



Overview of Virginia's Revenue and Tax Policy

November 16, 2023

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Sources of Revenues for Virginia's Budget

State revenues are defined as either general fund or nongeneral fund.

General Fund (GF) Revenues

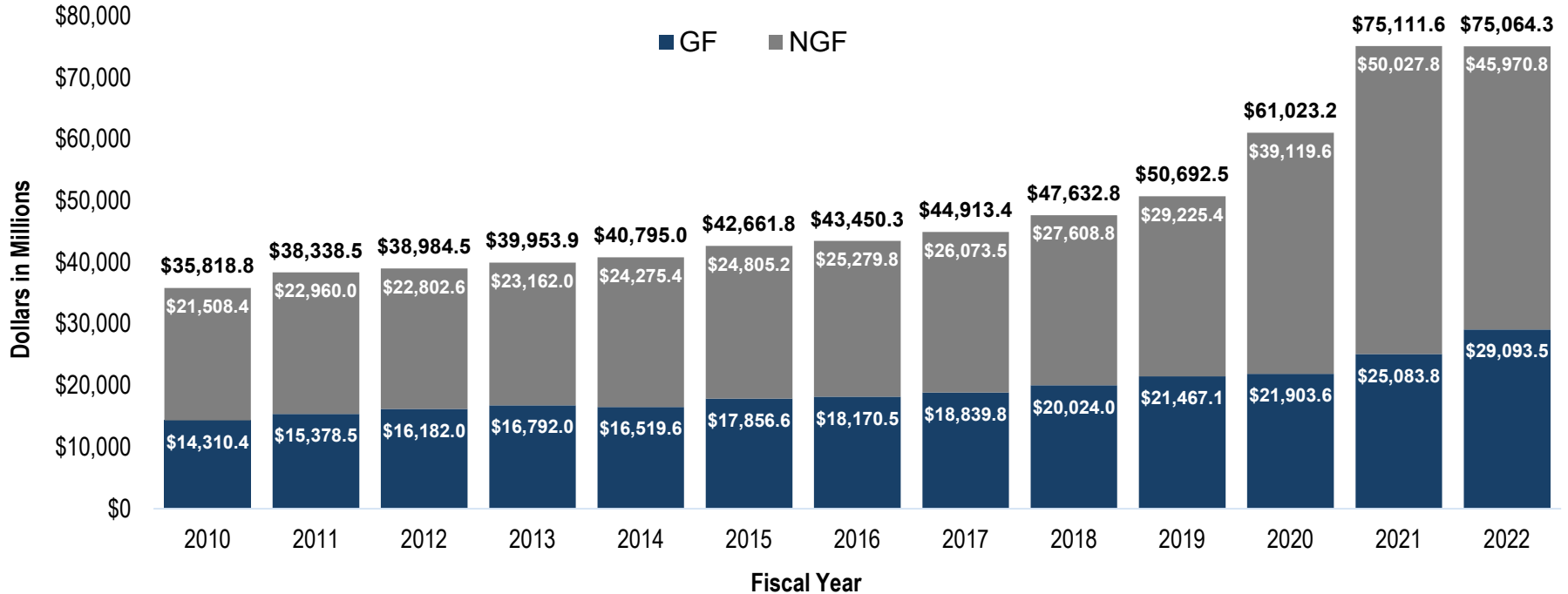
- Include income tax, sales tax, and corporate tax (three largest sources).
- Used for any purpose, such as education, health care, public safety, and social services.
- The Department of Taxation administers and collects most general fund revenue.

Nongeneral Fund (NGF) Revenues

- Include federal revenue, tuition and fees, gas taxes, lottery, unemployment taxes, etc.
- Tend to be earmarked for specific programs or purposes, such as transportation.
- Several agencies administer and collect NGF taxes, including Department of Motor Vehicles, Department of Taxation, and Virginia Employment Commission.

General Fund Revenue Comprises 40 Percent of State Revenue

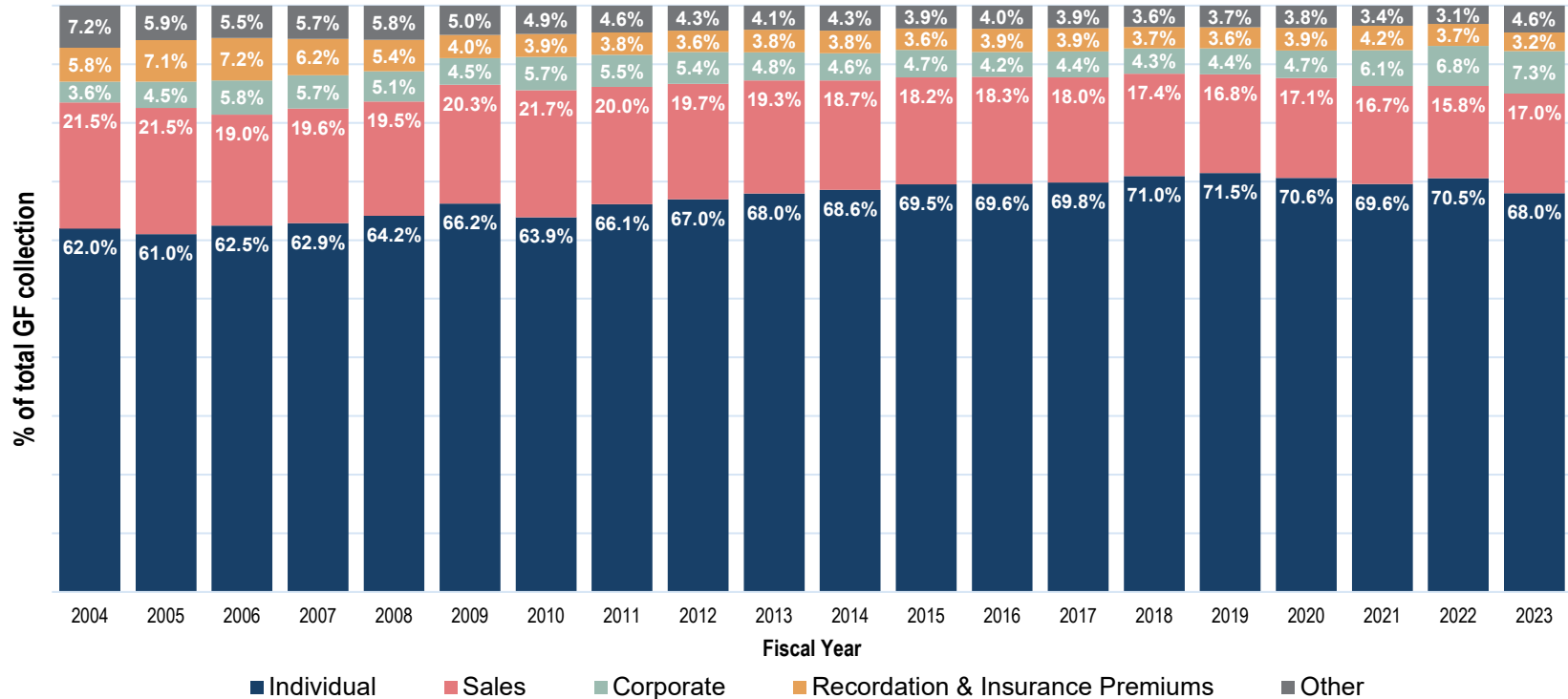
In FY 2022, statewide revenue collections totaled \$75.1 million with GF sources comprising 38.8 percent.



Source: Virginia Department of Taxation, Annual Reports.

General Fund Revenue is Dependent on Individual Income Tax

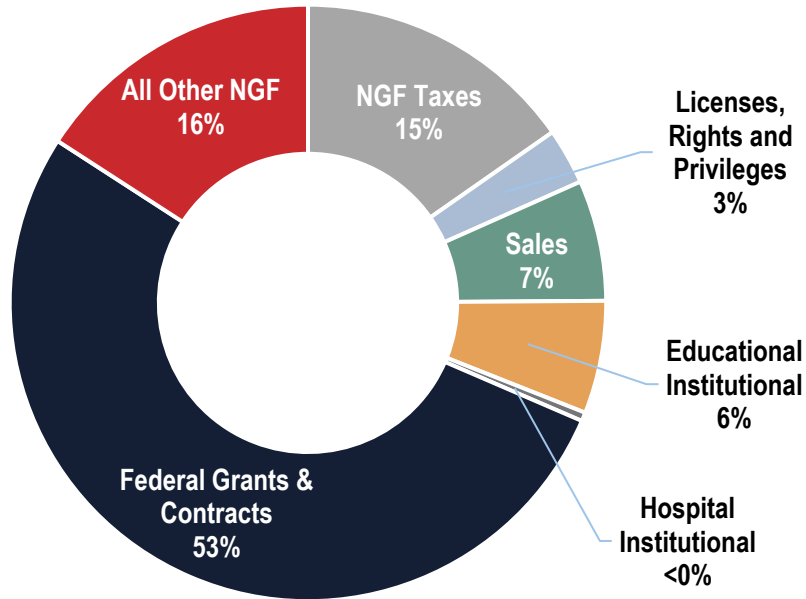
Individual income, sales tax, and corporate income taxes account for 90 percent of the general fund revenue.



Source: Virginia Department of Taxation.

Nongeneral Fund Revenue is Largely from Federal Grants

In FY 2022, 53% of NGF revenue was from federal grants.



Examples of NGF Revenue:

- Unemployment Payroll Tax
- Motor Vehicle Fuel Tax
- Motor Vehicle Sales and Use Tax
- Lottery Sales
- ABC Sales
- Higher Education Tuition and Fees
- Federal Highway Planning & Construction
- Federal Medicaid Assistance Program Grant
- Cigarette & Other Tobacco Products
- Casino Gaming Tax

Source: Secretary of Finance, Presentation to Joint Money Committee, December 15, 2022.
Per the Management Agreements between the tier 3 schools and the Commonwealth as set forth in Chapters 933 and 943 of the 2006 Acts of Assembly, the type 3 schools are not required to report actual revenue collections in Cardinal.

Virginia's Revenue and Taxes Compared to the Other States

| FY 2020 | Virginia | 50-State Average | Rank |
|-----------------------------------------------------------|-----------------|-------------------------|-------------|
| Per capita state taxes | \$3,251 | \$3,239 | #22 |
| Per capita local taxes | \$2,346 | \$2,110 | #17 |
| % of state & local tax revenue from individual income tax | 31.0% | 20.4% | #6 |
| State & local taxes as % of personal income | 9.0% | 9.2% | #29 |
| Per capita state revenue | \$8,036 | \$8,837 | #29 |
| Per capita local revenue | \$5,335 | \$5,719 | #27 |

Source: JLARC, Virginia Compared 2023.



Individual Income Tax

Individual Income Tax is Applied on a Graduated Basis

- Virginia applies a graduated income tax rate on net income of individuals.
- Individuals with Virginia adjusted gross income of at least \$11,950 for single filers and \$23,900 for married filers must file an income tax return.
- Most Virginians are in the highest tax bracket. In tax year 2020, 70 percent of returns reported \$20,000 or more in Virginia adjusted gross income, compared to 61 percent in tax year 2000.
- The highest income tax bracket was last increased in 1990 and is not adjusted for inflation.

| Virginia Taxable Income | Rate |
|-------------------------|------------------|
| \$0 to \$3,000 | 2% |
| \$3,001 to \$5,000 | 3% plus \$60 |
| \$5,001 to \$17,000 | 5% plus \$120 |
| \$17,001 and higher | 5.75% plus \$720 |

Individual Income Tax Liability is Based on Virginia Adjusted Gross Income

Computing the Tax

Start: Federal Adjusted Gross Income (FAGI)

- + Add-back certain items excluded from FAGI but taxable in Virginia (e.g., interest income on federally exempt bonds, etc.).
- Subtract items included in FAGI but not taxable in Virginia (e.g., certain military pay, etc.).

= Virginia Adjusted Gross Income

- Subtract Deductions (standard or itemized; taxpayer must use the same deduction as federal)
- Subtract Exemptions (personal, dependents, age and/or blind)

= Virginia Taxable Income

x Apply Tax Rates

= Amount of Tax

- Subtract Tax Credits (e.g. Historic Rehabilitation Tax Credit, etc.)

= Net Tax Liability

Virginia has Doubled the Standard Deduction in the Last Two Years

- Under the Tax Cuts and Jobs Act (TCJA) of 2017, the federal standard deduction was increased to \$12,000 (\$24,000 for joint filers), indexed for inflation.
 - In tax year 2023, the federal standard deduction is \$13,850 (\$27,700 for joint filers).
- Virginia’s standard deduction has been increased through legislation.

| Virginia Standard Deduction | | | | | | | | |
|-----------------------------|------------------------------------------------------------|---------|---------|-----------|-----------|-----------|-----------|------------|
| Filing Status | 1972-1986 | 1987 | 1988 | 1989-2004 | 2005-2019 | 2020-2021 | 2022-2023 | 2024*-2025 |
| Single | The greater of 15% of AGI or \$1,300 not to exceed \$2,000 | \$2,000 | \$2,700 | \$3,000 | \$3,000 | \$4,500 | \$8,000 | \$8,500 |
| Married | | | | \$5,000 | \$6,000 | \$9,000 | \$16,000 | \$17,000 |
| Married Filing Separately | The greater of 15% of AGI or \$650 not to exceed \$1,000 | \$1,000 | \$1,350 | \$2,500 | \$3,000 | \$4,500 | \$8,000 | \$8,500 |

*For TY 2024 and TY 2025, if specified revenue targets are not met, the standard deduction amounts are \$8,000/\$16,000.

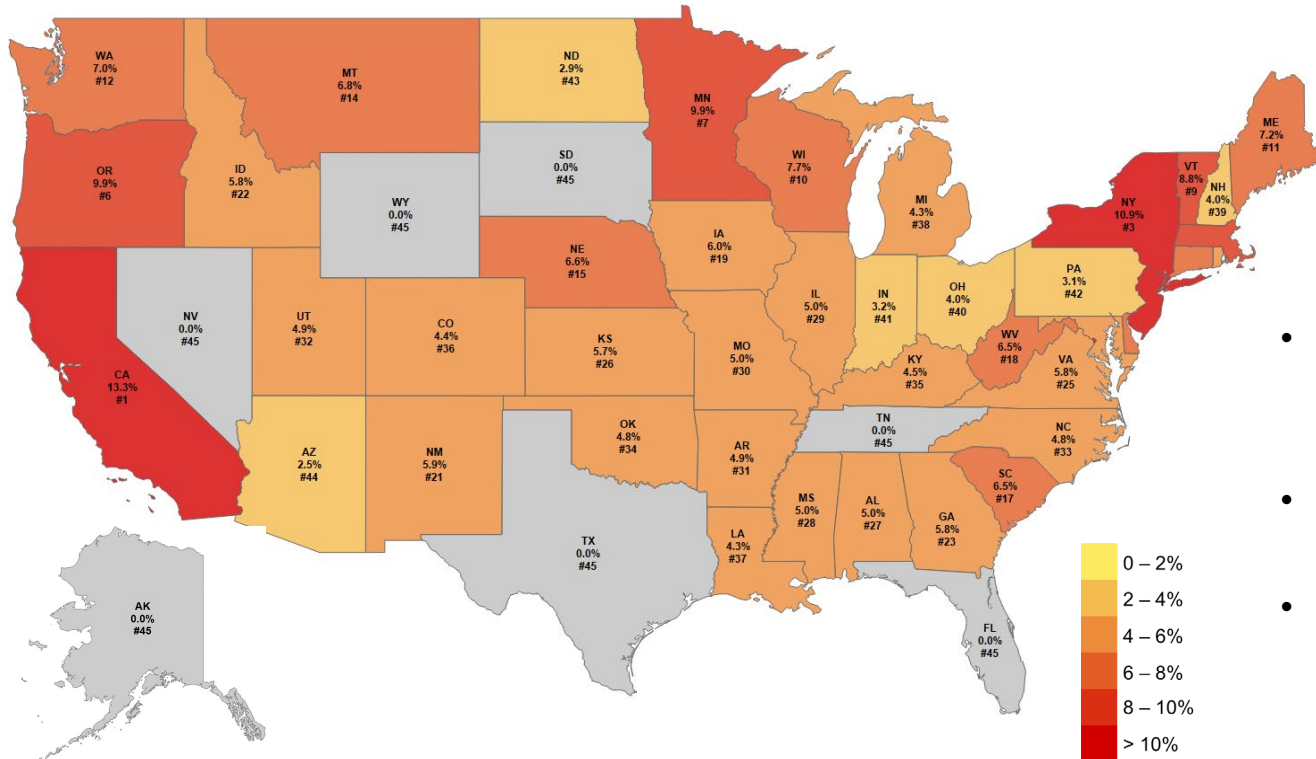
Virginia Offers Personal Exemptions for Each Filer

- The TCJA set the federal personal exemption at \$0 for tax years 2018 through 2025, which was previously \$4,050 for each filer and each dependent.
- Virginia provides a personal exemption for each filer, their spouse, and each dependent.
 - An additional \$800 exemption is allowed for individuals who are blind or over the age of 65.

| Virginia Personal Exemption | |
|-----------------------------|--------|
| Year | Amount |
| 1972 - 1985 | \$600 |
| 1986 | \$700 |
| 1986 - 2004 | \$800 |
| 2005 - 2007 | \$900 |
| 2008 - present | \$930 |

Virginia and 42 Other States Levy Individual Income Taxes

Virginia's highest marginal individual income tax rate ranks #25.



Source: Tax Foundation, State Individual Income Tax Rates and Brackets for 2023.

- Virginia, along with 29 states and DC, apply a graduated-rate income tax.
- Thirteen states have a flat income tax.
- Seven states have no income tax.

Virginia's Highest Income Tax Bracket Varies Substantially from Neighboring States

Selected State Individual Income Tax Rates and Brackets, as of January 1, 2023

| State | Structure | Highest Rate | Highest Income Bracket | Standard Deduction |
|----------------|-----------|--------------|----------------------------------|---------------------|
| Virginia | Graduated | 5.75% | > \$17k | \$8,000 / \$16,000 |
| DC | Graduated | 10.75% | > \$1.0m | \$13,850 / \$27,700 |
| Georgia | Graduated | 5.75% | > \$7k single & > \$10k joint | \$5,400 / \$7,100 |
| Maryland | Graduated | 5.75% | > \$250k single & > \$300k joint | \$2,400 / \$4,850 |
| North Carolina | Flat | 4.75% | | \$12,750 / \$25,500 |
| Tennessee | None | | | |
| West Virginia | Graduated | 6.5% | > \$60k | None |

Source: Tax Foundation, State Individual Income Tax Rates and Brackets for 2023.



Corporate Income Tax

Most Corporate Income Revenue is Collected from Two Percent of Taxpayers

- Virginia, like most states, imposes a corporate income tax on C corporations, but excludes other business structures such as S corporations, limited liability companies, partnerships, and sole proprietorships who pay individual income tax. Virginia exempts banks, insurers, and public service corporations as these entities are taxed separately.
- Virginia applies a flat rate of **six percent** to the net income of a corporation doing business in Virginia.
- Less than two percent of taxpayers account for 85 percent of corporate tax revenue.
- Computation of tax:
 - **Starting point is federal taxable income (amount of income subject to tax, after deductions and exemptions);**
 - Apply any additions, subtractions and deductions to determine Virginia taxable income;
 - Multi-state corporations must allocate and apportion income;
 - Apply six percent tax rate to the income subject to Virginia tax; and
 - Apply any tax credits to reduce liability.

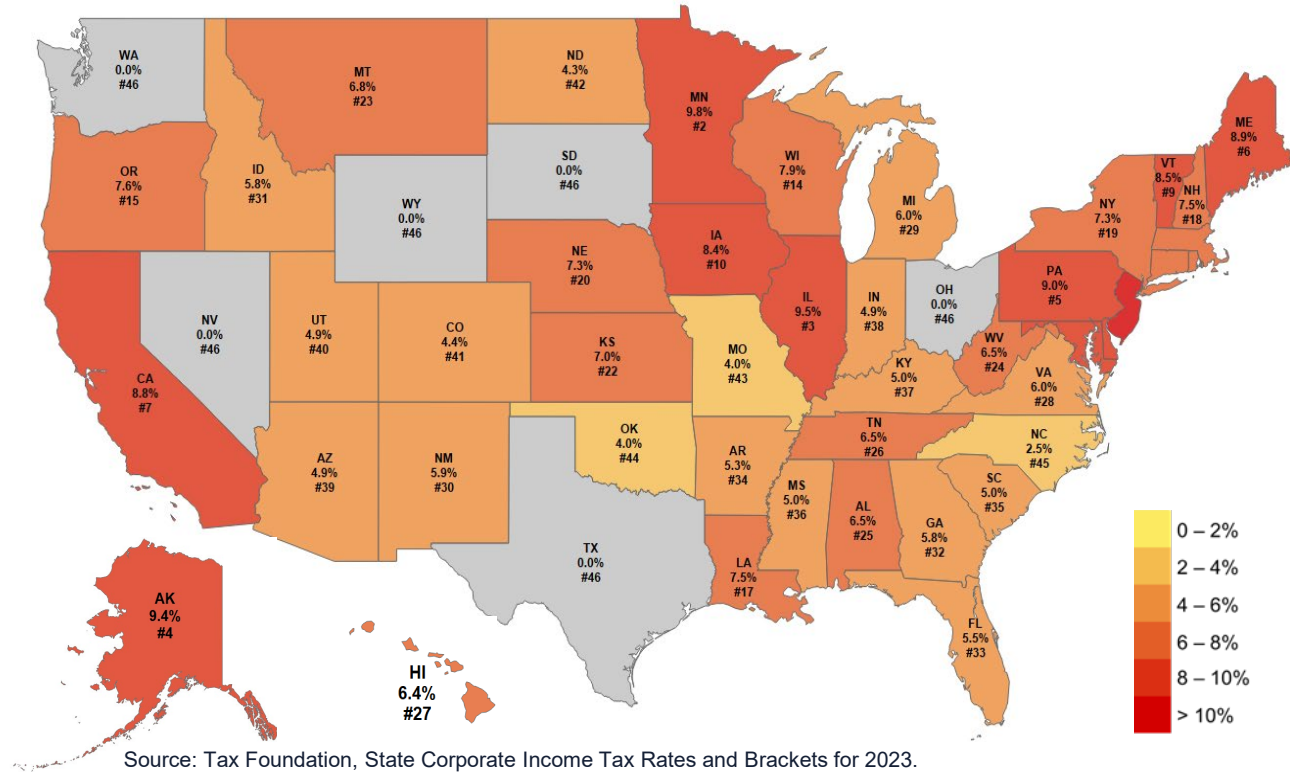
Multi-State Corporations Must Apportion Income for State Tax Purposes

- Virginia’s statutory method of apportionment consists of three factors: property, payroll, and sales (double-weighted).
- In certain situations, Virginia permits or requires the use of special apportionment methods that differ from the statutory three-factor apportionment method.
- Sales can be the most difficult to determine:
 - Sales of tangible property are assigned to Virginia if they are delivered to a location in Virginia.
 - Sales of services or intangible property are assigned to Virginia if the greater portion of income producing activity (measured by “costs of performance”) is in Virginia. “Cost of performance” is an all-or-nothing determination for purposes of sourcing sales of services and intangible property.

$$\left(\frac{\text{Property in Virginia}}{\text{Total Property}} + \frac{\text{Payroll in Virginia}}{\text{Total Payroll}} + \frac{\text{Sales in Virginia}}{\text{Total Sales}} + \frac{\text{Sales in Virginia}}{\text{Total Sales}} \right) / \text{Number of Factors}$$

Forty-Four States Levy Corporate Income Tax

Virginia's corporate income tax rate ranks #29 and is comparable to neighboring states.



- 29 states and DC have a flat rate.
- 16 states levy a flat rate higher than 6 percent.
- 12 states levy a flat rate equal to or less than 6 percent.
- 13 states have multiple tax brackets that tend to have overall rates higher than 6 percent.

Source: Tax Foundation, State Corporate Income Tax Rates and Brackets for 2023.



Retail Sales and Use Tax

Virginia Applies Sales and Use Tax to Tangible Personal Property

- Generally, all sales, leases, or rentals of tangible personal property (TPP) in or for use in Virginia, as well as accommodations and certain taxable services, are subject to the Sales and Use Tax.
 - Consumers are responsible for paying the Sales Tax at the time of purchase.
 - The business is responsible for charging and collecting the Sales Tax at the time of purchase.
- “Use Tax” is a term associated with businesses located outside of Virginia but making sales into Virginia, such as internet sales. “Use Tax” also applies to TPP purchased outside of Virginia but used, consumed, or stored in Virginia that would have been subject to the tax had it been purchased in Virginia.
- A one percent local option sales tax is imposed and distributed to the localities where the sales were made, and certain localities have an additional local option tax for school construction.
 - Local option sales tax still applies to the sale of food for home consumption and certain essential personal hygiene products.

Half of Sales Tax Revenue is Designated for a Specific Purpose

| Distribution | General Sales Tax | Hampton Roads/ Northern Virginia/ Central Virginia | Historic Triangle | Additional Local Option |
|---------------------------|-------------------|----------------------------------------------------------|-------------------|-------------------------|
| Unrestricted General Fund | 2.025% | 2.025% | 2.025% | 2.025% |
| K-12 Education | 1.375% | 1.375% | 1.375% | 1.375% |
| Transportation | 0.9% | 0.9% | 0.9% | 0.9% |
| Local Option | 1.0% | 1.0% | 1.0% | 1.0% |
| Regional Transportation | -- | 0.7% | 0.7% | -- |
| Historic Triangle | -- | -- | 1.0% | -- |
| School Construction | -- | -- | | 1.0% |
| Total | 5.3% | 6.0% | 7.0% | 6.3% |

- Additional 0.7 percent tax in Hampton Roads, Northern Virginia, and Central Virginia goes to the respective transportation authorities for the region's transportation and construction projects.
- Additional 1.0 percent in Historic Triangle is dedicated half to the Tourism Council and half to those localities.
- Additional 1.0 percent Local Option for school construction is authorized by the General Assembly. Nine localities have the authority to impose the additional local option after approval by local referendum.

Approximately 28 Percent of Sales Tax is from Remote Sellers

- 1992: *Quill Corp. v. North Dakota* barred a state from requiring an out-of-state mail-order company to collect use tax on goods sold to customers located within the state when the company has no physical presence in the state.
- 2017: Virginia law change required any dealer owning inventory for sale located in Virginia to register for collection of the Retail Sales and Use Tax.
- 2018: *South Dakota v. Wayfair (2018)* overturned *Quill* and held that physical presence is no longer required for a state to require a merchant to collect its tax.
- 2019: Virginia law change requires remote sellers and marketplace facilitators to collect and remit the Virginia sales tax if annual sales made or facilitated to Virginia customers exceed \$100,000 or 200 transactions (consistent with South Dakota thresholds approved in *Wayfair* decision).

Exemptions to Sales Tax Exist to Prevent Double Taxation or to Achieve Certain Policy Objectives

Exemptions are in eight broad categories:



Government: Prevents unconstitutional taxation of federal government and taxation of state government.



Commodities: Avoids double taxation.



Commercial & Industrial: Avoids taxing inputs used to create goods that will be taxed - tax pyramiding.



Agricultural: Avoids taxing inputs used to create goods that will be taxed - tax pyramiding.



Media-related: Encourages the use of Virginia businesses.



Service: Keeps the sales tax on tangible personal property only.



Medical-related: Reduces cost of medical necessities.

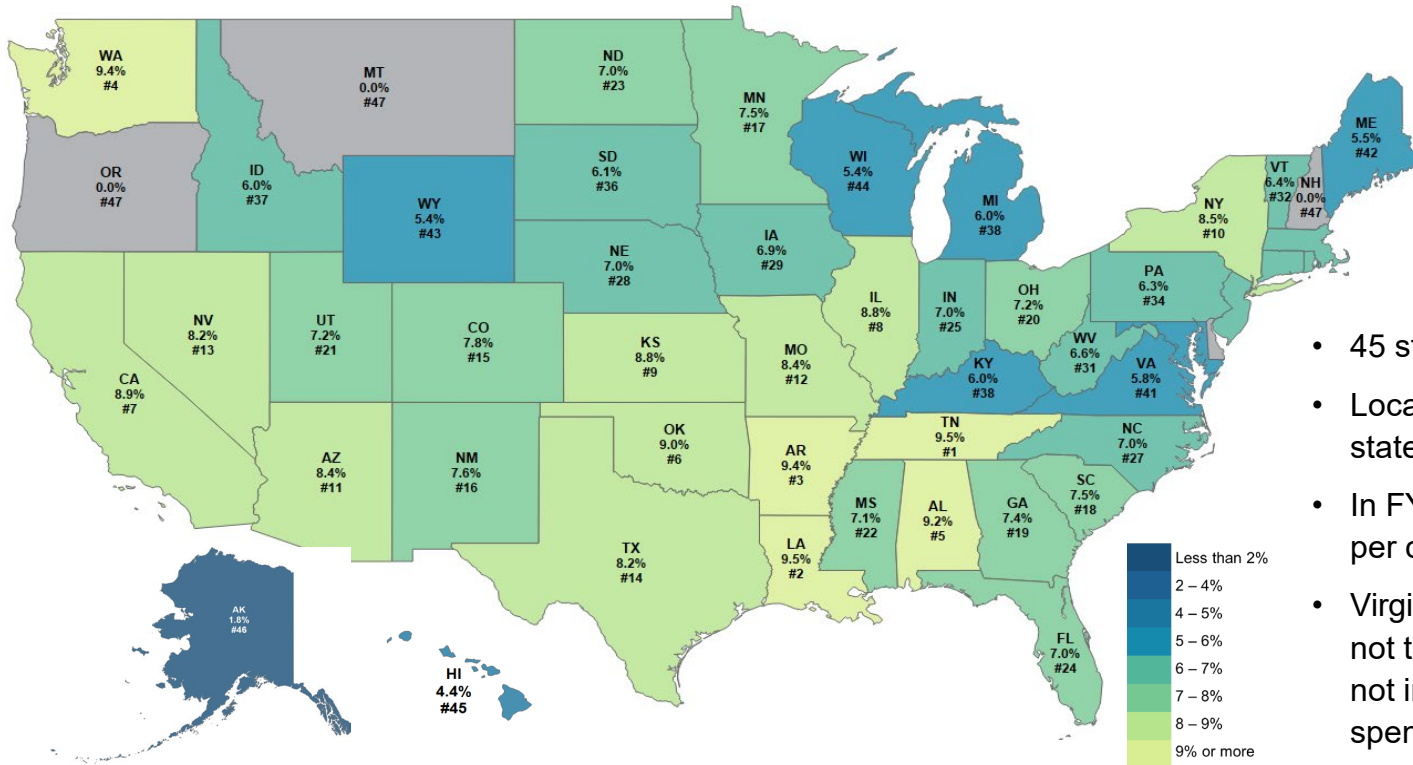


Nonprofit: Reduces costs to those aiding the community.

Source: Virginia Department of Taxation.

Forty-Five States and DC Impose a Statewide Sales and Use Tax

Virginia's general sales tax rate ranks low at #41.



- 45 states and DC collect sales tax.
- Local sales tax is imposed in 38 states.
- In FY 2020, Virginia collected \$834 per capita in general sales tax.
- Virginia, like most other states, is not taxing most services and thus not including most direct household spending in the sales tax base.

Source: Tax Foundation, State and Local Sales Tax Rates, Midyear July 2023.



Other Revenue Sources

Other General Fund Sources




| Tax | Tax Rate | Other Dedicated Purposes | Ten Year Avg % of GF Revenue |
|--------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------|
| Will/Suit/ Deeds | <p>Recordation tax of 25 cents per \$100 of the consideration or actual value of property conveyed (up to \$10.0 million; a sliding scale applies to values over \$10.0 million).</p> <p>Grantor tax of 50 cents per \$500 of the value.</p> <p>Probate tax of 10 cents per \$100 for estates over \$15,000.</p> | <p>3 cents of the 25 cents state recordation tax to the Commonwealth Transportation Trust Fund.</p> <p>\$20.0 million of the state recordation tax allocated to Hampton Roads Regional Transit Fund.</p> <p>Half of the grantor tax to the locality.</p> | 2.2% |
| Insurance Premiums | 2.25 percent of direct gross premium income (in lieu of corporate income tax). | One-third of the prior year's total collection to the Commonwealth Transportation Trust Fund. | 1.7% |

Sports Betting Revenue is Primarily Allocated to the General Fund

- Virginia imposes a 15 percent tax on sports betting permit holders adjusted gross revenue.
 - Of the tax collected, 97.5 percent is distributed to the general fund and 2.5 percent is allocated to the Problem Gambling Treatment and Support Fund.
- Budget language limits the deduction of bonuses or promotions from an operator's adjusted gross revenue to the operator's first year.
 - Noncash winnings (e.g. bonuses or promotions) decreased 84.9 percent in FY 2023 compared to FY 2022 from the limitation on deduction of bonuses or promotions.
- Sports betting tax collection for the general fund totaled \$67.2 million in FY 2023, compared to \$27.4 million in FY 2022.
 - Sports betting launched in Virginia in January 2021.

Casino Tax Revenue is Largely Dedicated for School Construction

- Casinos pay a variable tax rate based on their Adjusted Gross Receipts (AGR).
- Of the state's portion of the tax, the distributions are as follows:
 - 0.8 percent Problem Gambling Treatment and Support Fund;
 - 0.2 percent Family and Children's Trust Fund;
 - 1.0 percent Virginia Indigenous People's Trust Fund (if casino is operated by a tribe); and,
 - 98 - 99 percent School Construction Fund.
- School Construction Fund is administered by the Board of Education with criteria set out in the Appropriation Act.
- In 2020, the General Assembly authorized five cities to host a casino. Bristol, Danville, Norfolk, and Portsmouth have held successful referendums.

| Casino Wagering Tax Rate | | Adjusted Gross Receipts | | |
|-----------------------------------------------------------------------------------------------|-----|-------------------------|---------------------------------|---------------------|
| | | Less than \$200 million | Between \$200 and \$400 million | Above \$400 million |
|  Total Tax | 18% | 23% | 30% | |
|  State Tax | 12% | 16% | 22% | |
|  Local Tax | 6% | 7% | 8% | |

Cigarette and Tobacco Taxes Fund the State Medicaid Match

- Virginia imposes an excise tax of 3 cents per cigarette, equaling 60 cents per pack or \$6 per carton.
- Tobacco Products Tax is imposed on cigars, smokeless tobacco, pipe tobacco, loose leaf tobacco, liquid nicotine, and heated tobacco products.
 - Most tobacco products, other than moist snuff, loose leaf tobacco, and liquid nicotine, are currently subject to the tax at the rate of 20% of the manufacturer's sales price.
 - Liquid nicotine is taxed at the rate of 6.6 cents per milliliter.
- Revenues generated from the cigarette tax and the tobacco products tax are deposited to the Virginia Health Care Fund and used for the state match for Medicaid instead of the general fund.
 - Decreases in revenue to the Health Care Fund requires a corresponding increase in GF for the Medicaid state match.

Virginia Alcoholic Beverage Control Authority Contributes Revenue to the General Fund

- The Virginia Alcoholic Beverage Control Authority (ABC) transferred \$168.2 million from its net profit and \$376.8 million from tax collections to the general fund in FY 2023.
 - ABC contributions comprised nearly 2.0 percent of the general fund in FY 2023.
 - ABC net profit comprised 15.3 percent of its sales in FY 2023*.
- ABC net profit is total revenue less taxes collected, costs of goods sold, operating expenses, and ongoing infrastructure project costs.
- ABC also provides funding to other agencies including:
 - \$74.5 million to the Department of Behavioral Health and Developmental Services for care, treatment, study, and rehabilitation of alcoholics;
 - \$187,756 for services from agencies (APA, DOA, Treasury); and
 - 2.0 percent of the malt beverage tax to the Department of Environmental Quality Litter Control Fund (\$804,520 in FY 2023).

| ABC GF Contributions (\$ in millions) | FY 2023 |
|---------------------------------------------|----------------|
| GF Transfers from Net Profit | \$168.2 |
| Wholesale Tax on Wine and Beer ¹ | 70.9 |
| Excise Tax on ABC Sales ² | 237.6 |
| General Sales Tax on ABC Sales | <u>68.3</u> |
| Total GF Contribution | \$545.0 |

1. Wholesale taxes include 40 cents per wine liter, 8 cents per cider liter, and a variable rate by volume for beer and wine coolers (malt beverages).
2. Excise taxes on ABC sales include 20.0 percent on spirits and 4.0 percent on wine.

*Net profit as a percentage of sales listed using accrual basis accounting; all other amounts listed using cash basis accounting. Sources: ABC, Authority Transition – Enactment Clause 14 Report, 2023; Secretary of Finance, Review of the General Fund Revenues and the Virginia Economy for Fiscal Year 2023, August 23, 2023; ABC, staff email communication.



Tax Preferences and Recent Policy Actions

Tax Credits Reduce Taxpayer Liability and State Revenue

- Virginia has approximately 33 tax credits that may be claimed against Individual and Corporate Income Tax, Insurance Premium License Tax, and Bank Franchise Tax.
- In FY 2022, \$302.8 million in tax credits were claimed on 411,000 returns.

Top Seven Tax Credits Claimed in FY 2022

| Credit | Claimed Against | Number of Returns | FY 2022 Amount (\$ in millions) |
|--------------------------------------------------------------------|--------------------------------------------|-------------------|---------------------------------|
| Low-Income Taxpayer Credit (Refundable beginning in tax year 2023) | Individual Only | 398,037 | \$123.9 |
| Land Preservation Tax Credit | Individual and Corporate | 5,204 | 73.5 |
| Historic Rehabilitation Tax Credit | Individual, Corporate, Insurance, and Bank | 536 | 52.7 |
| Neighborhood Assistance Act Tax Credit | Individual, Corporate, Insurance, and Bank | 3,694 | 14.1 |
| Education Improvement Scholarships Tax Credits | Individual, Corporate, Insurance, and Bank | 1,583 | 11.4 |
| Major Research and Development Expenses Tax Credit | Individual and Corporate | 50 | 9.9 |
| Motion Picture Production Tax Credit (refundable) | Individual and Corporate | * | 4.5 |

Source: Virginia Department of Taxation, 2022 Annual Report. * Number of returns for this credit is not available for release because fewer than four returns claiming the credit were processed in FY 2022.

Sales Tax Exemptions Shrink Potential Revenue Base

- The largest categories of exemptions include (estimate for FY 2025 state and local sales and use tax): \$8.4 billion for services, \$1.3 billion for groceries (state portion), and \$980.6 million for data center equipment.
- As consumers continue to shift consumption from goods to nontaxable services, the revenue loss increases from \$8.4 billion in FY 2025 to \$10.2 billion in FY 2030.

| Type of Service | Examples of Service | Estimated Revenue Impact (State and Local) | |
|-----------------------|--------------------------------------------------------------------------|--------------------------------------------|------------------------|
| | | FY 2025 | FY 2030 |
| Personal Services | Admissions, auto repair, hairdressing, laundry, and maintenance services | \$925.6 million | \$1.1 billion |
| Business Services | Employment, consulting, advertising, and security services | \$3.0 billion | \$3.7 billion |
| Professional Services | Accounting, legal, engineering, and computer services | \$4.3 billion | \$5.3 billion |
| Insurance Services | Insurance agency/broker services | <u>\$112.6 million</u> | <u>\$139.1 million</u> |
| Total | | \$8.4 billion | \$10.2 billion |
| Streaming Services | Music and video | \$105.2 million | \$136.7 million |
| Digital Downloads | Music, video, books, magazines, and other digital publications | \$52.9 million | \$73.6 million |

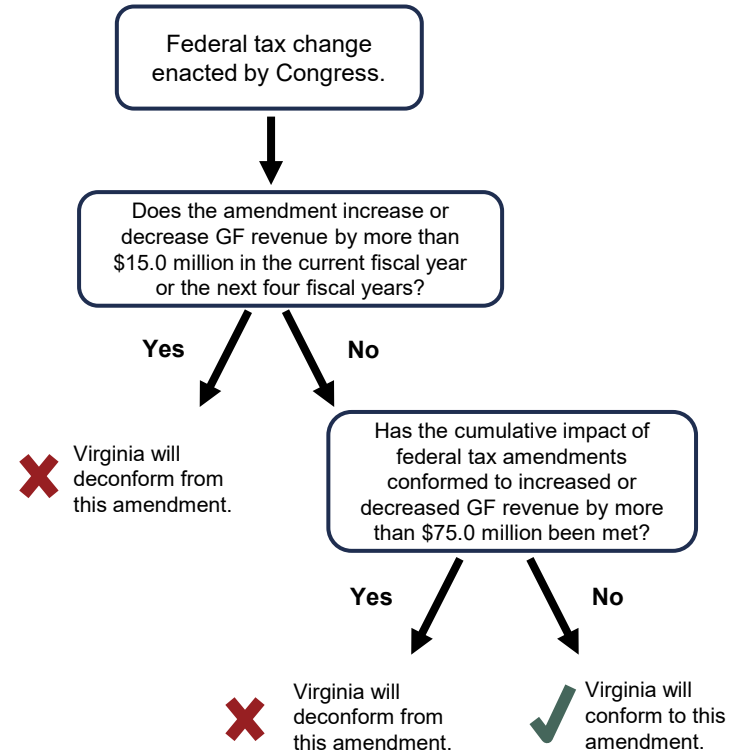
Source: Virginia Department of Taxation, Revenue Impact from Sales and Use Tax Exemptions, prepared October 2023 for SFAC. FY 2025 estimates represent full year revenue impact; however, if sales tax is applied to these services effective July 1, 2024, revenue estimate would be adjusted for 11 months of revenue collection

Virginia Conforming to Federal Tax Definitions Simplifies Tax Return Preparation and Administration of State Income Taxes

- Virginia generally conforms to federal definitions of income with some exceptions (e.g., limitation on itemized deductions, medical expense deduction).
- Reasons for conformity – simplicity, efficiency, and compliance:
 - Taxpayers do not have to recalculate their tax liability with different Virginia definitions and rules.
 - Virginia Tax can rely on federal data and compliance measures for accuracy, which reduces potential revenue loss attributable to noncompliance and administrative compliance costs (e.g., audits).
- After the federal Job Creation and Worker Assistance Act of 2002 (“JCWAA”) substantially reduced Virginia taxable income of businesses, the General Assembly adopted fixed date conformity in 2003.
- Since 2003, the General Assembly has advanced the date of conformity (fixed-date conformity) through legislation and revised the list of exceptions as needed.

Virginia Adopted Rolling Conformity in the 2023 Session

- During the 2023 Session, the General Assembly advanced conformity from December 31, 2021, to December 31, 2022 (fixed-date), and adopted rolling conformity effective on January 1, 2023 (Chapter 763 & 791, 2023 Session).
- Rolling conformity allows Virginia to conform to federal tax changes as soon as enacted by Congress.
- Rolling conformity has the potential to create large revenue variations and create structural imbalance in the budget. To mitigate this, the legislation allows Virginia to deconform:
 - From any federal amendment that either increases or decreases GF revenue by more than \$15.0 million in the fiscal year enacted or any of the succeeding four fiscal years; and,
 - From all federal amendments if the cumulative impact of enacted amendments to date increases or decreases GF revenue by more than \$75.0 million in the fiscal year or any of the succeeding four fiscal years.
 - Deconformity would not apply to any federal tax changes that the General Assembly subsequently adopts, the extension of the expiration date of a federal tax provision in which Virginia conforms, or amendments enacted before the date on which the cumulative projected revenue impact is met.



Elective Pass-Through Entity Tax

- The Tax Cuts and Jobs Acts limited the state and local tax (SALT) deduction to \$10,000. **The SALT cap applies only to individuals and not to business entities.**
- In 2022, Virginia established a 5.75 percent Pass-Through Entity (PTE) Tax at the state level to allow business owners to circumvent the SALT deduction limit.
- The PTE tax transfers state individual income tax burden from an individual to the business.
 - Generally, a PTE does not pay income tax at all, and only the entity's owners are required to pay tax on the distributive share of its income.
 - Under the PTE tax, this is reversed: the PTE now pays a 5.75 percent tax on its income at the entity-level, and the entity's owners receive their distributive share of income, generally tax-free, through means of an individual income tax credit.
- Entities' owners are then able to deduct the state PTE tax as a business expense on their federal returns while still deducting up to the SALT cap.
- Since the owner can deduct the full amount of state taxes paid on business income, their federal taxable income is significantly reduced.

Revenue Impact from Major Tax Policy Actions

| Tax Action (\$ in millions) | FY 2023 | FY 2024 | FY 2025 | FY 2026 |
|----------------------------------------------------------------------------------------------|--------------------|--------------------|--------------------|--------------------|
| Individual: Increase Standard Deduction \$8,000/\$16,000 * | (1,015.8) | (707.4) | (719.4) | (730.8) |
| Individual: Increase Standard Deduction \$8,500/\$17,000 (TY24) | 0.0 | (48.1) | (101.7) | (102.6) |
| Sales and Use: Eliminate State Portion on Groceries (1.5 percent) * | (115.0) | (267.2) | (272.5) | (273.6) |
| Individual: Refundable Earned Income Tax Credit to 15.0 percent of Federal Credit | (159.0) | (156.0) | (159.6) | (155.0) |
| Individual: Military Retirement Subtraction for Age 55 or Older | (145.0) | (156.0) | (182.0) | (194.4) |
| Individual: Military Retirement Subtraction Eliminate Age Limitation (TY24) | 0.0 | (37.8) | (33.4) | (34.7) |
| Individual/Corporate: Increase Business Interest Deduction Disallowed from 20% to 30% | (15.3) | (10.9) | (11.3) | (11.8) |
| Individual/Corporate: Increase Business Interest Deduction Disallowed from 30% to 50% (TY24) | <u>0.0</u> | <u>(10.3)</u> | <u>(22.6)</u> | <u>(23.5)</u> |
| Total Permanent Tax Cuts | (\$1,450.1) | (\$1,393.7) | (\$1,502.5) | (\$1,526.4) |
| Individual: 2022 Tax Rebate (\$250/\$500) | (\$1,048.6) | 0.0 | 0.0 | 0.0 |
| Individual: 2023 Tax Rebate (\$200/\$400) (Paid from Special Fund) | <u>0.0</u> | <u>(906.8)</u> | <u>0.0</u> | <u>0.0</u> |
| Total Permanent + One-Time Tax Cuts | (\$2,498.7) | (\$2,300.5) | (\$1,502.5) | (\$1,526.4) |

Source: Virginia Department of Tax, Revenue Impacts. * Estimates updated in July 2023 to reflect wage and inflation growth since fall 2021 estimates.

Key Takeaways – Virginia’s Revenue and Tax Policy

- Virginia’s state and local taxes are average compared to the other 50 states.
- Nongeneral funds support specific programs, such as transportation and Medicaid.
- General fund revenue, funds core services, is primarily from three major sources: income tax, sales tax, and corporate tax.
- Individual income tax comprises most general fund revenue.
 - Any significant tax policy changes in this source require consideration of the alignment of ongoing revenue to ongoing spending.
- Tax preferences can achieve goals of reducing tax burden, double taxation, or achieving certain policy goals, but these preferences must be evaluated over time.
- Fundamentally, state revenue growth must be sufficient to cover the utilization and inflation growth in core functions (public education, public safety, and health services) before making new investments or reducing revenue through tax policy actions.



Appendix

Glossary of Selected Tax Terms

- **Adjusted Gross Income (AGI):** Gross income reduced by adjustments to income, before exemptions and deductions are applied.
- **Deduction:** Deductions are expenses taxpayers are permitted to subtract from income before calculating the amount of tax due.
- **Exemption:** An exemption reduces the income subject to tax. Taxpayers can claim exemptions for themselves, their spouses, and eligible dependents. Virginia also has additional exemptions for the blind and for individuals over age 65.
- **Tax Credit:** Tax credits reduce a taxpayer's tax liability dollar-for-dollar. Some credits are refundable, meaning the amount of the credit is not limited by the taxpayer's tax liability; rather, the excess is refunded to the taxpayer.
- **Use Tax:** Counterpart to the retail sales tax. Consumers are required to pay a Use Tax if the sales tax is not collected at the time of the transaction.

Virginia Offers Special Apportionment Methods for Certain Taxpayers

- In certain situations, Virginia permits or requires the use of special apportionment methods that differ from the statutory three-factor apportionment method.
- Single-Sales Factor Apportionment assigns income based solely on the share of the corporation's sales occurring in Virginia as compared to sales everywhere.
 - Virginia has adopted for manufacturers (elective - 2009), retailers (2012), enterprise data centers (2015), and debt buyers (2018).
- Market Based Sourcing of Services and Intangibles sources a sale to the jurisdiction in which the corporation's market for such sale is located.
 - Virginia has adopted for debt buyers (2018) and property analytics firms (2022).
- Virginia also allows companies to request an alternative method of apportionment in situations where the statutory three-factor apportionment method is inapplicable or inequitable.

Certain Localities Have a Higher Sales and Use Tax Rate Imposed

| Hampton Roads & Historic Triangle (6-7%)* | Northern Virginia Region (6%) | Central Virginia Region (6%) | Additional 1% School Construction (6.3%) |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------|
| Chesapeake Franklin Hampton Isle of Wight Newport News Norfolk Poquoson Portsmouth Suffolk Virginia Beach Williamsburg* James City* York* | Alexandria Arlington Fairfax City Falls Church Loudoun Manassas Manassas Park Prince William | Charles City Co. Chesterfield Goochland Hanover Henrico New Kent Powhatan Richmond | Charlotte Gloucester Halifax Henry Northampton Patrick Pittsylvania Danville |

*Williamsburg, James City Co., and York Co. subject to additional 1% Historic Triangle tax rate.