ohio | 17% Wholesale price | 17% Wholesale price | 17% Wholesale price | 17% Wholesale price | 56 | 22.3% |
| Oklahoma | 9 to 30 cents/10 cigars | 40% Manufactures price | 30% Manufactures price | 30% Manufactures price | 23 | 9.3% |
| Oregon | 65% Wholesale price | 65% Wholesale price | 65% Wholesale price | 65% Wholesale price | 68 | 27.5% |
| Pennsylvania | None | None | None | None | 100 | 40.5% |
| Rhode Island | 20% Wholesale price | 20% Wholesale price | 20% Wholesale price | 20% Wholesale price | 132 | 53.4% |
| South Carolina | 5% Manufactures price | 5% Manufactures price | 5% Manufactures price | 5% Manufactures price | 7 | 2.8% |
| South Dakota | 10% Wholesale price | 10% Wholesale price | 10% Wholesale price | 10% Wholesale price | 33 | 13.4% |
| Tennessee | 6% Wholesale price | 6% Wholesale price | 6% Wholesale price | 6% Wholesale price | 20 | 8.1% |
| Texas | 1 to 15 cents/10 cigars | 35.213% Manufactures | 35.213% Manufactures | 35.213% Manufactures | 41 | 16.6% |
| Utah | 35% Manufactures price | 35% Manufactures price | 35% Manufactures price | 35% Manufactures price | 69.5 | 28.1% |
| Vermont | 41% Manufactures price | 41% Manufactures price | 41% Manufactures price | 41% Manufactures price | 93 | 37.7% |
| Virginia | None | None | None | None | 2.5 | 1.0% |
| Washington | 129.42% Wholesale price | 129.42% Wholesale price | 129.42% Wholesale price | 129.42% Wholesale price | 142.5 | 57.7% |
| West Virginia | 7% Wholesale price | 7% Wholesale price | 7% Wholesale price | 7% Wholesale price | 17 | 6.9% |
| Wisconsin | 25% Manufactures price | 25% Manufactures price | 25% Manufactures price | 25% Manufactures price | 77 | 31.2% |
| Wyoming | 20% Wholesale price | 20% Wholesale price | 20% Wholesale price | 20% Wholesale price | 12 | 4.9% |
| US Government | \$1.828 to \$48.75/1000 | 7¢/ounce | 1.2¢/ounce | 4¢/ounce | 39 | 15.6% |

States in bold type raised their non-cigarette taxes since 1/1/02; states with cigarette tax rate in bold raised their cigarette tax rates since 1/1/02. *Manufactures Price* is the price charged to wholesalers/distributors by the tobacco company that makes the product. *Wholesale Price* is either the price charged to retailers by the wholesalers/distributors or, in some states, it is the same as the Manufactures Price. Check state statutes for details. Current price charged by the major cigarette manufacturers to wholesalers is \$2.47 per pack. Nebraska's tax rates effective 10/1/02; Michigan's tax rates effective 8/1/02. New Jersey lowered its non-cigarette tax from 48% of wholesale price to 30% in January, 2002. In February, 2002, a bill was introduced to raise the tax back to 48%. Sources: Federation of Tax Administrators, 2002, <http://www.taxadmin.org>; Orzechowski & Walker, *The Tax Burden on Tobacco*, 2002; press reports; U.S. Bureau of Alcohol, Tobacco & Firearms, <http://www.atsf.treas.gov/alcohol/info/fag/subpages/altaxes.htm>. Economic Resource Service, USDA, <http://www.ers.usda.gov/Briefing/tobacco/Data/table8.pdf>. For more information on state tobacco taxes (and the benefits from increasing them), see the Campaign's website at <http://tobaccofreekids.org/reports/prices>.

National Center for Tobacco-Free Kids, July 25, 2002

¹ Youth Risk Behavior Surveillance (YRBS), 1999. The Youth Tobacco Survey (YTS) for 2000 – which does not include extensive state-specific data – found that in high school 11.8% of males and 1.4% of females use smokeless tobacco. Because of different procedures, the YTS and YRBS are not directly comparable.

VIRGINIA
STATE CIGARETTE EXCISE TAX INCREASES
ESTIMATED NEW REVENUES, COST SAVINGS, AND OTHER BENEFITS & EFFECTS

Current State Cigarette Tax Rate: 2.5 cents per pack

Rank Among All States: 51st (1 is highest)

Average rate among all states: 57.3 cents per pack

Average Pack Price in State: \$3.20 (Including all taxes)

State cigarette tax last raised: 9/1/86

Inflation since then: 454.9%

Inflation-adjusted tax rate would be: 14 cents per pack

Smoking-Caused Costs in State Per Pack Sold: \$5.57

| Tax Increase Per Pack | Additional New State Cig Tax Revenue (Millions/Yr) | Additional New State Sales Tax Revenue (Millions/Yr) | Fewer Packs Smoked (Millions) | Youth Smoker Decline | Fewer Future Youth Smokers | Related Lifetime Health Savings (Millions) | Adult Smoker Decline | Fewer Adult Smokers | Related Lifetime Health Savings (Millions) | Youth Future Smoking Deaths Avoided | Adult Smoking-Caused Deaths Avoided | 5-Yr Heart & Stroke Savings (Millions) | 5-Yr Smoking-Births Savings (Millions) | Overall Long-Term Health Savings (Millions) |
|-----------------------|--|--|-------------------------------|----------------------|----------------------------|--|----------------------|---------------------|--|-------------------------------------|-------------------------------------|--|--|---|
| 0.10 | \$65.5 | \$1.7 | -8.7 | -2.1% | 8,900 | \$106.8 | -0.7% | 7,200 | \$59.4 | 2,800 | 1,500 | \$2.5 | \$1.1 | \$166.2 |
| 0.15 | \$97.6 | \$2.8 | -13.0 | -3.2% | 13,300 | \$159.6 | -1.0% | 10,900 | \$89.9 | 4,200 | 2,300 | \$3.8 | \$1.7 | \$249.5 |
| 0.20 | \$129.3 | \$3.4 | -17.4 | -4.2% | 17,800 | \$213.6 | -1.3% | 14,500 | \$119.8 | 5,600 | 3,100 | \$5.1 | \$2.2 | \$333.2 |
| 0.25 | \$160.5 | \$4.2 | -21.7 | -5.3% | 22,200 | \$266.4 | -1.6% | 18,100 | \$149.3 | 7,100 | 3,900 | \$6.3 | \$2.8 | \$415.7 |
| 0.30 | \$191.4 | \$5.0 | -26.1 | -6.4% | 26,700 | \$320.4 | -2.0% | 21,800 | \$179.9 | 8,500 | 4,700 | \$7.6 | \$3.4 | \$500.3 |
| 0.35 | \$221.7 | \$5.8 | -30.4 | -7.4% | 31,200 | \$374.4 | -2.3% | 25,400 | \$209.6 | 9,900 | 5,500 | \$8.9 | \$3.9 | \$584.0 |
| 0.40 | \$251.7 | \$6.5 | -34.8 | -8.5% | 35,600 | \$427.2 | -2.6% | 29,000 | \$239.3 | 11,300 | 6,300 | \$10.1 | \$4.5 | \$666.5 |
| 0.45 | \$281.2 | \$7.3 | -39.1 | -9.5% | 40,100 | \$481.2 | -2.9% | 32,700 | \$269.8 | 12,800 | 7,100 | \$11.4 | \$5.0 | \$751.0 |
| 0.50 | \$310.3 | \$8.0 | -43.5 | -10.6% | 44,500 | \$534.0 | -3.3% | 36,300 | \$299.5 | 14,200 | 7,900 | \$12.6 | \$5.6 | \$833.5 |
| 0.55 | \$338.9 | \$8.7 | -47.8 | -11.7% | 49,000 | \$588.0 | -3.6% | 39,900 | \$329.2 | 15,600 | 8,700 | \$13.9 | \$6.2 | \$917.2 |
| 0.60 | \$367.1 | \$9.3 | -52.2 | -12.7% | 53,400 | \$640.8 | -3.9% | 43,600 | \$359.7 | 17,000 | 9,500 | \$15.2 | \$6.7 | \$1,000.5 |
| 0.65 | \$394.9 | \$10.0 | -56.5 | -13.8% | 57,900 | \$694.8 | -4.2% | 47,200 | \$389.4 | 18,500 | 10,300 | \$16.4 | \$7.3 | \$1,084.2 |
| 0.70 | \$422.2 | \$10.6 | -60.9 | -14.8% | 62,400 | \$748.8 | -4.6% | 50,900 | \$419.9 | 19,900 | 11,100 | \$17.7 | \$7.8 | \$1,168.7 |
| 0.75 | \$449.1 | \$11.2 | -65.2 | -15.9% | 66,800 | \$801.8 | -4.9% | 54,500 | \$449.6 | 21,300 | 11,900 | \$19.0 | \$8.4 | \$1,251.2 |
| 0.80 | \$475.6 | \$11.8 | -69.6 | -17.0% | 71,300 | \$855.6 | -5.2% | 58,100 | \$479.3 | 22,800 | 12,700 | \$20.2 | \$9.0 | \$1,334.9 |
| 0.85 | \$501.8 | \$12.4 | -73.9 | -18.0% | 75,700 | \$908.4 | -5.5% | 61,800 | \$509.9 | 24,200 | 13,500 | \$21.5 | \$9.5 | \$1,418.3 |
| 0.90 | \$527.2 | \$13.0 | -78.3 | -19.1% | 80,200 | \$962.4 | -5.8% | 65,400 | \$539.8 | 25,600 | 14,300 | \$22.8 | \$10.1 | \$1,502.0 |
| 0.95 | \$552.4 | \$13.5 | -82.6 | -20.1% | 84,600 | \$1,015.2 | -6.2% | 69,000 | \$569.3 | 27,000 | 15,100 | \$24.0 | \$10.6 | \$1,584.5 |
| 1.00 | \$577.1 | \$14.0 | -87.0 | -21.2% | 89,100 | \$1,069.2 | -6.5% | 72,700 | \$599.8 | 28,500 | 15,900 | \$25.3 | \$11.2 | \$1,669.0 |

Cigarette tax increases both boost state revenues and reduce smoking because the increased tax per pack brings in more new revenue than is lost from the prompted declines in pack sales. Sales tax revenues from cigarette sales similarly increase, despite fewer pack sales, because the state sales tax percentage applies to the total retail price of a cigarette pack, including the increased state cigarette tax amount. Healthcare savings from youth smoking declines accrue over the lifetimes of kids alive today who quit or don't start because of the tax. Adult health savings accrue over lifetimes of current adult smokers who quit. Adult plus youth lifetime health savings equals overall long-term health savings. A portion of the adult health savings are from fewer smoking-caused heart attacks and strokes, which produce the listed savings within five years after the tax increase – and even larger amounts each year after that. Smoking-birth savings from fewer smoking-affected pregnancies. Other substantial immediate savings from the smoking reductions would also accrue.

Parallel increases to state excise taxes on other tobacco products would provide additional new state excise tax and sale tax revenue, reduce the use of these products in the state, and reduce related harms and healthcare costs. For more information, see <http://tobaccofreekids.org/research/factsheets/pdf/0180.pdf>.

National Center for Tobacco-Free Kids, www.tobaccofreekids.org, June 18, 2002 / Eric Lindblom 7/24/02

Notes & Sources

These projections are based on the well-established estimates that for every 10% increase in cigarette prices youth smoking rates decline by 8.5%, adults rates by 2%, and total consumption by 4.0%. See, e.g., Chaloupka, F. J., "Macro-Social Influences: The Effects of Prices and Tobacco Control Policies on the Demand for Tobacco Products," *Nicotine & Tobacco Research*, 2000, and other price studies at <http://tigger.uic.edu/~fjc>; Tauras, J., et al., "Effects of Price and Access Laws on Teenage Smoking Initiation: A National Longitudinal Analysis," Bridging the Gap Research, ImpactTeen, April 24, 2001, and other price studies at www.uic.edu/orgs/impactteen. Figures also assume that tax increase is fully passed on in higher prices, and is adjusted for inflation over time. Estimate of starting price per pack includes all federal and statewide excise and sales taxes but not any purely local taxes, and is based on cigarette pricing and tax data available from *The Tax Burden on Tobacco*, 2001; and USDA Economic Research Service, Tobacco Briefing Room, www.ers.usda.gov/Briefing/tobacco.

Avoided premature adult and youth deaths and smoking-caused costs data from U.S. Centers for Disease Control and Prevention (CDC), *State Highlights 2002: Impact and Opportunity*, April 2002, www.cdc.gov/tobacco/StateHighlights.htm; CDC, "Annual Smoking-Attributable Mortality, Years of Potential Life Lost, and Economic Costs – United States, 1995–1999," *MMWR*, April 11, 2002, www.cdc.gov/mmwr/preview/mmwrhtml/mm5114a2.htm. See, also, CDC, "Projected Smoking-Related Deaths Among Youth – United States," *MMWR* 45(44): 971–974, November 11, 1996, www.cdc.gov/mmwr/mmwr_wk.htm. Kids stopped from smoking and from dying prematurely from smoking based on number of kids alive in the state today and current smoking, quitting, and dying trends.

Based on currently available research and data, it is not possible to estimate health savings in each year following a tax increase, or even provide reasonable estimates of the total health care savings over the first five or ten years. Overall, smoking-caused healthcare cost savings from a cigarette tax increase will be relatively small in the first year after the increase but grow quickly.

Healthcare savings from reducing the number of future youth and current adult smokers show cost reductions over the lifetimes of kids alive in Virginia today who quit or don't start because of tax increase and over the lifetimes of those current adult smokers who will quit because of the tax increase, based on Hodgson, T.A., "Cigarette Smoking and Lifetime Medical Expenditures," *The Milbank Quarterly* 70(1) (1992) [smokers' lifetime healthcare costs average \$12,000 higher than nonsmokers, despite shorter life spans]. Savings for each adult quitter will not equal the \$12,000 because adult smokers have already been significantly harmed from their smoking and have already incurred, on average, some extra, smoking-caused health costs. See, also, Nusselder, W., et al., "Smoking and the Compression of Morbidity," *Epidemiology and Community Health* (2000); Warner, K.E., et al., "Medical Costs of Smoking in the United States: Estimates, Their Validity, and Their Implications," *Tobacco Control* 8(3): 290–300 (Autumn 1999).

5-Year Heart & Stroke Savings show those reductions in statewide healthcare expenditures within first five years after the tax increase from reduced smoking-caused heart attacks and strokes, based on Lightwood & Glantz, "Short-Term Economic and Health Benefits of Smoking Cessation – Myocardial Infarction and Stroke," *Circulation* 96(4) (August 19, 1997). These savings will increase considerably in subsequent years. Other short-term savings will accrue from declines in smoking among pregnant women, and corresponding reductions in smoking-caused birth complications, and from other declines in smoking-caused health problems and other smoking-caused costs. See, e.g., Miller, D. et al., "Birth and First-Year Costs for Mothers and Infants Attributable to Maternal Smoking," *Nicotine & Tobacco Research* 3:25–35 (2001); U.S. Department of the Treasury, *The Economic Costs of Smoking in the U.S. and the Benefits of Comprehensive Tobacco Legislation* (1998).

Projections estimate the effect of the proposed tax increases, alone, and do not account for other factors that may affect smoking rates, revenues, etc., such as national smoking trends; cigarette company price changes and marketing expenditures; and national, state, or local tobacco-prevention efforts. All projected amounts have been rounded down. Projections may change based on the availability of new data or new research findings or on other refinements to the underlying model and formulas. Questions may be directed to Eric Lindblom, Campaign for Tobacco-Free Kids, elindblom@tobaccofreekids.org or 202-296-5469.

So far in 2002, fifteen states and Puerto Rico have increased their cigarette taxes: New York, Connecticut, Utah, Maryland, Nebraska, Kansas, Hawaii, Ohio, Rhode Island, Vermont, Illinois, Louisiana, Indiana, New Jersey, and Pennsylvania. New York City increased its own cigarette tax from eight cents to \$1.50 per pack, as proposed by Mayor Bloomberg (R). More than ten other states are also seriously considering significant increases to their state cigarette taxes.

For more information on state cigarette tax increases, see <http://tobaccofreekids.org/reports/prices>.

REAL ESTATE TAX APPEALS AOBA/VACRE/VML/ASSESSORS

Discussion Agenda

July 9, 2002

Background

- Virginia has most difficult burden in the US – Assessments are presumed to be correct. Presumption is overcome by plaintiff showing the assessment is the result of “manifest error” or “total disregard of controlling evidence.” If successful in overcoming the presumption, the plaintiff must then prove the case by a preponderance of the evidence. See Tab 1, Mark R. David, Burdens of Proof and Presumptions in Property Tax Litigation, IAAO 21st Annual Legal Seminar, New Orleans, La., 2000.
 - ♦ specific injustices
 - ♦ Supreme Court cases
 - ♦ use of standard as sword, not shield
 - ♦ inability to get lawyers to take cases
 - ♦ strongly contested litigation
 - ♦ legislative studies suggest unfair process (See Tab 2, Final Report of the Commission on State and Local Government Responsibility and Taxing Authority, 1998, House Document No. 88, p. 17, recommendations 4 and 6)
- trend in other states (e.g. Fla. Ga. Ill. Tex.)
- trend in Virginia (e.g. BPOL, business personal property tax appeals – See Tab 8, Guidelines for Appealing Local Business Taxes, Va. Dept. of Taxation)

Goals

- increase fairness of both process and result
- establish better dialogue with assessor
- decrease litigation
- produce better results

Alternatives Considered

- make USPAP standards applicable to assessors
- limit to certain jurisdictions
- place burden of proof on locality or create shifting burden
- apply only to commercial property
- attorneys fee awards

History

- 1999 legislation – SB 1008, SB 1009 (See Tab 3)
- 2000 legislation – HB 1175 (See Tabs 4 and 5)
- 2001 study resolution – HJR 782, HJR 685 (See Tabs 6 and 7)

House Bill 1175 (2000) (See Tabs 4 and 5)

- preserves presumption of correctness
- preserves burden of proof on plaintiff
- strong support by roughly 20 groups
- change in level of proof required to overcome presumption
- modeled on New York case law (See Tab 9)
- requirement for administrative appeal or appeal to Board of Equalization
- Fla. experience suggests decrease in litigated cases (See Tab 10)
- issue identification

Discussion

