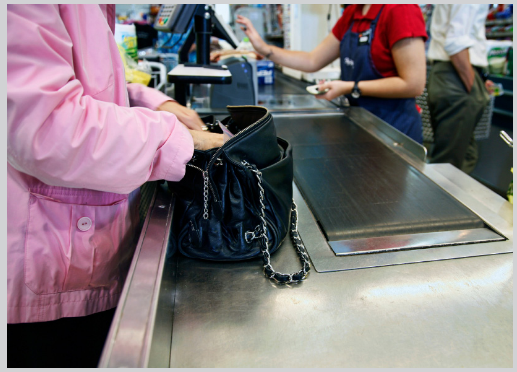
JLARC
JOINT LEGISLATIVE AUDIT
AND REVIEW COMMISSION

REPORT TO THE
GOVERNOR AND THE GENERAL ASSEMBLY OF VIRGINIA



Review of the Effectiveness of Virginia Tax Preferences

COMMISSION DRAFT — NOT APPROVED

COMMONWEALTH OF VIRGINIA
RICHMOND

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In Brief

Senate Joint Resolution 21 (2010) directs JLARC to examine the effectiveness of tax preferences. Virginia tax preferences collectively reduced taxpayers' liability by approximately $12.5 billion in 2008, which represents nearly 90 percent of the State revenue collected from the tax systems reviewed ($14.3 billion).

Tax preferences are intended to achieve either tax policy or public policy goals. While altering preferences with tax policy goals would generally have negative effects on the State's tax systems, changing the retail sales and use tax exemption on services could improve the reliability and equitability of that tax system.

Among tax preferences with public policy goals, those aimed at providing financial assistance achieve their goals, but some could be more efficiently targeted to their intended beneficiaries.

The effectiveness of tax preferences designed to promote specific activities appears to be mixed. Land and historic preservation tax credits appear to effectively achieve their goals, while others, such as coal tax credits, do not.

The State currently lacks a consistent process to evaluate the effectiveness of tax preferences. A joint subcommittee should oversee the evaluation process, with guidance from a technical advisory group and analysis from the Department of Taxation.

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This report is available on the JLARC website at http://jlarc.virginia.gov

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JLARC Report Summary:

Review of the Effectiveness of Virginia Tax Preferences

Key Findings

- Tax preferences collectively reduced taxpayers' liability by approximately $12.5 billion in tax year 2008, which represents nearly 90 percent of the amount of State revenue collected from the tax systems reviewed ($14.3 billion). The subset of tax preferences aimed at achieving public policy goals reduced tax liability by $2.9 billion. (Chapter 2)
- While altering many preferences with tax policy goals could have negative effects on the State's tax systems, changing Virginia's retail sales and use tax exemption on services could improve the reliability and equitability of that tax system. (Chapter 2)
- Virginia's tax preferences aimed at providing financial assistance achieve their goals, but some could be more efficiently targeted to their intended beneficiaries. (Chapter 3)
- The effectiveness of tax preferences designed to promote specific activities appears to be mixed. Land and historic preservation tax credits appear to effectively achieve their goals. Others, such as coal tax credits, do not appear to achieve their intended goals. (Chapter 4)
- The State makes limited use of sunset dates and periodic reviews as mechanisms to identify effective preferences and improve or eliminate ineffective ones. (Chapter 5)
- To most effectively evaluate Virginia tax preferences, a joint subcommittee should oversee the evaluation process. The Department of Taxation possesses the requisite expertise and is best suited to perform evaluations. A technical advisory group comprised of tax policy and evaluation experts could be created to provide guidance. (Chapter 6)

Like most states, Virginia uses tax preferences to achieve specific policy goals. Because tax preferences are not subject to the State budgetary process, they often remain in effect, sometimes indefinitely, without any evaluation of their effectiveness. Little information is available about tax preferences, including which ones should be continued because they are effective, and which ones could be revised to improve their effectiveness or eliminated altogether.

In response to these concerns, the 2010 General Assembly passed Senate Joint Resolution (SJR) 21, which directs the Joint Legislative Audit and Review Commission (JLARC) to study the effectiveness of Virginia tax preferences. In particular, the mandate requests that JLARC examine the use and fiscal impact of Virginia tax preferences, specific public policy goals for which they were established, and the extent to which these goals are achieved. Further, the mandate directs JLARC to propose mechanisms or processes for an ongoing evaluation of the effectiveness of Virginia tax preferences.

OVERVIEW OF VIRGINIA TAX PREFERENCES

Tax preferences are provisions in the tax code that decrease the tax liability of eligible taxpayers and ultimately reduce the amount of revenue that the State collects. Virginia offers almost 200 tax preferences in the form of exemptions, subtractions, deductions, or credits available through the tax systems included in this review. These preferences were typically adopted by the Virginia General Assembly to either achieve a public policy purpose, such as providing financial assistance or promoting a desired activity, or to improve the tax system. This evaluation focuses on Virginia tax preferences that were designed to achieve public policy goals and are granted through the individual income tax, corporate income tax, and retail sales and use tax systems.

VIRGINIA TAX PREFERENCES SUBSTANTIALLY REDUCE TAXPAYER LIABILITY AND STATE REVENUE COLLECTIONS

In 2008, Virginia tax preferences collectively reduced taxpayers' liability by $12.5 billion, which represents nearly 90 percent of the $14.3 billion in revenue collected.

Virginia's income and retail sales and use tax preferences have a substantial impact on the tax liability owed by qualifying taxpayers, and thus the amount of revenue collected by the State. In tax year (TY) 2008, tax preferences collectively reduced taxpayers' liability by $12.5 billion, which represents nearly 90 percent of the $14.3 billion in revenue that was collected under the tax systems examined. Three large preferences account for half of the reduction in tax liability: the exemption of services and of manufacturing materials and equipment from the retail sales and use tax, and the treatment of federal itemized deductions on individual income tax returns. Although estimates of reduced tax liability cannot be equated to the revenue impact of Virginia's tax preferences, estimates for each tax preference and all preferences combined demonstrate the magnitude of the impact that Virginia's tax preferences likely have on revenue.

Preferences aimed at achieving tax policy goals, such as avoiding double taxation or gaining efficiency, accounted for most ($9.6 billion) of the reduction in tax liability in TY 2008. Although State revenue collections could substantially increase if some of these preferences were altered or eliminated, their intent is to balance revenue considerations against principles of sound tax policy such as simplicity, equitability, and reliability. Consequently, changes to these preferences could adversely impact the State's tax systems. While public policy preferences represent a smaller ($2.9 billion) share of the total reduced liability, the State can more easily revise or eliminate ineffective ones without undermining principles of sound tax policy. Preferences with public policy goals are generally intended to provide financial assistance to certain populations or promote specific activities among taxpayers.

Preferences aimed at providing financial assistance account for the vast majority of the total reduction in tax liability resulting from preferences with public policy goals, as shown in the table below. These preferences generally benefit a large number of individuals but provide a relatively low reduction in the tax liability of each beneficiary. If found to be ineffective at providing financial assistance, these tax preferences could be revised to reduce their impact on State revenue. In contrast, tax preferences that promote activities that the State wishes to encourage tend to result in a lower total reduction in taxpayer liability, but they provide larger average reductions to each beneficiary. Changes to tax preferences that are ineffective at promoting their intended activities could enhance the State's ability to achieve desired policy goals while potentially impacting fewer taxpayers.

Five Preferences Aimed at Providing Financial Assistance Account for Vast Majority of Reduced Liability From Public Policy Tax Preferences (TY 2008)

Public Policy Preference	Tax System	Reduced Tax Liability ($ million)[a]
Tiered tax rate	Income	$869
Drug and medical product exemptions	Sales	438
Food partial exemption	Sales	346
Age deduction	Income	285
Social Security income subtraction	Income	244
Subtotal, top five financial assistance preferences[b]		**$2,183**
All other financial assistance tax preferences		216
All other tax preferences promoting activity		502
Total, all public policy preferences		**$2,901**

[a] Estimates likely overestimate revenue impact or potential additional revenue if the preferences were eliminated because the estimates do not account for (1) taxpayers using another similar preference or otherwise altering their behavior to reduce their tax liability or (2) the portion of sales tax revenue that businesses keep for administering the tax.
[b] Reported total and sum of values reported for preferences differs due to rounding error.

Source: JLARC staff analysis of Virginia income tax return data for TY 2008 and additional data sources as identified in Appendix B (Table B-2).

VIRGINIA COULD DISCONTINUE EXEMPTION OF SERVICES TO BETTER MEET TAX POLICY GOALS

Eliminating the retail sales and use tax exemptions for some or all services could enhance several tax policy goals, such as improving equitability while increasing the reliability of the tax system. According to the research literature, states did not apply sales taxes to services when they began adopting retail sales and use taxes in the 1930s and 1940s. Services were not taxed because they represented a relatively small sector of the economy and would not have generated sufficient revenue to offset the cost of administering and enforcing tax collections.

However, services now represent approximately two-thirds of the national economy, and Virginia could significantly broaden the retail sales and use tax base and improve the reliability of collections by taxing some or all services. Service exemptions represent the largest group of tax preferences in Virginia, reducing taxpayer liability by over $3.5 billion in 2008. The equitability of the retail sales and use tax system could be improved because consumers would be taxed regardless of their preference, whether they purchasing a good such as a lawnmower (currently taxed) or a service such as hiring a gardener (currently exempt). However, consideration should be given to factors which could make implementation difficult, including increased administrative costs and strong industry opposition.

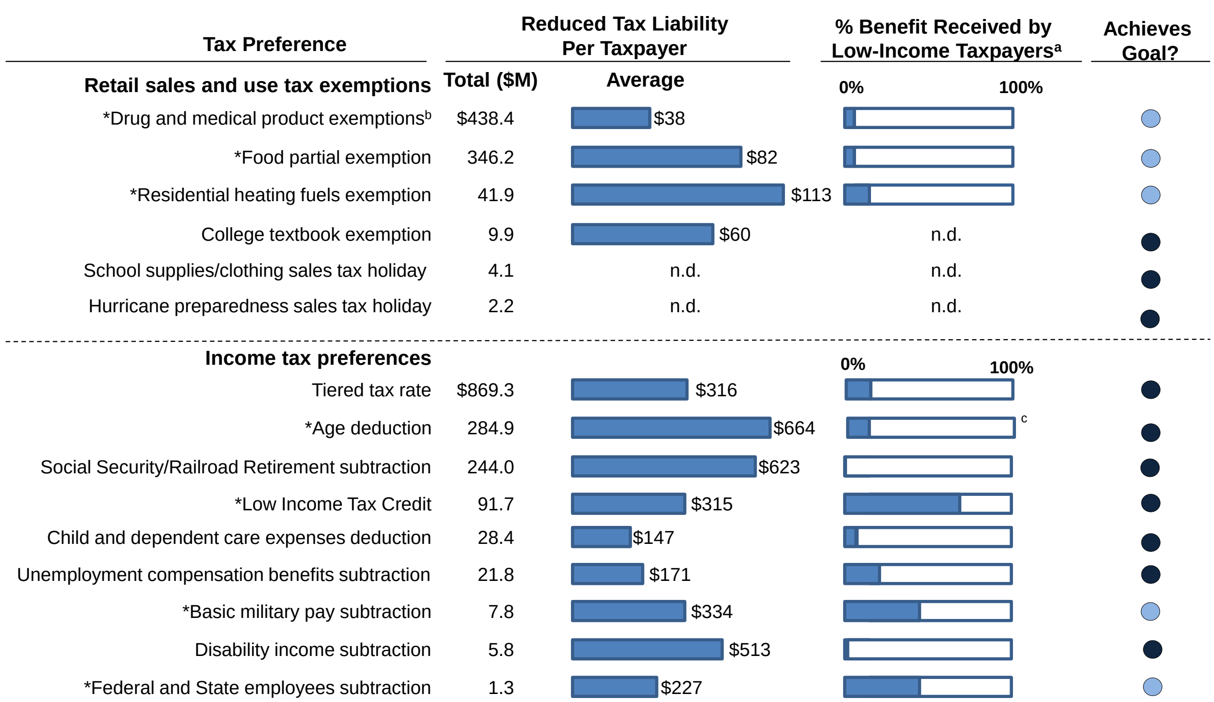
VIRGINIA FINANCIAL ASSISTANCE TAX PREFERENCES ACHIEVE GOALS, BUT SOME COULD BE MORE EFFICIENTLY TARGETED

Of the 26 tax preferences aimed at providing financial assistance in Virginia, 20 preferences were reviewed because they each reduced taxpayer liability by at least $1 million. All of these tax preferences achieved their goal of providing benefits that have value to taxpayers, as shown in the figure on the following page. Just under half of the tax preferences aimed at providing financial assistance are exemptions from the retail sales and use tax for purchases of certain basic necessities such as medications and food, and other goods such as school supplies. These preferences reduced taxpayer liability by an average of $38 to $113 a year, on average, depending on the preference, which allowed consumers to purchase additional goods. The remaining preferences are income tax subtractions, deductions, or credits that reduced taxpayer liability by annual amounts ranging between $147 and $664, on average.

Although 12 of the tax preferences reviewed are intended to especially benefit lower income individuals, ten of them do not appear to efficiently achieve this goal because higher income individuals receive a majority share of the reduction in tax liability. None of the retail sales and use tax exemptions for basic necessities appear to efficiently target lower income individuals, which is the group they were especially intended to benefit. For example, while taxpayers with incomes of $20,000 or less comprised 14 percent of Virginia households, they received only seven percent of the reduction in tax liability associated with the partial exemption on food purchases available to all taxpayers.

Income tax preferences that are targeted at lower income taxpayers through means testing may also reach unintended beneficiaries. For two income tax preferences that are means tested, more than one-half of the reduction in tax liability accrued to households with incomes above the eligibility limit for the preference. House-

Virginia Tax Preferences Designed to Provide Financial Assistance Achieve Goals, but Many Aimed at Lower Income Taxpayers Could Be Better Targeted (TY 2008)



Legend: appears to effectively achieve goal but could be more efficiently targeted; appears to effectively achieve goal

Note: n.d., no data available; *, means tested.
[a] Low-income taxpayers for sales tax exemptions are households with incomes less than $20,000. Low-income taxpayers for income tax preferences are those filing returns with incomes less than $25,000. Thresholds were selected because they approximate100 percent of federal poverty level for a family of four in 2008 ($21,200). Slightly different thresholds were selected due to differences in the data used.
[b] Represents six exemptions.
[c] Age deduction targets low to moderate income taxpayers.

Source: JLARC staff analysis of Virginia income tax return data for TY 2008 and additional data sources as identified in Appendix B (Table B-2).

holds with income levels above the thresholds can benefit because many preferences apply the means test to the qualifying individual's income, not total household income. The exception is the Low Income Tax Credit, because only lower income households can claim the credit, and 67 percent of the reduction in tax liability from the credit is distributed to taxpayers with incomes below $25,000.

NOT ALL VIRGINIA TAX PREFERENCES DESIGNED TO PROMOTE DESIRABLE ACTIVITY ACHIEVE INTENDED GOALS

Virginia has enacted more than 70 tax preferences intended to promote economic, resource preservation, charitable, and other activities that the legislature has determined to be desirable. While some of these tax preferences appear to be effective, others show little or no impact on the outcomes they are intended to encourage, as summarized in the figure below.

Of the Virginia tax preferences aimed at promoting activity, those intended to foster resource preservation reduce taxpayer liability by the greatest amount and are generally successful in achieving their intended goals. The Land Preservation Tax Credit appears to have successfully triggered a substantial increase in the volume of privately held Virginia land donated for conservation. Similarly,

Some Tax Preferences That Reduced Tax Liability by $20 Million or More May Not Promote Desirable Activity as Intended (TY 2008)

Tax Preference	Reduced Tax Liability ($ Millions)	Activity Moved in Desired Direction?	Activity Influenced by Preference?	Average % Reduction In Tax Liability[a]	Achieves Goal?
Promotes Preservation				0% 100%	
Land Preservation Tax Credit	**$119.6**	✓	✓		●
Historic Rehabilitation Tax Credit[b]	**60.8**	✓	✓		●
Promotes Charitable Activity				0% 100%	
Nonprofit purchases exemption	**178.8**	✓	✗	- -	○
Promotes Economic Development				0% 100%	
Coal tax credits[c]	**31.2**	✗	✗	[d]	○

Legend: ○ appears unlikely to achieve goal; ● appears to effectively achieve goal

[a] Represents reduction in income tax liability. Reduction in retail sales and use tax liability could not be determined because total retail sales and use taxes paid by beneficiaries for non-exempt purchases are unknown.
[b] Another $53 million in credits is claimed against insurance premium and bank taxes.
[c] Includes the Coal Employment Enhancement Tax Credit and Coal Employment and Production Incentive Tax Credit.
[d] Tax credit reduced tax liability by more than 100 percent, on average.

Source: JLARC staff analysis of Virginia income tax return data from TY 2008 and additional data sources as identified in Appendix B (Table B-2).

the Historic Rehabilitation Tax Credit appears to have effectively promoted rehabilitation projects. Still, while both credits achieve their goals, some concerns have been voiced regarding how the credits are structured and whether they are being properly claimed.

Tax preferences intended to encourage charitable activities are the next largest in terms of their reduction in taxpayer liability. The largest of these preferences, the sales tax exemption for nonprofits, does not appear to increase charitable activity, because less than one-quarter of Virginia nonprofits have applied with the Department of Taxation (TAX) to use the exemption. Instead, the exemption appears to serve as recognition of the value of the services provided by nonprofits, such as education and health and human services, that may otherwise not exist or have to be funded by the State. Two other exemptions aimed at promoting charitable activities were reviewed and yielded similar conclusions. The Neighborhood Assistance Tax Credit was also reviewed and appears to achieve its goal to some extent.

Tax preferences that are designed to promote economic activity vary widely in their effectiveness. The largest of these preferences, Virginia's coal income tax credits, may not be effectively promoting coal production and employment because changes in coal mining activity appear unaffected by the credits. Limited reviews of ten other tax preferences intended to promote economic activities, such as job creation and capital investment by selected industries, found that most appear to achieve their goals to some extent. According to reviews of the literature and information provided by stakeholders, factors exist that may hinder the extent to which these preferences can successfully achieve their goals.

SEVERAL FACTORS MAY HINDER EFFECTIVENESS OF VIRGINIA TAX PREFERENCES IN ACHIEVING PUBLIC POLICY GOALS

Based on reviews of the literature and research conducted for this study, multiple factors appear to preclude some Virginia tax preferences from effectively achieving their public policy goals. In addition to external influences such as socio-economic factors, public policy tax preferences may have a limited impact if they are not valuable enough to make claiming them worthwhile, usable, or well-targeted toward intended beneficiaries. One option may be to structure less effective preferences as refundable tax credits or change them to a grant program. However, the potential benefits of refundable credits could be offset by potential drawbacks such as increased cost and administrative burden on the State. Grant programs allow the legislature to better manage the financial impact to the State but may be less valuable to beneficiaries if appropriated funding is limited.

Limited or no utilization is one indication that a tax preference may not be accomplishing its goal, and 12 of Virginia's tax preferences appear to be currently underutilized. (Other tax preferences may be underutilized but were not identified because of insufficient data.) These preferences should be evaluated to determine the reasons why they are not more widely used by taxpayers and whether they should be revised to increase use, eliminated, or phased out with a sunset date.

Only 20 out of 187 Virginia tax preferences currently have sunset dates, and they do not appear to trigger any meaningful evaluation or result in many preferences being allowed to expire.

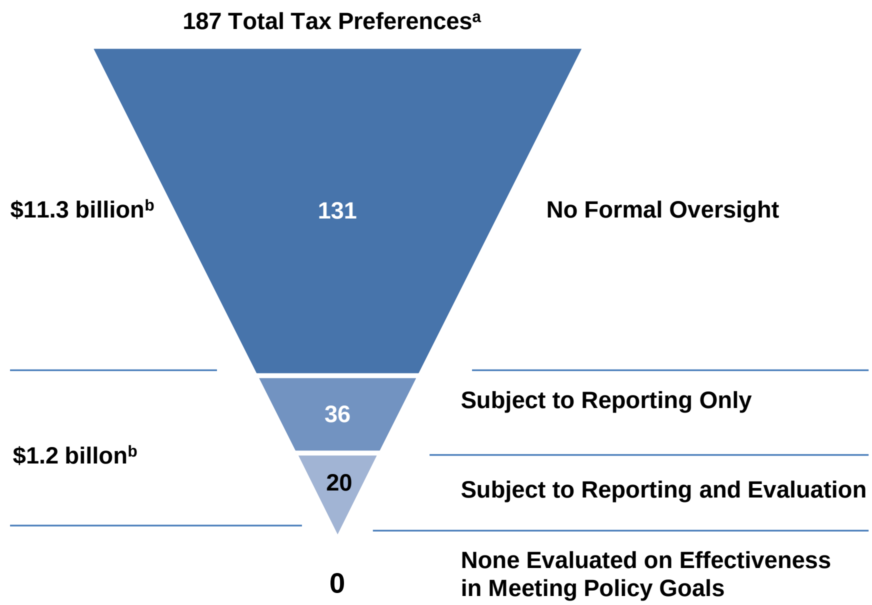
Sunset dates are not frequently used as a mechanism to identify, remedy, or eliminate ineffective tax preferences. Only 20 out of 187 Virginia tax preferences currently have sunset dates, and they do not appear to trigger any meaningful evaluation. According to legislative staff and a review of the legislative record, tax preferences set to expire are frequently renewed without debate, such that few tax preferences appear to have been eliminated as a result of sunset dates. Virginia's limited usage of sunset dates is similar to practices in other states, with the exception of Oregon and Nevada which appear to use sunset dates regularly.

Policymakers also lack comprehensive information on the effectiveness of tax preferences, which hinders their ability to identify, revise, or eliminate those that are ineffective. As shown in the figure on the following page, little to no information is available about the vast majority of Virginia tax preferences, resulting in a lack of formal oversight for preferences that collectively reduce tax liability by approximately $11.3 billion. Further, only a few tax preferences are evaluated, and none are assessed to determine if their policy goals are being achieved.

JOINT SUBCOMMITTEE RECOMMENDED TO OVERSEE ONGOING EVALUATION OF VIRGINIA TAX PREFERENCES

SJR 21 directed JLARC to propose a process for the ongoing review of the effectiveness of Virginia's tax preferences. Based on reviews of the research literature and other states' practices, several elements could maximize the effectiveness of an evaluation process and promote action being taken to continue, revise, or eliminate tax preferences. The legislature could oversee the evaluation of tax preferences because it is responsible for approving tax preference legislation. To this end, a joint subcommittee could be established that would include members from the House Finance, House Appropriations, and Senate Finance committees. Each year, the joint subcommittee could report its recommendations to the General Assembly as an effort to promote action for continuing, revising, or eliminating tax preferences based on evaluation findings.

Minority of Public or Tax Policy Preferences Are Subject to Formal Evaluation or Reporting



a. Includes all preferences that were active as of November 2011.
b. Estimates of taxpayer liability are the TY 2008 totals for these preferences, as this is the last year for which complete data was available. The estimates do not include the reduction in liability from 16 new preferences that have been added since 2008 or the reduction in liability from the eight preferences that have expired or been repealed since 2008.

Source: JLARC staff analysis of Title 58.1 of the *Code of Virginia*, TAX sales tax studies from 2007 to 2010, and TAX annual reports.

TAX has the combination of tax, legal, and analytical expertise to most effectively and efficiently evaluate Virginia tax preferences. A technical advisory group could also be established to provide guidance and additional expertise in the evaluation process as well as to review findings. The joint subcommittee, with assistance from TAX and the technical advisory group, should develop procedures for the evaluation process to ensure that evaluations are conducted comprehensively and consistently.

Chapter 1 Overview of Virginia Tax Preferences

In Summary

Virginia currently offers almost 200 tax preferences in its individual and corporate income and retail sales and use tax systems. These preferences typically were adopted by the Virginia General Assembly either to achieve a public policy purpose, such as providing financial assistance or promoting a desired activity, or to improve the tax system. In accomplishing these goals, tax preferences decrease the tax liability of eligible taxpayers and ultimately reduce the amount of revenue that the State and localities collect. However, unlike programs that require annual or biennial appropriations, tax preferences are not subject to regular legislative review or performance evaluation. Without evaluations, legislators do not have the information necessary to determine which preferences are effective, how they can be improved, and which preferences should be eliminated. Concerns have been raised because tax preferences are often difficult to eliminate, regardless of their effectiveness, and limited information is currently available about them.

Virginia, like other states and the U.S. government, utilizes tax preferences to achieve specific policy goals. Unlike programs that require appropriations, Virginia's tax preferences are not subject to routine evaluation as part of the State budgetary process. Instead, tax preferences are written into the *Code of Virginia* and tend to remain in effect without evaluation. Moreover, information about the revenue impact of many tax preferences and their beneficiaries is neither estimated nor reported.

The 2010 General Assembly passed Senate Joint Resolution (SJR) 21, which directs the Joint Legislative Audit and Review Commission (JLARC) to study the effectiveness of Virginia tax preferences (Appendix A). Specifically, the study mandate requests that JLARC review preferences for three types of taxes: individual income, corporate income, and retail sales and use taxes. In addition, the mandate directs JLARC to perform five specific actions:

- determine which tax preferences are being claimed or taken and to what extent,
- provide an estimate of the fiscal impact of the tax preferences claimed or taken,
- examine the public policies for which the tax preferences were established and whether they have been achieved,
- report on whether other states routinely provide a sunset date for their tax preferences, and

- propose mechanisms or processes for the ongoing evaluation of the effectiveness of Virginia's tax preferences in bringing about the desired public policies for which they were established.

To address the mandate, JLARC staff conducted extensive document and literature reviews to determine which provisions in Virginia's tax code are tax preferences. In addition, these reviews assisted staff to deduce the public policy goals for which tax preferences were established because goals are rarely specified in the statute enabling the preference. JLARC staff also conducted extensive data analysis of Virginia tax return, national, and industry data to estimate the extent to which tax preferences are used and by how much they reduce taxpayer liability, and determine the extent to which tax preferences achieve their public policy goals. Further, JLARC staff interviewed staff of the Department of Taxation and other State agencies that assist in administering Virginia tax preferences, industry officials, and representatives of stakeholder groups. A more complete discussion of research methods is included in Appendix B.

TAX PREFERENCES REVIEWED ARE OFFERED THROUGH THREE TAXES THAT ARE LARGEST REVENUE SOURCES FOR THE STATE

The individual income, corporate income, and retail sales and use taxes are the three largest revenue sources for the State general fund (Figure 1). The individual income tax alone accounted for $9.1 billion of the general fund's total $14.2 billion in revenues in fiscal year (FY) 2010, followed by the retail sales and use tax ($3.1 billion), and the corporate income tax ($0.8 billion). Tax preferences granted through these three tax systems were evaluated for this review (preferences are also granted through other State tax systems, such as the insurance premiums tax).

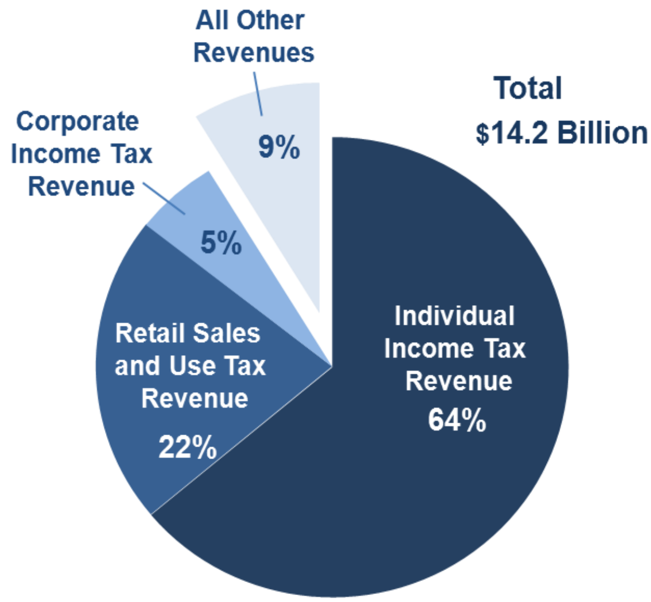
Corporations and Individuals Are Subject to Income Taxes

Virginia has two income taxes: the corporate income tax and individual income tax. Most C corporations with income from Virginia sources are subject to the corporate income tax; however, some are exempt because they pay alternative taxes such as the bank franchise or insurance premiums tax. Individuals, both resident and non-resident, with income from Virginia sources are subject to the individual income tax. In addition, other forms of businesses, such as S corporations and limited liability companies, are taxed primarily through the individual income tax because all income and losses are passed to their owners, many of whom are individuals. Corporate owners are taxed through the corporate income tax system. All income tax revenues are deposited into the State's general

C Corporation vs. S Corporation

Many large companies are organized as either C or S corporations, named after Subchapters C and S of the Internal Revenue Code. C Corporations are typically larger than S corporations, which must have no more than 100 shareholders. S corporations are generally taxed under the individual income tax system.

Figure 1: Revenues From Three Taxes Represent Over 90 Percent of General Fund Revenues in FY 2010



Source: JLARC staff analysis of Department of Planning and Budget and Department of Taxation reports for FY 2010.

fund, where they have historically comprised more than two-thirds of annual general fund revenues.

The Virginia Department of Taxation (TAX) administers both of the State's income taxes and requires taxpayers to file an annual tax return that reports their net income as determined for federal tax purposes, as well as applicable State subtractions or deductions used to determine Virginia taxable income. The tax liability of each taxpayer is calculated by applying the appropriate rate (six percent for corporations and between two and 5.75 percent for individuals) to Virginia taxable income less available tax credits. Almost all the information provided on individual tax returns and the majority of information on corporate returns is captured electronically, and this information can be used to determine the extent to which tax preferences are used and by how much they reduce taxpayer liability.

Consumers Are Subject to the Retail Sales and Use Tax

Virginia's retail sales and use tax consists of two complementary components. The first is a sales tax on transactions occurring within the State. The second is a use tax on goods purchased outside of the State and then brought into Virginia. The base of the sales and use tax is the retail sale price, and both sales and use taxes are applied only to the retail sale made to the final consumer. For ex-

Use Tax Intended to Complement Sales Tax

States which first enacted sales taxes found that consumers would, when possible, purchase goods from outside the state in order to avoid paying the tax. The use tax was designed to make consumers liable for paying taxes to Virginia if a good was purchased in another state tax-free but was subsequently brought into the Commonwealth. States have traditionally encountered challenges in collecting use taxes, especially for small purchases. Challenges have grown with the expansion of online sales.

ample, sales made by an electronics wholesaler to an electronics retailer are not taxed, but the retailer's sales to consumers are. Only retail sales are taxed to avoid taxing the same good multiple times. Virginia also imposes several specialized sales and use taxes (which were not included in this review) such as the aircraft, communications, motor vehicles, and watercraft sales and use taxes.

The State's retail sales and use tax has two different rates. The tax rate for most taxable goods and services is five percent of the sales price. This rate includes a four percent State tax plus a one percent local tax. However, food that is sold for consumption at home is taxed at a reduced rate of 2.5 percent. The reduced tax rate imposed on food includes a 1.5 percent State tax plus a one percent local tax. Although local governments have the option of whether to impose the one percent local tax on retail sales, all have elected to impose it.

Revenues collected from retail sales and use taxes are distributed between the State and localities. Funds from the State portion of the tax are deposited in the State's general and transportation trust funds and to localities for public school funding and real property tax relief. Revenues collected under the one percent local option are distributed back to the localities from which they were collected. Net tax revenues from FY 2010, as well as the amounts distributed to the State and localities, are shown in Table 1.

Table 1: Retail Sales and Use Tax Revenues Are Distributed to the State and Localities (FY 2010)

	Fund	Revenues (millions)
State	General Fund[a]	$2,118
	Transportation Trust Fund[b]	491
	Education[c]	964
	SOQ / property tax relief[d]	209
	Subtotal	**$3,782**
Local	Local option (one percent tax)	980
	Total Net Revenues	**$4,762**

a. General fund collections under the State's portion of tax less amount that is distributed to local governments for education (see note c) and Standards of Quality (SOQ) / property tax relief (see note d).
b. Allocation is one-eighth of the four percent State general tax and one-third of the 1.5 percent State food tax.
c. One-fourth of the four percent State general tax and two-thirds of the 1.5 percent State food tax are appropriated to localities for expenses incurred in the operation of public schools, based on each locality's school-age population.
d. One-sixteenth of the four percent State tax is appropriated to the Public Education SOQ/Local Real Estate Property Tax Relief Fund.

Source: JLARC staff analysis of TAX Annual Report, FY 2010.

Although TAX administers the retail sales and use tax, the burden of collecting and remitting tax revenues generally falls on businesses or other entities that make retail sales to consumers in Virginia. Businesses collect the appropriate sales taxes from customers when retail sales are made and remit the collections to TAX on a monthly or quarterly basis, along with their tax returns. Each tax return must include the business's aggregate sales for the period, the amount of sales that were taxable, and the amount of taxes that was collected. Businesses do not provide information on specific sales, customers, or the specific exemptions that were claimed. While information reported on retail sales and use tax returns is captured electronically, it does not capture information specific to consumers or exemptions claimed, as noted above. Therefore, sales and use tax return data is not useful for determining beneficiary use, revenue impact, or the effectiveness of most preferences granted through the tax.

It is important to note that retail businesses with no presence in Virginia cannot be made to collect and remit taxes to the State, according to a ruling of the U.S. Supreme Court. Because of this ruling, states are limited in their ability to require retailers with no physical presences, such as a store, in the state to collect and remit sales taxes. If the retailer does not collect the tax, consumers are responsible for self-reporting and remitting taxes owed by reporting it on their income tax return or filing a consumer use tax return. However, requiring consumers to pay taxes on their online transactions has proven difficult for states to enforce.

Amazon Statute

By adopting an "Amazon" statute, states can impose sales taxes on online retailers such as Amazon.com that have a contractual relationship with in-state businesses (affiliates) through which they pay the in-state business to refer customers to their website.

To address this issue, states are becoming members of the Streamlined Sales Tax Project as an effort to encourage Congress to overturn the U.S. Supreme Court decision or adopt affiliate statutes such as an "Amazon statute." The General Assembly has considered legislation to become a member of the Streamlined Sales and Use Tax Agreement (SSUTA) and to adopt an "Amazon statute" in recent years, but these bills were not approved. Based on fiscal impact statements prepared for this legislation in 2010, it was estimated that Virginia could realize approximately $10 million annually by adopting the SSUTA legislation or up to $17 million by adopting an "Amazon statute." However, Virginia could realize revenues of $100 million or more annually if the State adopted SSUTA legislation and the federal government also adopted legislation to overturn the Supreme Court ruling.

TAX PREFERENCES REDUCE TAX LIABILITY OF CERTAIN TAXPAYERS

Tax preferences are provisions in the tax code that reduce the tax liability of certain taxpayers, thereby lowering the overall revenue that the State and local governments receive. In particular, tax preferences are targeted at taxpayers in special circumstances because of their level of income, participation in particular activities, or purchase of certain goods. The extent to which tax liability is reduced depends on the specific preference and the taxpayers' circumstances. Whereas a preference such as the Historic Rehabilitation Tax Credit reduced individual income tax liability by 84 percent in 2008, on average, the deduction claimed by individuals with long-term health care insurance coverage reduced individual income tax liability by an average of only nine percent. Tax experts and the research literature often refer to tax preferences as tax expenditures, because they represent indirect government spending by reducing the amount of revenue that would otherwise be collected.

Tax Preferences Can Be Granted Through Several Mechanisms

Tax preferences include exemptions, deductions, credits, structural components, and deferrals (Table 2). Virginia's income tax

Table 2: Multiple Types of Tax Preferences Are Used to Reduce Tax Liability

Type	Definition/Purpose	Virginia Example
Exemption/ Exclusion[a]	Income or sale that is not included when calculating the taxable amount because of a specific provision that prevents the income/sale or entity earning the income/making the purchase from being taxed.	Banks' incomes are exempt from the corporate income tax because they are subject to the bank franchise tax. Sales of drugs and medical products are exempt from the retail sales and use tax.
Subtraction/ Deduction	An amount that is removed from the tax base before tax liability is calculated. Results in a marginal reduction of tax liability.	Income from service in the Virginia National Guard is subtracted prior to calculating Virginia taxable income.
Credit	An amount that offsets or reduces tax liability after tax liability is calculated. Results in a dollar-for-dollar reduction in tax liability.	Corporations eligible for the Major Business Facility Job Tax Credit can reduce their tax liability by $1,000 per job created.
Structural Component	Component of tax system that impacts how taxable income or tax liability is calculated.	Manufacturers can elect to use single sales factor apportionment to determine taxable income. Individuals within different income tax brackets are taxed at different rates.
Deferral	A provision that delays recognition of income or accelerates deductions by allowing a greater deduction in the current year than would otherwise be deducted in future years.	Accelerated depreciation of assets allows current year tax liability to be reduced by allowing depreciation for future years to be deducted in the current year.

[a.] As applies to income taxes, the research literature typically differentiates between exclusions (income that is not part of the tax base) and exemptions (income that would be part of the tax base except for a specific provision of the tax code). Virginia typically uses the terms interchangeably.

Source: JLARC staff review of the *Code of Virginia* and research literature on tax preferences.

preferences take multiple forms, while retail sales and use tax preferences are typically full or partial exemptions (Table 3). Although all tax preferences reduce tax liability, they do so in different ways that can result in varying levels of benefits. For instance, tax credits provide a dollar-for-dollar reduction in tax liability, which means that a $1,000 credit will reduce a taxpayer's liability by $1,000. In contrast, a $1,000 subtraction or deduction will reduce taxpayer liability by only a fraction of that amount, based on the tax rate. For example, corporations are taxed at a rate of six percent, and so a $1,000 deduction would reduce a corporation's tax liability by $60.

Table 3: Virginia's Retail Sales and Use Tax Preferences Are Typically Exemptions, While Income Tax Preferences Take Multiple Forms

Type	Corporate Income Tax	Individual Income Tax	Retail Sales and Use Tax
Exemption/Exclusion	✓	✓	✓
Subtraction/Deduction	✓	✓	
Credit	✓	✓	
Structural component	✓	✓	✓[a]
Deferral	✓	✓	

[a] Modular building manufacturers may apply a credit equal to the value of retail sales and use taxes already paid on materials which are incorporated into a modular building that is sold at retail.

Source: JLARC staff review of the *Code of Virginia* and research literature on tax preferences.

Definition of Tax Preference Varies Among Tax Experts and State Practices

Although tax preferences are widely utilized, their definitions vary depending on the source. According to the research literature, exemptions, deductions, and other tax provisions that reduce revenue are considered tax preferences only if they depart from the normal tax base. The normal tax base includes provisions designed to raise revenue according to an agreed-upon taxing structure. For example, the exemption of wholesale goods from the retail sales and use tax is not a tax preference because the agreed-upon base for the tax only includes sales made to the final consumer. While this definition is generally accepted, tax experts often disagree on what constitutes the normal tax base, and thus which tax provisions should be considered tax preferences. For instance, some experts consider charitable giving deductions to be part of the normal base of the income tax because these deductions have long existed in U.S. tax codes, but others consider these deductions to be preferences.

States also define tax preferences differently, as indicated by a review of other states' tax preference reports. Specifically, practices vary regarding what exemptions, exclusions, subtractions, deductions, credits, structural components, and deferrals are considered to be preferences. Differences among states likely exist because there is no universally agreed-upon definition among tax experts. While many states have adopted definitions that mirror the federal government's definition, they typically have made modifications. Modifications are usually necessary because the federal definition is limited to the income tax system, and states often grant preferences through other taxes such as sales and use or gross receipts taxes.

Federal Definition of Tax Preference

The Congressional Budget and Impoundment Control Act of 1974 defines a tax expenditure (preference) as revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.

Although definitions vary, most states appear to include three requirements in their definition of a tax preference. First, there should be a specific provision in the state's tax code that details the special treatment that is being granted to certain taxpayers. Second, the provision should result in a reduction of tax revenues that could have otherwise been collected. Lastly, the provision should be a departure or deviation from the normal base of the tax.

Tax preferences were defined as specific provisions in the State's tax code that result in reduced revenue that would otherwise be collected under the normal tax base.

Because Virginia lacks a statutory definition of what should be considered a tax preference, JLARC staff established a broad definition that mirrors the requirements that other states typically use. Tax preferences were defined as specific provisions in the State's tax code that result in reduced revenue that would otherwise be collected under the normal tax base. In a few instances, it was possible to identify provisions that were intended to exempt income or sales that would otherwise not be collected or are not part of the tax base. Examples of these provisions include the income tax subtraction for income derived from obligations of the United States (the federal government prohibits states from taxing this income), and the wholesale exemption from the retail sales and use tax (retail sales, not wholesales, constitute the normal base of the tax).

TAX PREFERENCES CAN BE USED TO ACHIEVE STATE PUBLIC POLICY AND TAX POLICY GOALS

According to stakeholders and the research literature, tax preferences are often enacted to achieve state public policy and tax policy goals. For example, state public policy goals, such as providing financial assistance to certain taxpayers or promoting a desirable activity, and tax policy goals, such as increasing the efficiency of a given tax or preventing over-taxation, may be achieved through tax preferences (Table 4).

Tax Preferences Can Be Used to Achieve State Public Policy Goals

In many cases, the State's public policy goals can be accomplished through a tax preference. For example, Virginia adopted the Land

Table 4: Tax Preferences Can Be Used to Promote State Public or Tax Policy Goals

Goal	Purpose	Type
Provide financial assistance	Remedy a perceived inequity or unfairness in tax burden	Public
Promote activity	Encourage and reward the performance of certain socially and economically desirable activities	Public
Provide clarification	Specify what types of businesses or incomes are not subject to the tax	Tax
Ensure conformity to federal or State policy	Conform the State tax code to federal requirements, the Internal Revenue Code, or Virginia Constitution	Tax
Increase efficiency	Mitigate the cost of adequately collecting and administering the tax compared to the potential revenue that could be gained	Tax
Prevent over/double taxation	Exclude from taxation under one system because it is subject to another comparable tax system	Tax
Reduce pyramid effect	Prevent taxes being imposed on a good or service at more than one stage of the production process so that the tax is only imposed on the price of the good or service at the final stage	Tax

Source: JLARC staff review of the *Code of Virginia*, Virginia Administrative Code, tax preference literature, and Virginia legislative reports.

Preservation Tax Credit to promote the donation of land for conservation purposes. However, a public policy goal may also usually be addressed through a government program. For instance, although the State provides tax relief for Virginians with disabilities through a tax credit that helps fund home accessibility modifications, funds could have been appropriated for a program that would directly pay for needed modifications instead.

Policymakers often consider tax preferences more advantageous than government programs because they do not require annual or biennial appropriations and can be viewed as "tax cuts." Moreover, tax preferences may cost less to administer than government programs because their administration is usually absorbed by existing tax or revenue department staff. Administrative costs are minimized because, in many cases, taxpayers determine the preferences for which they are eligible and file their tax returns accordingly. Administrative reviews of whether taxpayers appropriately claimed preferences usually only occur under audit. However, administrative costs are higher for preferences that require specific agencies to review and certify eligibility before they are awarded or if the claiming of a credit is disputed during an audit.

Tax Preferences Can Be Used to Achieve State Tax Policy Goals

Tax preferences are also commonly used to achieve state tax policy goals. While public policy tax preferences are adopted to benefit selected taxpayers in order to promote an activity or provide financial assistance, preferences with tax policy goals are enacted to improve the State's tax structure. As shown in Table 4, these improvements include providing clarification, increasing efficiency, and reducing the pyramid effect that could occur if sales taxes were applied to multiple stages of producing a good.

Based on a review of Virginia's tax policy preferences, the majority are designed to either increase the efficiency of the tax or reduce double taxation. An example of a preference that aims to increase efficiency is Virginia's tax exemption for low-income individuals. This preference is sometimes referred to as a filing threshold because it exempts individual taxpayers below a certain level of income from having to file a State income tax return. This preference reduces the number of individuals who file taxes in the State, thereby decreasing the administrative burden and enhancing efficiency.

Although Virginia's tax code includes numerous preferences with tax policy goals, only a limited number of these preferences were reviewed, primarily because JLARC staff were directed to evaluate the extent to which preferences achieve public policy goals. (Further information about how tax preferences were selected for evaluation is included in Appendix B.) An effective evaluation of preferences with tax policy goals would be broader in scope than an evaluation of preferences with public policy goals. For example, a review of tax preference evaluation reports in the state of Washington indicates that the mere presence of preferences with tax policy goals often accomplishes their purpose, and so these types of preferences should be measured using criteria other than goal achievement. A more insightful review of Virginia preferences with tax policy goals would consider whether the goal is appropriate, whether a preference is the best mechanism to achieve the goal, and how changes to these preferences could impact Virginia's tax structure, including whether changes could result in Virginia's tax system conflicting with federal law.

CONCERNS HAVE BEEN RAISED ABOUT THE USE AND EFFECTIVENESS OF TAX PREFERENCES

Tax preferences have been criticized because they often are not evaluated after being adopted to ensure that they are meeting their objectives.

In addition to concerns raised by legislators, researchers have also raised several concerns about tax preferences. In particular, tax preferences have been criticized because they are typically subject to less scrutiny than other government spending programs that require annual appropriations and are often not evaluated after being adopted to ensure that they are meeting their objectives. In contrast, a legislature may be more inclined to scrutinize government programs during the appropriations process.

In addition, concerns have been raised about tax preferences because they are hard to eliminate. As they are not typically evaluated on a regular basis, minimal information about tax preferences is routinely collected and reported. As a result, there may be insufficient information to demonstrate whether certain tax preferences are effective, which may impact legislators' ability and willingness to eliminate preferences. Tax preferences that may not be effective but which are politically popular could be especially difficult to eliminate without adequate evidence demonstrating their ineffectiveness. Furthermore, preferences are often perceived as "tax breaks," and eliminating them is unpopular because it is viewed as a tax increase.

Principles of Sound Tax Policy

Tax structures should be **simple** so that taxpayers understand the rules and comply with them.

Tax structures should be **equitable** by imposing similar liabilities on taxpayers in similar circumstances.

Tax structures should be **reliable** so that revenue collections are sufficient and stable over time.

Finally, concerns have been raised about tax preferences because they conflict with key principles of sound tax policy. For example, preferences increase the complexity of the tax system by adding rules to the tax code and requiring taxpayers to provide additional information along with their returns. In addition, preferences often reduce the equitability of the tax system by treating similar taxpayers differently. Tax preferences, by nature, grant special treatment to taxpayers involved in certain activities or under certain circumstances but not others, even though they may have similar incomes. Moreover, preferences result in foregone revenue, reducing the reliability of revenues needed to adequately fund government operations.

Chapter 2 Virginia Tax Preferences Substantially Reduce Taxpayer Liability and State Revenue

In Summary

Virginia's income and retail sales and use tax preferences reduced taxpayers' liability by $12.5 billion in tax year 2008, which is almost as much as the amount of revenue collected under these taxes. Preferences that are intended to achieve a tax policy goal, such as avoiding double taxation, accounted for most of the reduction in tax liability. Because these preferences were adopted to ensure that the State's tax system adheres to basic principles of taxation, altering them could adversely impact Virginia's tax system. Tax preferences with public policy goals, such as providing financial assistance and promoting desired activities, could be altered without adversely affecting the tax system. These preferences account for almost one-quarter of the reduced liability from tax preferences, totaling an estimated $2.9 billion in tax year 2008. To alter or eliminate preferences that are ineffective or no longer needed, the legislature should be kept informed about the extent to which Virginia's tax preferences are achieving their intended public policy goals.

Tax preferences reduce the tax liability owed by qualifying taxpayers, and thus reduce the amount of revenue collected by the State. By revising or eliminating tax preferences that are not achieving their goals, or that are otherwise determined to not be justified by the benefits the State receives from offering the preferences, Virginia could lessen the impact tax preferences have on State revenues.

Reduced Tax Liability and Revenue Impact

The reduction in taxpayer liability should not be equated to the revenue impact to the State if preferences were eliminated because (1) taxpayers could still achieve lower tax liability by using a similar preference or altering their behavior, and (2) reductions for retail sales and use tax preferences do not reflect the portion of sales tax revenue that is kept by businesses for collecting and remitting taxes to the State.

Although estimates of reduced tax liability should not be equated to the revenue impact of Virginia's tax preferences, estimates for each tax preference and all preferences combined demonstrate the magnitude of the impact that Virginia's tax preferences likely have on revenue. In addition, these estimates indicate which groups of tax preferences could be altered to reduce their adverse impact on State revenues yet not create a significant hardship for taxpayers. For example, preferences that are aimed at providing financial assistance account for the majority of the total reduction in tax liability, but tend to provide low reductions per taxpayer. Changes to these tax preferences could significantly reduce their revenue impact but could be designed to shield taxpayers that are likely to be most negatively impacted, such as those with lower incomes.

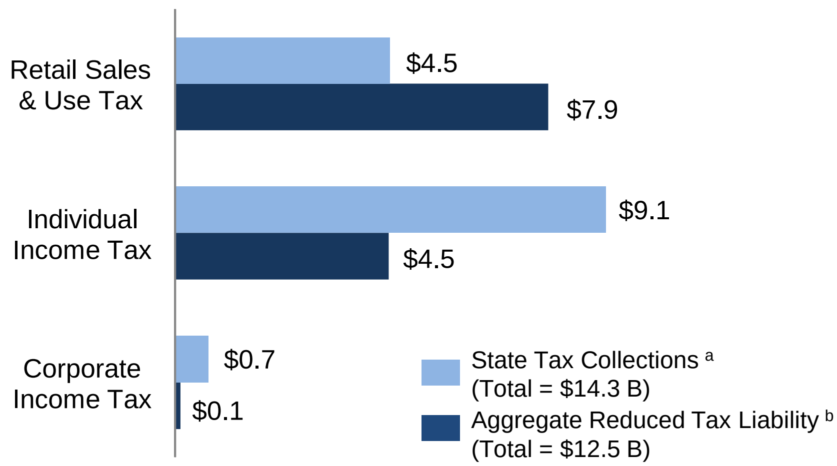
VIRGINIA TAX PREFERENCES REDUCE TAXPAYER LIABILITY BY ALMOST AS MUCH AS REVENUE COLLECTIONS

Corporate, individual, and retail sales and use tax preferences are estimated to have reduced Virginia taxpayers' liability by approx-

The total impact of Virginia's tax preferences on taxpayer liability was equivalent to nearly 90 percent of collections.

imately $12.5 billion in tax year (TY) 2008. In comparison, revenues raised from these three taxes were $14.3 billion over the same period, meaning that the total impact of preferences on taxpayer liability was equivalent to nearly 90 percent of collections. Of the preferences within the tax systems reviewed for this report, retail sales and use tax preferences were estimated to reduce liability the most, followed by individual income tax preferences (Figure 2). Within each tax, a few preferences account for the majority of the estimated reduction in liability, including (1) the State's broad exemption of services ($3.5 billion) and manufacturing materials and equipment ($0.9 billion) from the retail sales and use tax, (2) conformity to federal itemized deductions ($1.9 billion) and the tiered tax rate ($0.9 billion) from the individual income tax, and, on a smaller scale, (3) the foreign source income subtraction ($0.03) and coal tax credits ($0.02 billion) from the corporate income tax.

Figure 2: Sales Tax Exemptions Reduce Liability the Most and Are Larger Than Tax Collections ($ Billions, TY 2008)



[a] Tax collections as reported on tax returns.
[b] Aggregate reduced tax liability is the sum of the reduction in taxpayer liability of all preferences for which a reasonable estimate could be determined. Appendixes C and D list the reduction in taxpayer liability that was calculated for each preference.

Source: JLARC staff analysis of TY 2008 Virginia income tax and sales and use tax return data and additional data sources as identified in Appendix B (Table B-2).

TAX POLICY PREFERENCES REDUCE TAX LIABILITY THE MOST, BUT ALTERING THEM COULD HAVE ADVERSE IMPACTS

Tax policy preferences represent the largest share of the total reduced tax liability from Virginia's tax preferences. In fact, Virginia's tax preferences with tax policy goals were estimated to reduce taxpayer liability by $9.6 billion in TY 2008. Table 5 lists the ten tax policy preferences that provide the greatest reductions in tax

Calculation of Reduced Liability

The estimated impact of individual preferences on taxpayer liability was determined in one of two ways. For income tax preferences, estimates were determined based on amounts claimed on tax returns. For sales tax preferences, estimates were determined from a variety of data sources (Appendix B, Table B-2).

liability. Of note, the largest of these preferences are mostly retail sales and use tax exemptions. Although reduced tax liability should not be equated to revenue impact, the magnitude of reduced liability resulting from tax policy preferences suggests that revenue collections could significantly increase if some of these preferences were revised or eliminated.

Despite the substantial adverse impact that preferences with tax policy goals collectively have on revenue collections, Virginia may not wish to alter them because doing so could negatively impact the State's tax systems. In particular, changing or eliminating some of these preferences could increase the administrative burden of the tax system, reduce its equitability, or result in some taxpayers being over taxed. Although there are multiple preferences with tax policy goals, only a few examples are discussed in this section for illustrative purposes. Additional preferences with tax policy goals are listed in Appendix C.

Table 5: Tax Policy Preferences Reduce Tax Liability Significantly, Particularly Retail Sales and Use Tax Exemptions (TY 2008)

Tax Policy Preference	Tax System	Tax Policy Goal	Reduced Tax Liability ($ Millions)[a]
Service exemptions[b]	Sales	Increase efficiency	$3,518
Conformity to federal itemized deductions	Income	Ensure conformity to federal or State policy	1,859
Manufacturing materials & equipment exemption	Sales	Reduce pyramid effect	917
Motor vehicle and aircraft fuel exemption	Sales	Prevent over/double taxation	850
Motor vehicles exemption	Sales	Prevent over/double taxation	809
Utilities exemption[c]	Sales	Prevent over/double taxation	346
Virginia personal exemption	Income	Ensure conformity to federal or State policy	303
Standard deduction	Income	Ensure conformity to federal or State policy	263
Credit for taxes paid to other states	Income	Prevent over/double taxation	221
Agricultural materials and equipment exemption	Sales	Reduce pyramid effect	125
Subtotal, top ten tax policy preferences[d]			**$9,209**
All other tax policy preferences			$401
Total, all tax policy preferences[d]			**$9,610**

[a] Estimates likely overestimate revenue impact or potential additional revenue if the preferences were eliminated because the estimates do not account for (1) taxpayers using another similar preference or otherwise altering their behavior to reduce their tax liability or (2) the portion of sales tax revenue that businesses keep for administering the tax.
[b] Includes estimates for selected services considered exempt under § § 58.1-609.5 and 58.1-609.6(5) of the *Code of Virginia*. Exemptions that have a negligible impact on tax liability (such as gift wrapping services provided by nonprofits) were not estimated.
[c] Electric and natural gas utilities (the largest utilities) are subject to State consumption taxes under §§ 58.1-2900 and 58.1-2904.
[d] Reported total and subtotal differ from sum of listed preferences due to rounding error.

Source: JLARC staff analysis of Virginia income tax return data from TY 2008 and data sources identified in Appendix B (Table B-2).

Alterations to Some Tax Policy Preferences Could Reduce Efficiency of Virginia Tax Systems

Several retail sales and use tax exemptions were adopted to increase the efficiency of the tax. The exemption for sales of materials from the State Board of Elections, sales of prisoner artwork, and sales of official State or U.S. flags are examples of preferences that were adopted because the cost of adequately collecting and administering the tax on these items was expected to exceed the revenue gained. Based on prior estimates of the revenue impact of these exemptions developed by the Department of Taxation (TAX), repealing them would likely yield minimal additional revenue. In fact, the exemptions for prisoner artwork and materials sold by the Board of Elections impacted taxpayer liability by less than $5,000 each, according to a 1994 TAX study. The reduced liability due to the exemption for sales of official flags was not estimated but was expected to be minimal.

In addition, many federal tax preferences are automatically adopted because of the provision in Virginia's tax code that conforms the State's income tax system to the federal Internal Revenue Code (IRC). Because of this provision, calculating income that is taxable in Virginia begins with federal taxable income (corporations) or federal adjusted gross income (individuals). Both represent income after federal tax preferences have been claimed. The three largest federal tax preferences include the exclusion of employer contributions for medical insurance premiums and medical care, the net exclusion of pension contributions and earnings, and the deduction of mortgage interest on owner-occupied homes. These tax preferences reduced federal tax revenue by $1.3 billion, $1.2 billion, and $0.9 billion, respectively, in TY 2008. Because Virginia conforms to the IRC, these preferences also impact the amount of income that Virginia can tax, and thus the tax revenue it can collect.

Although preferences granted at the federal level impact Virginia income tax revenue, the State's administrative burden is significantly reduced because it conforms to the IRC. If Virginia did not conform, the State would have to develop much more expansive tax rules and regulations than it currently has and would likely need to expand the capacity of its audit and taxpayer appeals functions. In addition, most other states conform to the IRC, which reduces the burden for taxpayers that are required to file returns in multiple states. If Virginia no longer conformed to the IRC, taxpayer compliance, and thus revenue collections, could be reduced until taxpayers become more familiar with a new tax system that could be very different than that used by the federal government and other states in which they operate.

Alterations to Other Preferences Could Result in Over-taxation, and Possibly Place Virginia at a Competitive Disadvantage

Virginia has adopted several retail sales and use and income tax preferences to prevent certain tangible goods as well as types of income from being taxed more than once. For example, airplane sales are exempt from retail sales and use taxation because they are subject to the aircraft sales and use tax instead. In addition, banks are exempt from paying the corporate income tax because they are subject to the bank franchise tax instead. Altering these exemptions would result in double taxation unless the alternate tax systems were eliminated. However, such changes should only be initiated after a thorough comparison of the advantages and disadvantages of taxing banks or airplane sales under the differing tax systems.

Virginia has adopted several retail sales and use tax preferences to prevent "tax pyramiding," whereby taxes are applied to the same product during multiple stages of production. In particular, Virginia exempts manufacturing and agricultural businesses from paying sales taxes on their purchases of materials, machinery, and equipment, as long as these items are used directly to produce tangible goods for sale to a final consumer.

While these exemptions were adopted to ensure that only the final retail sale would be taxed, some stakeholders assert that part of the impetus was to incentivize manufacturing and agricultural production in the State. This assertion may result from the fact that most other states historically exempted only materials used in production from their sales taxes, but not equipment or machinery like Virginia. While the State's broader exemption may have provided it with a competitive advantage, the research literature indicates that machinery and equipment used in manufacturing or agriculture should generally be exempt to avoid tax pyramiding. Further, a review of other states' practices indicates that 35 states in addition to Virginia fully exempt production machinery and equipment and 34 other states fully exempt agricultural machinery and equipment, as of 2010. Not only could eliminating these exemptions lead to over-taxation because of tax pyramiding, it could also place Virginia at a competitive disadvantage with many other states that now exempt these items.

VIRGINIA COULD DISCONTINUE EXEMPTION OF SERVICES TO BETTER MEET TAX POLICY GOALS

Eliminating the retail sales and use tax exemptions for some or all services would satisfy several tax policy goals, but implementation may be difficult. Virginia exempts most services from its retail sales and use tax, and these exemptions reduced taxpayer liability by a total of more than $3.5 billion in TY 2008, as shown in Table

6. Moreover, Virginia appears to tax fewer services than most other states. Based on a 2007 report by the Federation of Tax Administrators, Virginia taxes only 18 out of 168 possible services, whereas other states with broad sales taxes extend them to an average of 40 services. Removing the retail sales and use tax exemptions for services could improve the reliability and equitability of the tax system.

Service Exemptions Were Adopted Primarily to Enhance Efficiency, but Original Purpose Appears No Longer Relevant

When many states began adopting a retail sales and use tax in the 1930s and 1940s, services did not constitute as large a sector of the economy as they do today. At the time, tangible goods represented approximately three-fifths of the economy, as measured by personal consumption (Figure 3). In addition, it was thought to be more difficult for states to enforce a tax on services. For example, unlike for services that are largely intangible, tangible goods are made of raw materials for which invoices generally exist that could be used to estimate the sales tax owed. Consequently, the administrative burden of collecting taxes for hard-to-document transactions might have offset the revenue that could be raised from a relatively small

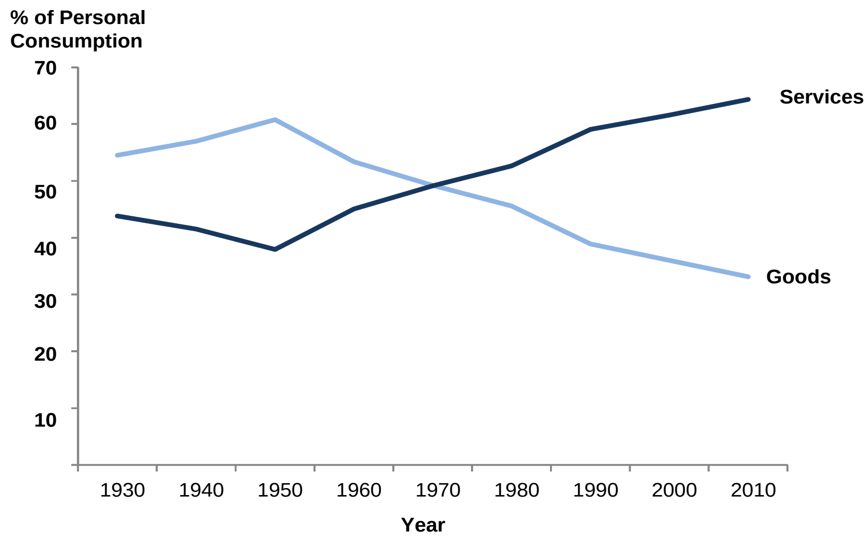
Table 6: Virginia's Service Exemptions Provide Significant Reductions to Taxpayer Liability (TY 2008)

Exempt Services	Reduced Tax Liability ($ Millions)[a]
Health	$1,391.8
Legal	205.7
Employment	204.2
Engineering	178.1
Computer systems	144.0
Selective consulting	139.3
Accounting	125.2
Vehicle repair	116.3
Insurance and brokerage	111.5
Data management	96.4
Subtotal, top ten services exempted	**$2,712.5**
All other services	805.2
Total, service exemptions[b]	**$3,517.7**

[a.] Reduced tax liability estimates likely overestimate revenue impact or potential additional revenue if the preferences were eliminated because the estimates do not account for (1) taxpayers using another similar preference or otherwise altering their behavior to reduce their tax liability or (2) the portion of sales tax revenue that businesses keep for administering the tax.
[b.] Not all services exempted from Virginia's retail sales and use tax are included. Exemptions that have a negligible impact on tax liability (such as gift wrapping services provided by nonprofits) were not estimated.

Source: JLARC staff review of estimates prepared by TAX.

Figure 3: Personal Consumption of Services Exceeds Personal Consumption for Goods



Source: JLARC staff analysis of Bureau of Economic Analysis data on annual personal consumption expenditures 1930-2010.

sector of the economy. The research literature suggests that states chose not to tax services to avoid such inefficiency. Although services represented almost half of the economy when Virginia adopted its retail sales and use tax in 1966, the State's tax was modeled after the systems that were implemented earlier in other states.

The rationale for exempting services from the retail sales and use tax to avoid inefficiency appears to be largely irrelevant today. While collecting sales taxes on services would likely require additional administrative efforts, the amount of additional revenue that could be collected would far exceed administrative costs. As shown in Figure 3, personal consumption of services has increased dramatically since sales taxes were first enacted in the 1930s. In fact, it surpassed consumption of tangible goods in the 1970s and represented two-thirds of personal consumption in 2010. According to the research literature, the service sector has grown substantially because U.S. residents now earn higher average incomes and they are more willing to pay for services that make their lives easier (such as housecleaning and lawn care services), more enjoyable (such as going to amusement parks, the movies, and professional sporting events), and more secure (such as insurance policies and home alarm system monitoring). Further, economists expect that the growth of the service sector will continue.

Eliminating Service Exemptions Could Improve Several Facets of Retail Sales and Use Taxation

Eliminating some or all of Virginia's service exemptions could improve the State's retail sales and use tax system by broadening the tax base to include additional transactions, thereby enhancing the reliability of revenue collections. The short-term reliability of tax revenue would be improved primarily because the tax would apply to more transactions and therefore generate more revenue. In addition, the long-term reliability of the tax system would be improved because the tax would be imposed on transactions involving services, which are expected to represent an increasingly larger share of economic activity, as measured by personal consumption.

Horizontal Equity

Taxpayers who are in similar circumstances should have a similar tax liability.

Vertical Equity

Taxpayers with a greater ability to pay should have a larger tax liability. How much more taxpayers should owe as their ability to pay increases is a policy decision.

In addition, the equitability of the retail sales and use tax system could be improved. Horizontal equity of the sales tax could be improved because consumers would be taxed regardless of their consumption preferences. For example, consumers are currently taxed if they decide to purchase exercise equipment to use at home, but are not taxed if they join a gym. If services were taxed, both purchases of gym equipment and payment of membership dues would be taxed at the same rate. Vertical equity could also be improved because the tax would no longer apply to purchases of goods only. For example, individuals in lower income households may be more likely to clean their own houses and purchase the supplies and equipment to do so (which are currently taxed), while persons in higher income households may be more likely to use a housecleaning service (which is currently exempt).

However, concerns have been raised in the research literature that vertical equity could be harmed if taxing services increases the overall tax burden of lower income consumers. Some costly services, such as health care, may be frequently used by lower income consumers and would encumber an even greater share of their income if they were taxed. To mitigate an increase in tax burden, tax experts recommend coupling the imposition of the sales tax on services with a reduction in the sales tax rate.

Several Considerations Could Complicate Changes to Virginia Service Exemptions

Despite the multiple benefits of removing retail sales and use tax exemptions on services, several considerations should be noted, as they have factored into other states' decisions as to how extensively to tax services. Whether the State should move forward on eliminating service exemptions is largely a policy determination that should balance the need to make improvements to Virginia's tax system with the political and administrative complications of removing these exemptions.

Although eliminating service exemptions could improve the reliability of Virginia's retail sales and use tax by expanding the tax base and increasing the reliability of revenue collections, the extent to which reliability would be enhanced depends upon which exemptions would be removed. While removing exemptions for professional services such as health, legal, and accounting services would generate the highest revenue collections, as indicated in Table 6, these services have proven to be among the most difficult to tax. For example, Florida adopted legislation to impose its retail sales and use tax on these services in 1987, but the provisions were repealed the following year due to taxpayer resistance. These industries reportedly have strong lobbying groups that have continually made it difficult for states to tax them. According to a 2007 Federation of Tax Administrators report, only four states broadly tax professional services.

Eliminating exemptions for smaller service sectors may be less challenging, but such action may not significantly enhance the reliability of the retail sales and use tax. According to the research literature, states are increasingly imposing sales taxes on amusement services and motor vehicle parking services because of other states' successes in taxing them. Exempting these services in Virginia was estimated to reduce taxpayers' liability by $55 million and $24 million, respectively, in 2008. Eliminating exemptions for only these types of services, which represent a small portion of the economy, will not substantially broaden the tax base and so will have a limited impact on improving the reliability of revenue collections.

Additional consideration should be given to how business-to-business transactions should be taxed or exempted. According to the research literature, business-to-business transactions should generally be exempt to preserve the true base of the tax as final consumers. In some cases, businesses may be the final consumers, but making this determination could be difficult. To resolve the issue, some tax experts suggest that all business-to-business transactions be exempt. Careful consideration of this issue is warranted to ensure that equity exists between sellers of tangible goods and services. Exempting all business-to-business transactions of services could be inequitable toward businesses purchasing tangible goods, for which business-to-business transactions are exempt only under specific circumstance.

Eliminating service exemptions could also increase the administrative burden on businesses by requiring them to determine and record taxable transactions for services. Taxing professional services used by businesses, such as accounting and legal services, could be administratively complex because many businesses have operations in other states or countries. The professional services performed for these businesses can occur in multiple states or countries and benefit operations outside of Virginia. In these cases, it may be difficult to determine which transactions should be subject to Virginia taxes. Additionally, businesses may have to purchase new software in order to track and report taxes collected on services. However, in this case, the research literature suggests that businesses selling both goods and services could face a lower compliance burden because they may no longer need to keep separate sales records.

Finally, TAX's administrative burden of processing returns and enforcing the sales tax could increase significantly if a large number of businesses have to remit taxes. However, many businesses provide both services and tangible products, and therefore already collect and remit sales taxes to TAX. To reduce administrative burden, some states have staggered the time periods over which services have become taxable.

PUBLIC POLICY PREFERENCES, ESPECIALLY THOSE PROVIDING FINANCIAL ASSISTANCE, REDUCE TAX LIABILITY BY $2.9 BILLION

Although public policy tax preferences do not reduce taxpayer liability by as much as preferences with tax policy goals, their impact on liability is still substantial, amounting to $2.9 billion in TY 2008. This equates to eight percent of the total State budget in 2008, or the equivalent of appropriations for all agencies within the Public Safety and Natural Resources secretariats for fiscal year 2008. Public policy tax preferences may be easier to alter or eliminate than tax policy preferences, particularly if evidence shows that they are not achieving their intended goals.

Majority of Reduced Liability Granted Through Public Policy Preferences Is Attributable to Ten Preferences

Virginia has over 100 different tax preferences intended to achieve public policy goals, but most of the impact on taxpayer liability is attributable to ten large preferences (Table 7). In fact, these ten preferences accounted for 92 percent of the reduction in taxpayer liability attributable to public policy preferences in 2008. The three largest tax preferences (tiered tax rate, drug and medical product exemptions, and partial exemption for food) accounted for over half of the reduced liability from all public policy preferences.

Financial Assistance Preferences Reduce Overall Taxpayer Liability the Most but Have Limited Impact Per Taxpayer

Within the group of tax preferences with public policy goals, those that provide financial assistance reduce taxpayer liability by the

Table 7: Ten Preferences Account for 92 Percent of Reduced Liability From Public Policy Tax Preferences (TY 2008)

Public Policy Preference	Tax System	Public Policy Goal	Reduced Tax Liability ($ Millions)[a]
Tiered tax rate	Income	Financial assistance	$869
Drug and medical product exemptions	Sales	Financial assistance	438
Food partial exemption	Sales	Financial assistance	346
Age deduction	Income	Financial assistance	285
Social security income subtraction	Income	Financial assistance	244
Nonprofit purchases exemption	Sales	Promote activity	179
Land Preservation Tax Credit	Income	Promote activity	120
Credit low income individuals	Income	Financial assistance	92
Historic Rehabilitation Tax Credit[b]	Income	Promote activity	61
Residential heating fuels exemption	Sales	Financial assistance	42
Subtotal, top ten public policy preferences			**$2,676**
All other tax policy preferences			225
Total, all public policy preferences			**$2,901**

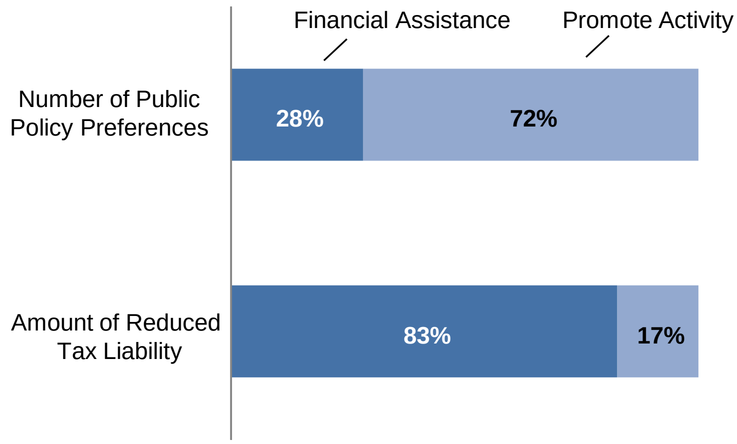
[a.] Estimates likely overestimate revenue impact or potential additional revenue if the preferences were eliminated because the estimates do not account for (1) taxpayers using another similar preference or otherwise altering their behavior to reduce their tax liability or (2) the portion of sales tax revenue that businesses keep for administering the tax.
[b.] Another $53 million in credits is claimed against insurance premium and bank taxes.

Source: JLARC staff analysis of TY 2008 Virginia income tax return data and additional data sources as identified in Appendix B (Table B-2).

greatest amount overall. In fact, all but three of the top ten public policy tax preferences are designed to provide financial assistance rather than promote a desirable activity (Table 7). Tax preferences aimed at providing financial assistance account for 83 percent of the reduced liability attributable to preferences with public policy goals, even though they only represent 28 percent of these preferences (Figure 4). The reduction in taxpayer liability from financial assistance preferences is high because they tend to benefit a large number of taxpayers. For example, the broadest financial assistance preferences, such as the partial sales tax exemption for food, benefit all consumers making purchases in Virginia. Even financial assistance preferences that benefit individuals within a certain demographic, such as all persons receiving unemployment compensation, still benefit thousands of Virginia taxpayers.

Tax preferences that promote activities collectively reduce taxpayer liability less than preferences aimed at providing financial assistance, but generally provide greater reductions in liability per taxpayer. For example, almost half of the income tax preferences that were intended to promote an activity reduced tax liability by over $1,000 per individual taxpayer in 2008. In contrast, only one of the financial assistance preferences under the income tax provided individual filers with savings in excess of $1,000.

Figure 4: A Few Financial Assistance Preferences Account for Majority of Reduced Liability for Public Policy Preferences (TY 2008)



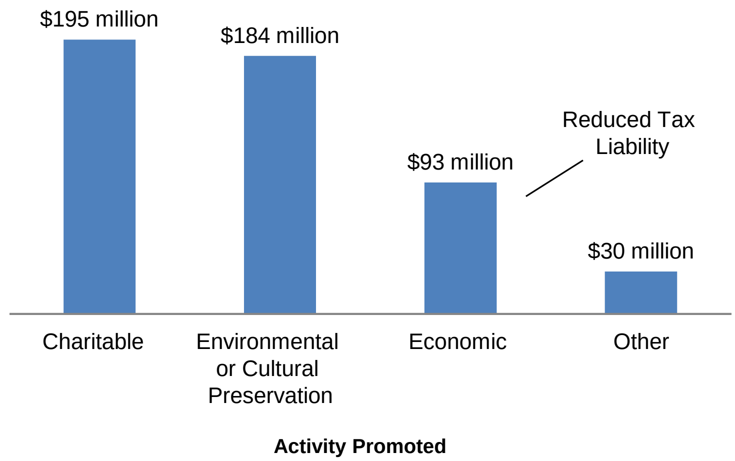
Source: JLARC staff analysis of TY 2008 income tax returns and additional data sources as identified in Appendix B (Table B-2).

Tax preferences that promote activities have a smaller aggregate impact on tax liability because they tend to benefit a narrow range of specific organizations, such as nonprofits, specific industries, or smaller groups of individuals such as owners of historic properties. However, these taxpayers are often able to benefit to a greater extent because the reductions in tax liability they receive correspond to higher levels of income and purchasing, especially when the beneficiary is a business or other organization with more income and spending resources than are available to a typical individual. In a few cases, preferences that target a narrow range of businesses or desired activities can provide a company with millions in savings per year. For example, six companies each claimed more than $1 million in coal tax credits in TY 2008. In addition, six individual taxpayers claiming the Historic Rehabilitation Tax Credit claimed over $1 million each in TY 2008.

Tax Preferences Promoting Preservation and Charitable Activities Are the Largest Preferences That Promote Activities

Virginia currently grants over 70 tax preferences intended to promote economic activities, environmental or cultural preservation, charitable activities, or other activities. Tax preferences promoting preservation and charitable activities are the largest preferences in terms of reduced taxpayer liability, and therefore are likely to have the largest impact on State revenue collections (Figure 5). The activities that are encouraged by these preferences include conservation of land and historic properties and charitable work by nonprofits and churches. Tax preferences that are intended to

Figure 5: Tax Preferences Promoting Preservation and Charitable Activities Have Largest Impact on Taxpayer Liability (TY 2008)



Source: JLARC staff analysis of Virginia income tax return data for TY 2008 and additional data sources as identified in Appendix B (Table B-2).

promote economic activity have the next largest impact on taxpayer liability, and are intended to encourage job creation and business expansion in Virginia. Additionally, there are a few tax preferences intended to promote other activities such as saving for college or purchasing long-term care insurance.

Virginia Could Alter Public Policy Preferences, and May Benefit by Changing Those That Are Not Achieving Their Goals

Unlike most tax policy preferences, preferences that serve a public policy goal can be altered without negatively impacting Virginia's tax systems. Because public policy preferences grant special treatment to some taxpayers, increase administrative complexity, and reduce State revenue collections, revising or eliminating ineffective preferences could improve the State's tax systems.

Tax preferences that are not achieving their goals reduce revenue collections but likely provide little or no value to the State in return.

Public policy preferences can be an efficient and effective way to achieve policy goals, as discussed in Chapter 1. Tax preferences that achieve their goals provide value to the State by successfully assisting taxpayers or promoting desired activities. However, tax preferences that are not achieving their goals reduce revenue collections but likely provide little or no value to the State in return. By making improvements to ineffective tax preferences, the State could more successfully achieve its desired public policy goals. It may not be possible to alter some ineffective preferences to increase their effectiveness, but eliminating them could enhance State revenue collections.

Chapter 3 Virginia Financial Assistance Tax Preferences Achieve Goals but Some Not Efficiently Targeted

In Summary

An analysis of 20 tax preferences intended to provide financial assistance indicates that they achieve their goals, but the distribution of benefits to taxpayers is typically skewed to higher income Virginians. Like many other states, Virginia provides financial assistance to taxpayers through tax preferences. A total of 26 such preferences are available through the retail sales and use tax or the individual income tax. Most of these preferences are effective at providing financial assistance that has value to their intended beneficiaries, predominantly individuals. In fact, the average reduction in tax liability resulting from sales tax preferences is sufficient to allow additional purchases of essential goods such as food or medications. The financial assistance provided through these preferences tends to disproportionately accrue to higher income taxpayers. Even tax preferences that are granted based on low-income levels tend to provide a greater share of the overall reduction in tax liability to higher income taxpayers, suggesting that these preferences may not be efficiently targeted. In most instances, Virginia offers comparable tax preferences for providing financial assistance as other states, particularly states most similar to Virginia.

Just under half of the tax preferences aimed at providing financial assistance are retail sales and use tax exemptions that exempt consumers from paying sales taxes on their purchases of certain basic necessities and other goods. The remaining preferences are income tax subtractions, deductions, or credits that reduce the tax liability of individual taxpayers. Because these tax preferences reduce taxes paid by consumers or income taxes, they effectively achieve their goal of providing financial assistance. However, some of the tax preferences were intended to especially benefit lower income individuals and do not efficiently achieve this goal because higher income individuals receive a disproportionate share of reduced tax liability.

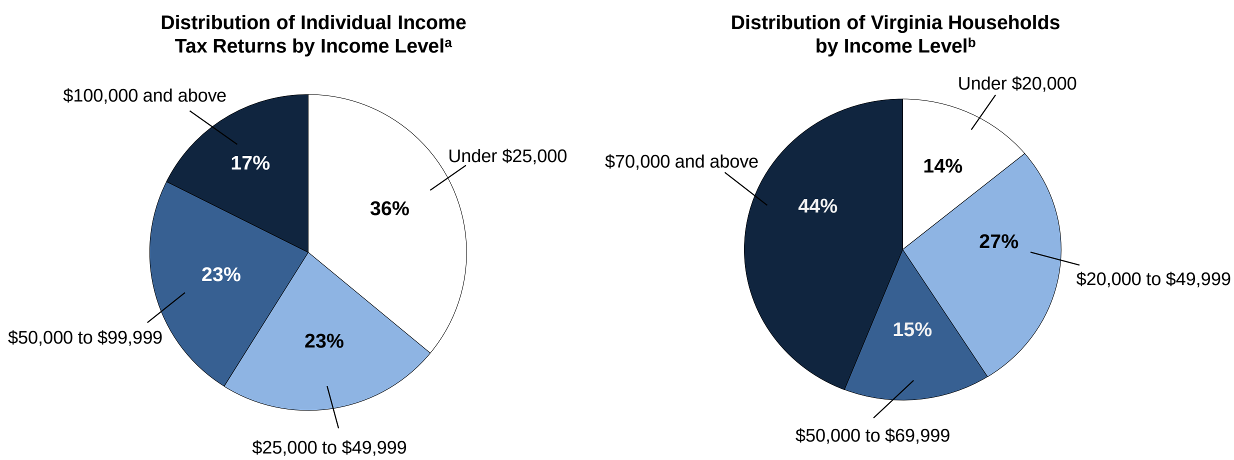
FINANCIAL ASSISTANCE PREFERENCES ACHIEVE GOALS, BUT SOME LACK EFFICIENT TARGETING BASED ON TWO PRIMARY MEASURES

To determine the effectiveness of tax preferences that provide financial assistance, they were evaluated against two primary measures. First, tax preferences were evaluated based on the magnitude of reduced liability that taxpayers received from tax preferences because, in order for a preference to provide financial assistance, it must have some value to the taxpayer. Second, the distribution of the reduction in tax liability between taxpayers with different income levels was analyzed because several preferences were adopted primarily to benefit lower income individuals, based on interviews with stakeholders and a review of Virginia documents. While the first measure focuses on whether the preference is effective in providing taxpayers with financial assistance that has value, the second measure examines whether preferences efficiently target the intended taxpayers. The distribution of households and taxpayers within the income levels used for this review are shown in Figure 6. Slightly different income levels were used to evaluate retail sales and use and individual income tax preferences because analyses were based on different data sources. Low-income taxpayers correspond with those taxpayers in the lowest income level for which the upper limit closely corresponds to $21,000, which was 100 percent of the federal poverty line for a household of four in 2008.

Less than 20 percent of total reduced tax liability is attributed to low-income individuals using the tax preferences for 13 of the 20 preferences reviewed.

An evaluation was conducted on the 20 preferences that reduced taxpayer liability by $1 million or more per year, which represents nearly all (99.9 percent) of the reduction in tax liability from all financial assistance preferences. The 20 tax preferences aimed at providing financial relief achieve their goal by reducing taxpayer liability, in some instances significantly (Figure 7). However, less than 20 percent of total reduced tax liability is attributed to low-income individuals using the tax preferences for 13 of the 20 preferences reviewed. For tax preferences that are intended to especially benefit lower income individuals, such as the food partial sales tax exemption, these findings suggest the tax preferences could be more efficiently targeted. Additional tax preferences

Figure 6: Many Virginia Taxpayers and Households Earn More Than $50,000 (TY 2008)



[a] Estimated based on TY 2008 individual income tax returns.
[b] Estimated based on 2008 American Community Survey data for Virginia.

Source: JLARC staff analysis of Virginia income tax return data for TY 2008 and additional data sources as identified in Appendix B (Table B-2).

Figure 7: Virginia Tax Preferences Designed to Provide Financial Assistance Achieve Goal, but Majority of Reduced Liability Often Attributable to Higher Income (TY 2008)

Tax Preference	Reduced Tax Liability Per Taxpayer: Total ($M)	Reduced Tax Liability Per Taxpayer: Average	% Benefit Received by Low-Income Taxpayers[a] (0%–100%)	Achieves Goal?
Retail sales and use tax exemptions				
*Drug and medical product exemptions[b]	$438.4	$38		○
*Food partial exemption	346.2	$82		○
*Residential heating fuels exemption	41.9	$113		○
College textbook exemption	9.9	$60	n.d.	●
School supplies/clothing sales tax holiday	4.1	n.d.	n.d.	●
Hurricane preparedness sales tax holiday	2.2	n.d.	n.d.	●
Income tax preferences				
Tiered tax rate	$869.3	$316		●
*Age deduction	284.9	$664	[c]	●
Social Security/Railroad Retirement subtraction	244.0	$623		●
*Low Income Tax Credit	91.7	$315		●
Child and dependent care expenses deduction	28.4	$147		●
Unemployment compensation benefits subtraction	21.8	$171		●
*Basic military pay subtraction	7.8	$334		○
Disability income subtraction	5.8	$513		●
*Federal and State employees subtraction	1.3	$227		○

Legend: ○ appears to effectively achieve goal but could be more efficiently targeted; ● appears to effectively achieve goal

Note: n.d., no data available; *, means tested.
[a] Low-income taxpayers for sales tax exemptions are households with incomes less than $20,000. Low-income taxpayers for income tax preferences are those filing returns with incomes less than $25,000. Thresholds were selected because they approximate 100 percent of federal poverty level for a family of four in 2008 ($21,200). Slightly different thresholds were selected for sales and income tax preferences due to differences in the data used.
[b] Represents six exemptions.

Source: JLARC staff analysis of Virginia income tax return data for TY 2008 and additional data sources as identified in Appendix B (Table B-2).

Top Ten States Most Socioeconomically Similar to Virginia

Arizona, California, Colorado, Maryland, Michigan, Minnesota, New Jersey, North Carolina, Pennsylvania, and Washington are the states most similar to Virginia based on comparisons of socioeconomic characteristics using 2008 U.S. Census Bureau data (Appendix B).

aimed at providing financial assistance that reduced tax liability by less than $1 million per year are listed in Appendix D.

Other states' practices were also reviewed to determine the extent to which they offered similar preferences for purposes of providing financial assistance. While this effort was not a primary measure of the effectiveness of a tax preference, it is important to note the extent to which Virginia's tax preferences are similar to those offered in other states, particularly those that are socioeconomically similar to the State. Findings that other states tend to provide financial assistance through means other than tax preferences or through preferences that are structured significantly different than Virginia tax preferences could suggest that the State may want to consider revising its tax preferences that provide financial assistance or eliminating them and adopting other programs.

SALES TAX EXEMPTIONS ON CONSUMER GOODS ACHIEVE GOALS BUT MAY NOT BE EFFICIENTLY TARGETED

Two broad types of retail sales and use tax exemptions were evaluated to determine whether they effectively achieve their public policy goals of providing financial assistance. These exemptions included those that provide consumers with sales tax relief for purchasing basic necessities such as medication, food, certain types of heating fuels, and exemptions for other goods that are important for certain individuals, such as students, or at specific times of the year, such as hurricane season. All of the exemptions appear to provide financial assistance that provides value to the consumers who use them.

Exemptions for Basic Consumer Necessities Provide Value to Virginia Consumers

Virginia provides financial assistance to consumers by exempting certain basic necessities, such as medication and food, from the retail sales and use tax. These preferences appear to achieve their goal of providing financial assistance to consumers by reducing their tax liability, based on analysis of federal consumer expenditure and census data. However, these exemptions may not be efficiently targeted to lower income individuals, which is the group that is especially intended to benefit.

Sales tax exemptions for basic necessities reduced tax liability by $827 million.

Virginia Exempts Purchases of Basic Necessities From Sales Taxes. The State exempts three groups of basic necessities, and these exemptions have a substantial overall impact on taxpayer liability. Exemptions include those for (1) drugs and medical products, (2) the partial exemption for food, and (3) the residential heating fuels exemption (Table 8). These exemptions reduced the tax liability of individual, and in some cases business, consumers by a combined $827 million in TY 2008. While these exemptions are available to all consumers, they are intended especially to benefit those with lower incomes who may be less able to afford basic necessities, according to legislative documents and discussions with agency and legislative staff. Exemptions for drugs and medical products are also intended to provide financial assistance to Virginia consumers with high medical costs, such as those who are older or have chronic health conditions. Virginia offers a few other exemptions for basic necessities, but these exemptions benefit a much smaller group of consumers, such as individuals who are deaf and in need of purchasing communication devices or individuals with physical disabilities who require special devices for driving a vehicle (Appendix D).

Table 8: Virginia Exempts Purchases of Several Basic Consumer Necessities From the Retail Sales and Use Tax

Public Policy Purpose: Provide financial assistance to Virginia consumers, especially those with lower incomes, by reducing the cost of essential goods. Exemptions for medical necessities are also especially intended to benefit Virginians with high medical costs, such as the elderly.

Tax Preference *(Reduced Tax Liability[a])*	**Description**
Drug and medical product exemptions[b] *($438.4 million)*	Grant individual consumers and health care providers such as hospitals and health clinics a tax exemption on purchases of (1) prescription drugs, (2) prescription eyewear, (3) prescription hearing aids, (4) nonprescription drugs, (5) durable medical equipment (wheelchairs, slings, glucose monitors, etc.)[c], and (6) dialysis supplies and equipment. Insurance companies also appear to benefit as they share the cost of purchasing many of the exempted goods with their subscribers.
Food partial exemption *($346.2 million[d])*	Grants individual consumers a reduced tax rate of 2.5 percent on purchases of food for home consumption, which serves as a partial exemption. The partial exemption generally does not apply to alcohol, cigarettes, and food sold for immediate consumption, such as hot foods at grocery stores and food sold at restaurants.
Residential heating fuels exemption *($41.9 million)*	Grants individual consumers a tax exemption on purchases of home heating oil, artificial or propane gas, firewood, or coal for consumption in a residential household. The exemption does not apply to purchases of natural gas or electricity. Exemption does not apply to purchases made by commercial entities, including lessors.

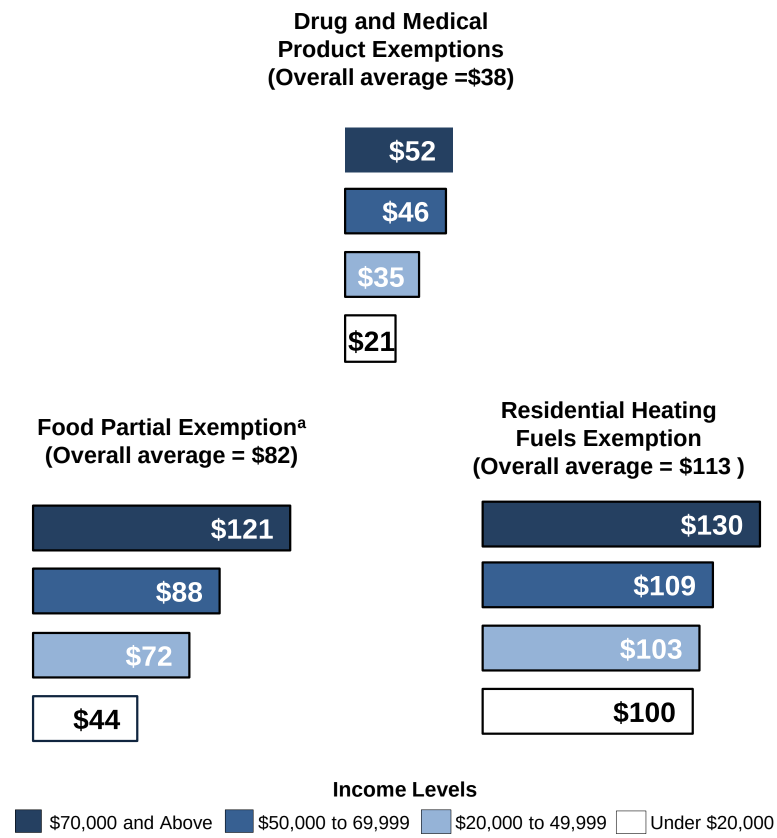
a. Estimates are for TY 2008 and are based on sources noted in Appendix B (Table B-2).
b. Represents six separate exemptions that have been grouped together for analytical purposes.
c. Applies only to durable medical equipment purchased for use by a specific individual, not purchases by a nonprofit or business to be used by that business or held in inventory for later distribution.
d. Estimate includes businesses that purchase food for home consumption. SNAP and WIC program benefits are not included in the estimate.

Source: JLARC staff analysis of §58.1-609.10 and §58.1-611.1 of the *Code of Virginia*, the Virginia Administrative Code, and interviews with State officials and industry representatives as noted under Appendix B (Table B-1).

Sales Tax Exemptions for Basic Necessities Effectively Provide Assistance to Virginia Consumers. An analysis of Virginia household demographics and spending trends found that the State's exemptions for basic necessities appear to achieve their goal of providing financial assistance to Virginia consumers. Goals are achieved because consumers pay no or less in sales taxes on the exempt goods. Average consumer tax liability was reduced by $38 from the drug and medical products exemption, $82 from the partial food exemption, and $113 from the residential heating fuels exemption in 2008. Consumers of all income levels benefited from these exemptions (Figure 8).

While all consumers save money on their purchases of exempt drugs and medical products, food, and heating fuels, average savings to consumers from these exemptions are low relative to income. For example, the average reduction in tax liability from the

Figure 8: All Consumers Receive Some Financial Assistance, but Higher Income Consumers Receive Greater Amounts (TY 2008)



[a.] Estimates do not include business consumers who purchase food for home consumption. Food items purchased with SNAP program benefits have been factored out of estimates. Food items purchased with WIC program benefits have not been factored out of estimates due to data limitations.

Source: JLARC staff analysis of 2008-2010 TAX data, 2008-2009 U.S. Energy Information Administration data, 2008-2009 Consumer Expenditure Survey data, and 2008 American Community Survey data.

heating fuels exemption amounted to 0.9 percent of the annual income of households earning under $20,000 per year, and only one-tenth of one percent of income for households earning $70,000 and above. Reductions in tax liability from drug and medical product and food exemptions account for an even lower portion of income.

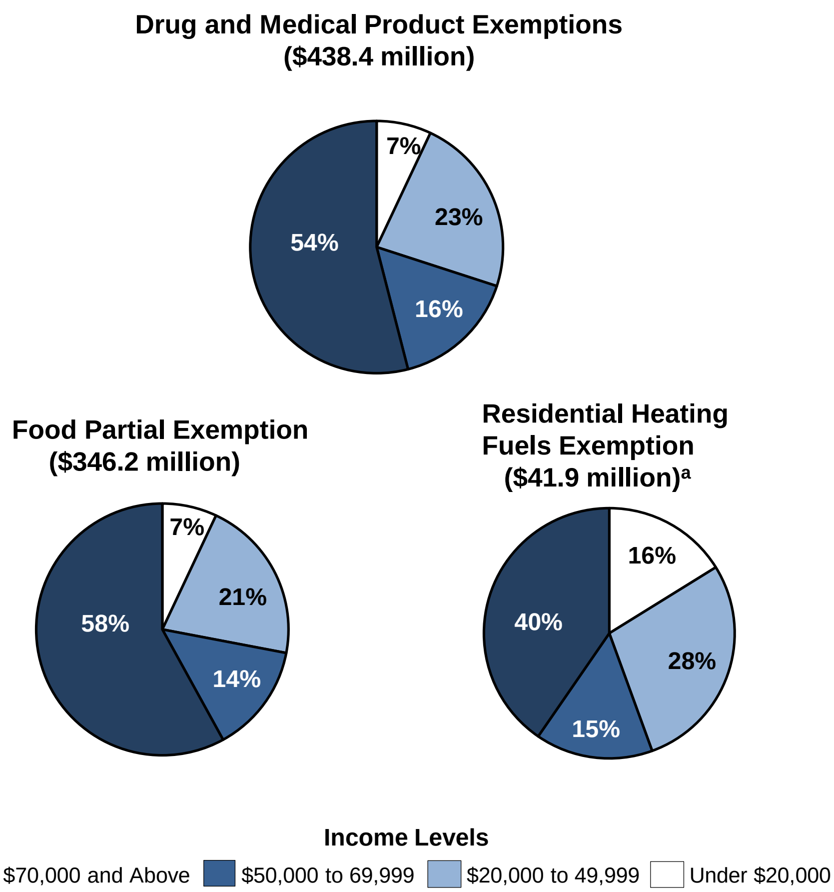
Although average reductions in tax liability are relatively low for consumers, this reduction appears to be a meaningful amount because it allows them to purchase additional quantities of needed goods. For example, the partial exemption for food provided households in Virginia with enough annual savings to purchase an additional nine days of groceries in 2008. Similarly, annual savings from drug and medical product exemptions were enough to allow an average household to purchase up to nine prescriptions of commonly used generic drugs according to prices listed by a major retailer.

Majority of Reduced Tax Liability From Basic Necessity Exemptions Attributed to Higher Income Consumers, Suggesting Exemptions May Not Be Efficiently Targeted. Higher income consumers tend to receive the largest portion of the reduction in tax liability. This finding for exemptions for basic necessities suggests that these exemptions may not be an efficient means of providing financial assistance to lower income Virginians, who were especially intended to benefit according to legislative documents and discussions with agency and legislative staff (Figure 9). Based on an analysis of federal consumer expenditure and census data, households earning $70,000 and over accounted for 44 percent of Virginia households but received 58 percent of the reduction in tax liability from the partial exemption on food in 2008. In contrast, households earning under $20,000 account for 14 percent of households but received a disproportionately small share (seven percent) of the reduction. By this measure, Virginia's basic consumer necessity exemptions appear to be most effective at providing financial assistance to higher income consumers.

The largest portion of reduced tax liability is attributable to higher income consumers for several reasons. First, the exemptions apply to all consumers regardless of income level. In addition, higher income consumers tend to spend more on these exempted goods and therefore receive greater reductions in tax liability. For example, based on an analysis of federal consumer expenditure and census data, consumers with incomes $70,000 and over spend an average of $1,048 out-of-pocket on drugs and medical products and $4,852 on food. In comparison, consumers with incomes less than $20,000 spend an average of $418 and $1,777 out-of-pocket (not including payments made with food stamps) on these exempt items, respectively.

Sales Tax Exemptions for Drugs and Medical Products Effectively Benefit Virginians With Higher Medical Costs. Unlike the other major necessity exemptions, the exemptions for drugs and medical products have another intended purpose, which is to benefit Virginians with higher medical costs, such as older persons or those with chronic medical conditions. Analysis of Virginia household demographics and spending trends found that drug and medical product exemptions appear to successfully provide financial assistance to older persons. As shown in Figure 10, average out-of-pocket reductions in tax liability to households with at least one member 65 or older was $66 in 2008, which was above the statewide average ($38) for all households. Their savings were

Figure 9: Majority of Reduced Tax Liability From Basic Necessity Exemptions Received by Higher Income Consumers (TY 2008)

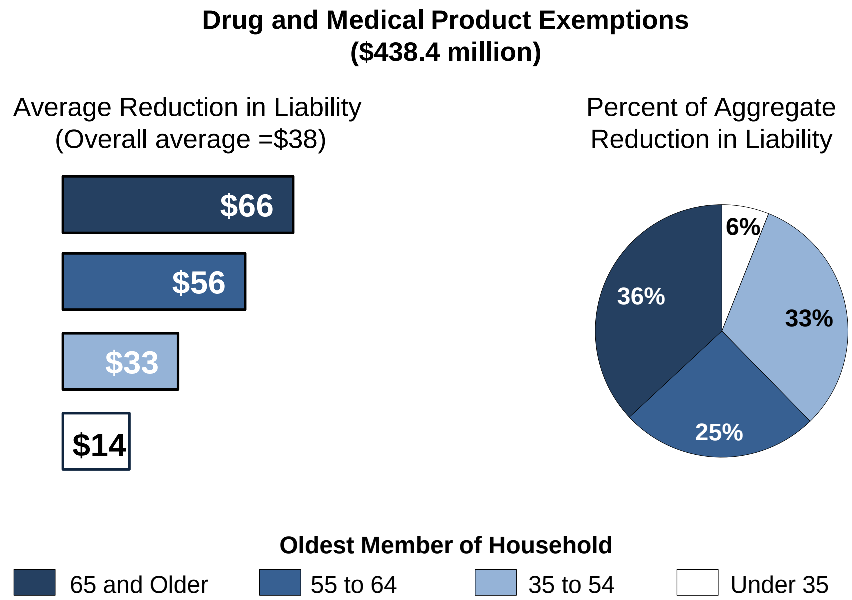


[a] Percentages do not add up to 100 percent due to rounding error.

Source: JLARC staff analysis of 2008-2010 TAX data, 2008-2009 U.S. Energy Information Administration data, 2008-2009 Consumer Expenditure Survey data, and 2008 American Community Survey data.

enough to enable them to purchase a year-and-a-half's worth of prescription drugs for common conditions such as arthritis or diabetes, according to prices under a major retailer's discount prescription drug program. In addition, households with at least one resident 55 or older accounted for 41 percent of households yet were responsible for 61 percent of the total reduction in tax liability (Figure 10). It was not possible to determine whether individuals with chronic medical conditions benefit to a similar extent due to the lack of adequate data.

Figure 10: Drug and Medical Product Exemptions Benefit Older Consumers More Than Others (TY 2008)



[a.] Age group was determined by oldest member of household.

Source: JLARC staff analysis of 2008-2010 TAX data, 2008-2009 Consumer Expenditure Survey data, and 2008 American Community Survey data.

Other Sales Tax Exemptions for Consumer Goods Achieve Goals

In addition to basic necessities, Virginia also exempts certain goods such as school supplies, clothing, and hurricane preparedness items during sales tax holidays, and college textbooks (Table 9). Similar to sales tax exemptions for basic necessities, these exemptions provide benefit by reducing the tax liability for consumers who purchase these goods.

Sales Tax Holidays Provide Financial Assistance, but May Be Ineffective at Assisting Lower Income Consumers. Virginia has granted sales tax holidays since 2007. Currently, three holidays are allowed, but only two are designed to provide financial assistance: school supplies and hurricane preparedness. The Energy Star/WaterSense holiday, in contrast, is designed to incentivize purchases of socially beneficial goods. Because sales tax holidays work like all other exemptions but for the limited time in which they can be used, they provide a benefit to consumers by reducing tax liability and thus achieve their goal of providing some level of financial assistance. However, the average reduction in tax liability, and therefore how valuable sales tax holidays are for consumers, is unknown because of the lack of data.

Table 9: Virginia Exempts Purchases of Several Basic Consumer Necessities From the Retail Sales and Use Tax

Public Policy Purpose: Sales tax exemptions for consumer goods are intended to provide financial assistance to Virginia consumers by reducing the cost of essential goods.

Tax Preference *(Reduced Tax Liability[a])*	**Description**
School supplies & clothing sales tax holiday *($4.1 million)*	Grants individuals a tax exemption on eligible school supplies of $20 or less and clothing and footwear of $100 or less for three days beginning on the first Friday of August each year. Examples of exempt items include: school instructional materials, art supplies, and everyday clothing items. Computers and athletic wear are not exempt.
Hurricane preparedness sales tax holiday *($2.2 million)*	Grants individuals a tax exemption on portable generators of $1,000 or less and other approved preparedness equipment of $60 or less for seven days beginning on May 25th each year. Examples of exempt items include: preparedness items like artificial ice, batteries, portable lights, radios, rope, bottled water, and select portable generators.
College textbook purchases exemption *($9.9 million)*	Grants students attending a college or other institution of learning a tax exemption on purchases of textbooks. Applies to purchases made by students or on their behalf, but not to purchases made by the institution for distribution.

[a] Estimates for reduced tax liability are for TY 2008 and are based on sources noted in Appendix B (Table B-2).

Source: JLARC staff analysis of §§ 58.1-609.10, 58.1-611.2 & 58.1-611.3 of the *Code of Virginia*, the Virginia Administrative Code, and interviews with State officials and industry representatives as noted under Appendix B (Table B-1).

Although sales tax holidays provide financial assistance, the research literature suggests that these mechanisms are ineffective at benefitting certain consumers for several reasons. Lower income individuals may not be able to take advantage of sales tax holidays, which may result in inequitable treatment. Sales tax holidays are available to all consumers, but Virginians with lower incomes may not have the spending flexibility because of their paycheck and bill schedules to make qualifying purchases during the exempt period. Furthermore, the savings generated by sales tax holidays may not be large enough to assist consumers with their purchases of more expensive exempted items. For example, during Virginia's hurricane preparedness sales tax holiday, individuals can save up to $50 on a $1,000 portable generator. Although $50 is a large amount of savings for one item, reducing the total price of a generator from $1,050 (including the tax) to $1,000 (with exemption) may not be sufficient to render it affordable for some consumers.

If the General Assembly wished to better reach lower income consumers, it could consider other options instead of sales tax holidays. The research literature recommends that states consider implementing permanent exemptions to more effectively provide assistance to lower income consumers. Permanent exemptions could provide these individuals with more opportunities to purchase essential goods at a reduced rate, instead of confining relief to a specified sales tax holiday period, which tends to last a week or less.

College Textbook Exemption Provides Assistance to Students Purchasing Books in Virginia. The exemption for purchases of textbooks by students attending an institution of higher education appears to achieve its goal of providing financial assistance to these consumers. In 2008, the exemption reduced students' sales tax liability by an average of $60. Based on a review of textbook price lists at public universities and community colleges, the average reduction in liability may not always be enough to cover the cost of an additional textbook, depending on the courses a student takes. However, the reduction is enough to allow students to purchase other school supplies.

Most Other States Provide Exemptions for Consumer Necessities to Varying Extents

Although Virginia is similar to the majority of states and partially or fully exempts basic necessities such as prescription drugs, durable medical equipment, and medical supplies like eyewear and hearing aids, only a minority of states, including Virginia, exempt nonprescription drugs (Table 10). Additionally, Virginia is one of the few states that only partially exempts food, as most states fully exempt food for home consumption. Moreover, while Virginia is among the 18 states with sales tax holidays for school supplies, this trend changes each year as states frequently suspend these holidays due to budget constraints. Furthermore, while nearly half of all states exempt school textbooks for students attending universities, Virginia remains in the minority of states that provide this exemption for textbooks sold by both public and private vendors.

INCOME TAX PREFERENCES ACHIEVE GOAL OF PROVIDING FINANCIAL ASSISTANCE, BUT SOME ARE INEFFICIENTLY TARGETED AT INTENDED BENEFICIAIRES

Nine Virginia income tax preferences provided more than $1 million each in financial assistance to individual taxpayers in TY 2008 and were evaluated for this review (Table 11). All nine preferences effectively accomplish their goal of providing financial assistance that is valuable to taxpayers, but the degree to which the benefits of reduced tax liability reach intended taxpayers varies. In most cases, taxpayers with incomes below $25,000 receive less than half of the overall reduction in tax liability, even for preferences that are means tested. Although higher income taxpayers receive a greater reduction in tax liability, lower income taxpayers often experience a greater percent reduction in their liability.

Table 10: Virginia and Most States Exempt Basic Necessities, but Few States Exempt Other Goods That Virginia Does

Exemption	Are Virginia Exemptions Similar to Majority of Other States?[a]	Number of States With Similar Exemptions
Basic Necessities		
Prescription drugs	Yes	45
Durable medical equipment	Yes	30
Dialysis equipment and supplies	Yes	27
Prescription eyewear	Yes	32
Prescription hearing aids	Yes	39
Nonprescription drugs	No	11
Food (partial)	No	7 [b]
Residential heating fuels	n.d. [c]	n.d. [c]
Other Consumer Goods		
Sales tax holiday- school supplies & clothing	No	18 [d]
Sales tax holiday- hurricane preparedness	No	3
College textbooks	No	18

[a.] 46 states including the District of Colombia (DC) have a retail sales and use tax.
[b.] The majority of states (31 states and DC) fully exempt food.
[c.] No data available.
[d.] In total, 18 states and DC have offered a sales tax holiday on school supplies, clothing, or both. Only 11 states (including Virginia) and DC have offered a combined school supplies/clothing holiday.

Source: JLARC staff analysis of other states' statutes and TAX sales and use tax expenditure reports.

The tiered tax rate ($869.3 million), the age deduction ($284.9 million), and the Social Security and railroad retirement income subtraction ($244.0 million) accounted for 90 percent of the overall reduction in taxpayer liability from the nine tax preferences examined.

As shown in Table 11, the tax preferences that were evaluated were adopted to provide individual taxpayers with assistance because of various circumstances they face such as the source of their income, income level, or age. Three tax preferences accounted for most (90 percent) of the overall reduction in taxpayer liability from the nine tax preferences examined: the tiered tax rate ($869.3 million), the age deduction ($284.9 million), and the Social Security and railroad retirement income subtraction ($244.0 million). Five other income tax preferences aimed at providing financial assistance were not reviewed because the tax liability for all taxpayers claiming them was less than $1 million; these preferences are listed in Appendix D.

Income Tax Preferences Aimed At Providing Financial Assistance Reduced Taxpayer Liability, More So for Higher Income Taxpayers

Nine of Virginia's income tax preferences aimed at providing financial assistance achieve their goal because individuals pay less in income taxes when they claim one or more of these preferences.

Table 11: Nine Preferences Aimed at Providing Financial Assistance Reduced Tax Liability by Over $1 Million in TY 2008

Tax Preference *(Reduced Tax Liability[a])*	**Public Policy Purpose(s)**	**Description**
Tiered tax rate *($869.3 million)*	Provide financial assistance to lower income individuals by taxing lower incomes at lower rates.	Tax liability is calculated by applying a different rate to certain levels of Virginia taxable income. The rates range from 2% to 5.75%. All income over $17,000 is taxed at 5.75%.
Age deduction[b] *($284.9 million)*	Provide financial assistance to older Virginia taxpayers with low to moderate income.	Taxpayers 65 years and older can claim a deduction of up to $12,000.[c] It is means tested for qualifying taxpayers born after January 1, 1939, and is reduced dollar-for-dollar for any income over $50,000 for individuals, $75,000 for joint filers. It is not means tested for taxpayers born on or before January 1, 1939, and they can claim the full deduction regardless of income.
Social Security and tier 1 railroad benefits subtraction[d] *($244.0 million)*	Maintain the financial assistance provided to retirees receiving Social Security income after the federal government began partially taxing it. Comply with federal Railroad Retirement Act of 1974, which prohibits states from taxing these benefits.	Taxpayers receiving Social Security and Tier I Railroad retirement benefits can subtract the entire amount of this income. All benefits conferred under Title II of the Social Security Act (Old-Age, Survivor, and Disability Insurance) are included in the Social Security subtraction. Prior to 1984 the federal government did not tax these types of income.
Low Income Tax Credit[b] *($91.7 million)*	Provide financial assistance to low-income taxpayers.	Low-income taxpayers can claim one of two credits. The first credit is equal to $300 for each person in the household, but the family's Virginia adjusted gross income cannot exceed 100 percent of the federal poverty line. The second credit is 20 percent of the federal EITC claimed by the taxpayer(s) on their federal return. Neither is refundable.
Child and dependent care expenses deduction *($28.4 million)*	Provide financial assistance to taxpayers who need to hire care for their children or dependents in order to be gainfully employed.	Taxpayers can claim a deduction equal to the amount of expenses for dependent care services necessary for gainful employment. The deduction may be up to $3,000 per dependent; the limit is $6,000 total.
Unemployment compensation benefits subtraction *($21.8 million)*	Maintain the financial assistance provided to taxpayers receiving unemployment compensation benefits after the federal government began taxing them.	Taxpayers can claim a subtraction equal to the unemployment compensation benefits received.
Basic military pay subtraction[b] *($7.8 million)*	Provide financial assistance to low-income military personnel on extended active duty for more than 90 days.	Military personnel who are on extended active duty for more than 90 days can subtract up to $15,000 of military basic pay.[c] If basic pay exceeds $15,000, then the subtraction is reduced dollar-for-dollar after $15,000.
Disability income subtraction *($5.8 million)*	Provide financial assistance to permanently and totally disabled Virginia taxpayers.	Permanently and totally disabled taxpayers can claim a subtraction for employer or privately provided disability income up to $20,000.
Federal and State employees subtraction[b] *($1.3 million)*	Provide financial assistance to low-income federal and State employees.	Federal and State employees with income from all employment less than $15,000 can subtract their salary from the government job, unless income from all employment exceeds $15,000.[c]

[a] Estimates based on JLARC staff analysis of income tax return data for TY 2008.
[b] Preferences are means tested.
[c] Claiming this tax preference may preclude taxpayer from claiming other preferences.
[d] The tier 1 railroad benefits subtraction is not considered a public policy preference, but it cannot be separated from the Social Security subtraction since the two are claimed on the same line.

Source: JLARC staff analysis of the *Code of Virginia* and interviews with State officials and industry representatives.

In fact, reductions in taxpayer liability ranged from $147 to $664, on average, depending on the preference. As shown in Figure 11, individuals of all income levels benefitted from these income tax preferences because their tax liability was reduced. In some cases, the reduction in tax liability is significant. For example, older individuals earning more than $250,000 in TY 2008 were able to reduce their tax liability by more than $2,000, on average, if they were able to claim both the Social Security subtraction and the age deduction.

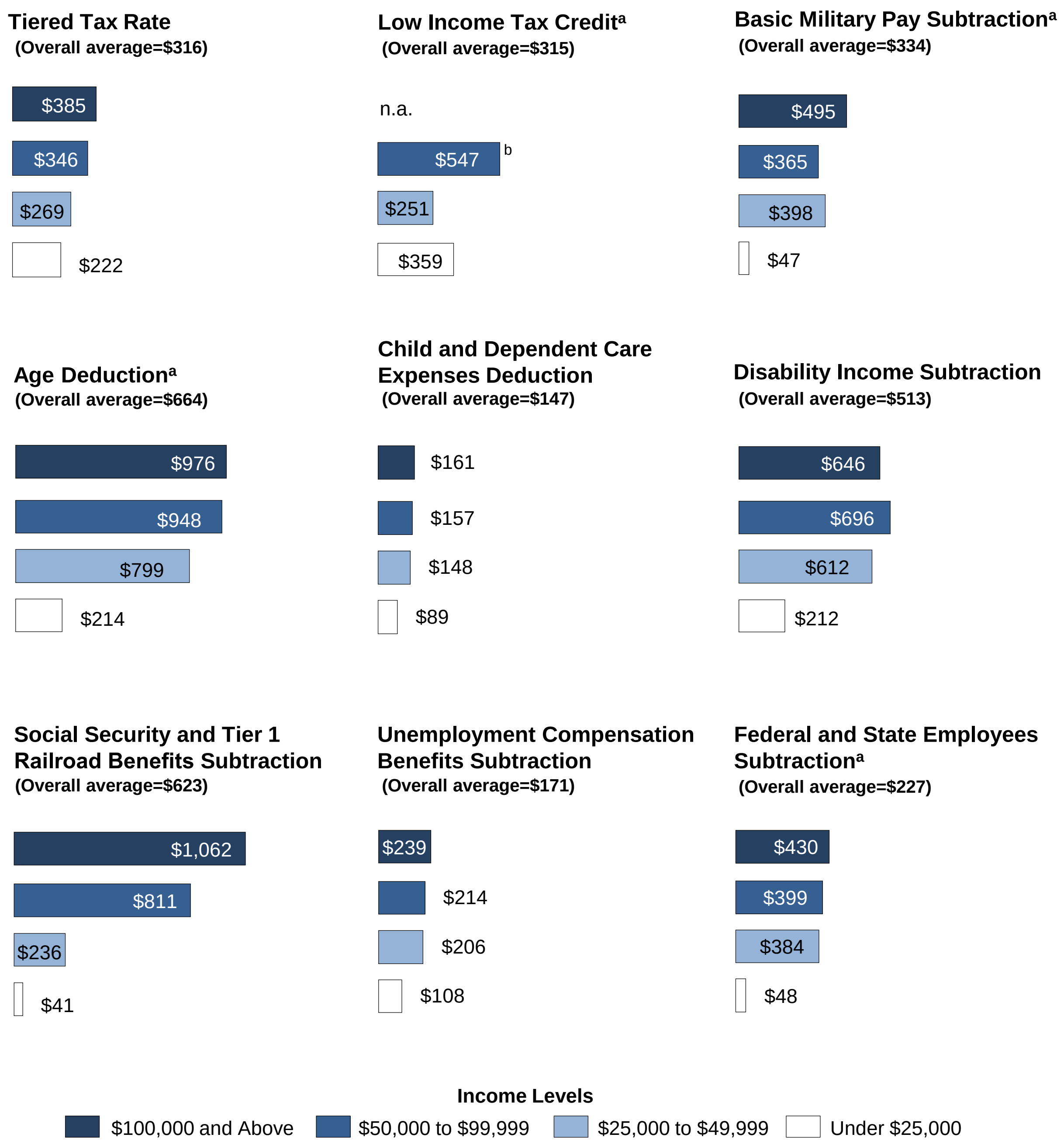
Figure 11 also illustrates that lower income individuals tend to achieve lower reductions in tax liability. Several factors related to the structure of Virginia's income tax limits the extent to which they can benefit from tax preferences. First, Virginia taxpayers with Virginia adjusted gross income below $11,250 (single filer) or $22,500 (joint filer) fall below the filing thresholds and are not required to pay any individual income taxes, although some may have to file returns to have withheld tax refunded. Because these taxpayers have benefitted from the filing threshold, other tax preferences provide no additional benefit to them. Moreover, Virginia's tiered marginal rate taxes higher income at a greater rate, making subtractions and deductions more valuable for higher income taxpayers. For example, a $1,000 subtraction for unemployment compensation benefits would be worth $57.50 for a taxpayer with an income of $18,000 but only $20 for a taxpayer with an income of $3,000 (Table 12). All but one of Virginia's financial assistance tax preferences are subtractions and deductions. Virginia's only financial assistance tax credit, the Low Income Tax Credit, provides dollar-for-dollar benefits, but its amount cannot exceed the taxpayer's tax liability because it is not refundable.

Means Test

Means-tested preferences are generally limited to lower income taxpayers. Eligibility for some tax preferences is determined by taxpayers' income. Taxpayers with incomes above the means tests are not eligible. Some means tests are based on total income, while others are limited to income from specific sources.

Unlike the other income tax preferences, the Low Income Tax Credit does not provide a greater reduction in tax liability to higher income taxpayers because it is means tested based on household income (Figure 11). However, even this tax credit provides its beneficiaries with an increasing amount of assistance as their income increases within eligible levels. Only households with incomes below 100 percent of the federal poverty line qualify for the $300-per-person portion of the credit. In 2008, the federal poverty line for a family of four was $21,200. Alternatively, Virginia taxpayers who claim the federal earned income tax credit (EITC) can claim 20 percent of the EITC on their State return under the Low Income Tax Credit. The highest income level that could qualify for the EITC in 2008 was $41,646 for joint filers with two or more qualifying dependents. Because it is not refundable, the Low Income Tax Credit's benefit is limited by the beneficiaries' tax liability, which

Figure 11: Most Preferences Result in Greatest Tax Liability Reduction for Higher Income Taxpayers (TY 2008)



Note: n.a., not applicable.
[a] Tax preference is means tested.
[b] Few Virginia households with Federal adjusted gross incomes above $50,000 were eligible to claim the $300-per-person credit because of substantial subtractions or household size.

Source: JLARC staff analysis of income tax return data for TY 2008.

Table 12: Subtractions and Deductions Reduce the Tax Liability of Higher Income Taxpayers Because of Tiered Tax Rate

Without $1,000 Subtraction		With $1,000 Subtraction		Effect of Subtraction on Tax Liability	
Taxable Income	*Tax Liability*[a]	*Taxable Income*	*Tax Liability*[a]	$ Reduction[b]	% Reduction
$18,000	$777.50	$17,000	$720.00	$57.50	7.4%
$3,000[c]	$60.00	$2,000	$40.00	$20.00	33.3%

a. Tax liability was calculated using the Department of Taxation's Tax Table Calculator.
b. The difference in tax liability without and with the subtraction.
c. Taxable income is only subject to tax if Virginia adjusted gross income is above the respective filing threshold.

Source: JLARC staff analysis of the *Code of Virginia* and TAX documents.

generally increases with higher incomes. The federal EITC is refundable, allowing lower income taxpayers to receive the full benefit of the credit, regardless of tax liability.

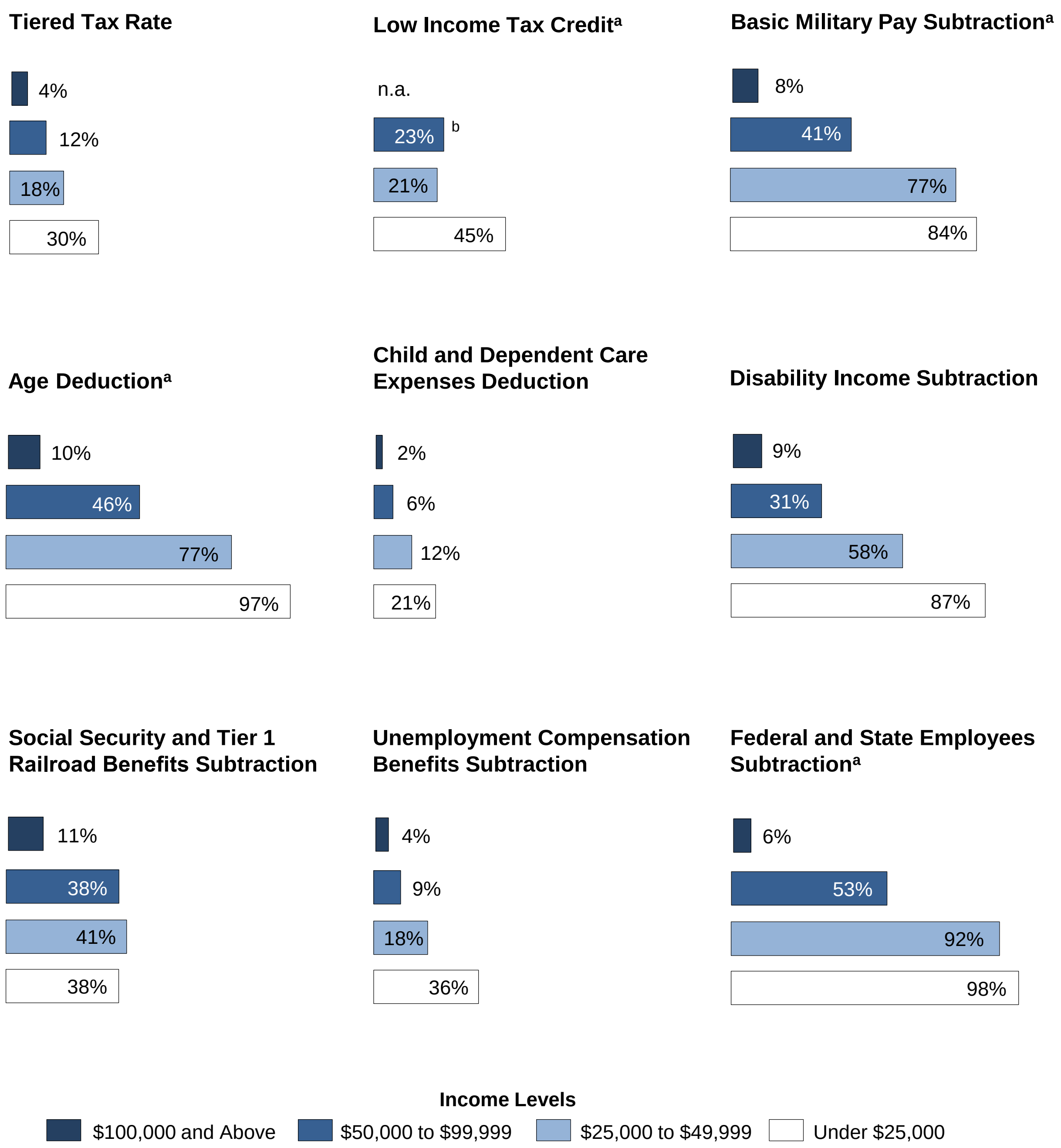
Although individuals with higher incomes tend to receive greater dollar reductions in their tax liability than those with lower incomes, individuals with lower incomes still received meaningful percentage reductions in tax liability in 2008 (Figure 12). Individuals with incomes below $25,000 tended to receive the greatest percent reduction in tax liability from the nine income tax preferences evaluated for this report, especially through the federal and State employees' subtraction (98 percent) and the age deduction (97 percent). In fact, these two preferences eliminated nearly all of the tax liability of these taxpayers. The child and dependent care expenses deduction had the least impact on taxpayers' liability across all income levels.

All nine of the income tax preferences aimed at providing financial assistance granted the greatest percent reduction in tax liability to lower income taxpayers because the magnitude of the reduction is higher relative to their income tax liability (Figure 12). For example, a subtraction of $1,000 has a value of $20 for a taxpayer with $3,000 of income while the same subtraction has a value of $57.50 for a taxpayer with income of $18,000. However, the lower income taxpayer receives a 33 percent reduction in tax liability from the subtraction, whereas the higher income taxpayer only receives a 7.4 percent reduction (Table 12).

Majority of Reduced Tax Liability Received by Higher Income Taxpayers, Even for Most Means-Tested Tax Preferences

As shown in Figure 13, higher income individuals received the majority of the overall reduced tax liability generated by income tax preferences. While tax preferences that are means tested generally

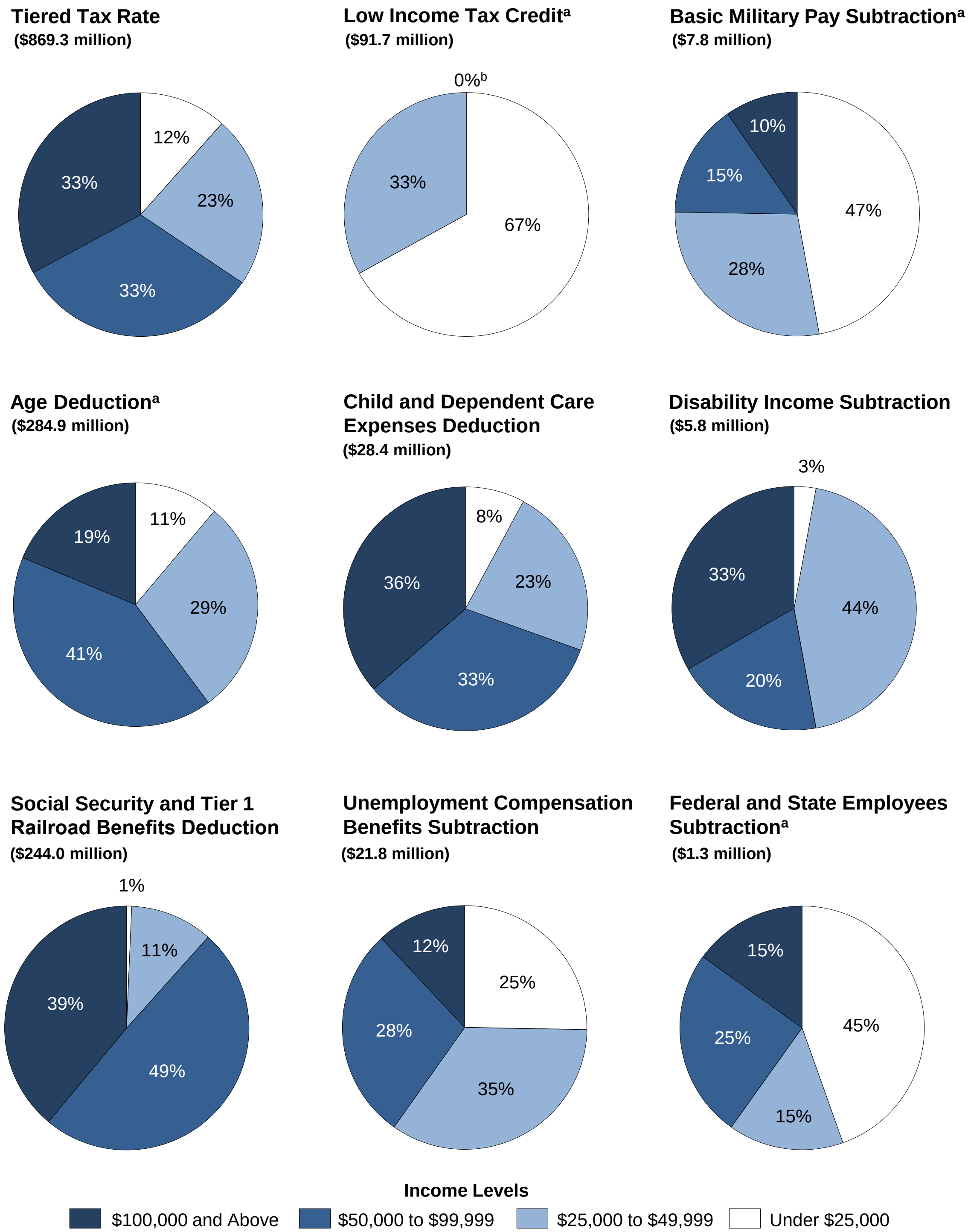
Figure 12: Lower Income Taxpayers Receive Greatest Percent Reduction in Tax Liability From Financial Assistance Tax Preferences



Note: n.a., not applicable.
[a] Tax preference is means tested.
[b] Few Virginia households with Federal adjusted gross incomes above $50,000 were eligible to claim the $300-per-person credit because of substantial subtractions or household size.

Source: JLARC staff analysis of income tax return data for TY 2008.

Figure 13: Higher Income Taxpayers Receive Majority of Tax Liability Reduction From Tax Preferences Intended to Provide Assistance, Even When Means Tested (TY 2008)



[a] Tax preference is means tested.
[b] 0.02% of returns claiming the Low Income Tax Credit had incomes between $50,000 and $99,999.

Source: JLARC staff analysis of income tax return data for TY 2008.

provide a higher percentage of their benefits to low-income taxpayers (income below $25,000), the majority of their overall reduction in tax liability often accrues to taxpayers in households earning more. For example, ten percent of the reduced tax liability from the basic military pay subtraction benefitted taxpayers with household incomes above $100,000, even though it is intended to benefit individuals earning between $15,000 and $30,000. This finding suggests that some means-tested preferences may not be effectively targeted. Part of the reason why the age deduction benefits a large number of higher income taxpayers is because the means test only applies to certain taxpayers and the income thresholds are higher than other preferences that are means tested. As a result, some higher income taxpayers are able to claim the age deduction. Conversely, only one tax preference that is not means tested provided the majority of its benefit to lower income taxpayers. The majority of reduced tax liability from the unemployment compensation benefits subtraction was provided to lower income taxpayers largely because the maximum unemployment benefit in Virginia equates to less than $20,000 per year.

Virginia's Use of Income Tax Preferences Aimed at Providing Financial Assistance Similar to Most Other States

Like Virginia, most states with an individual income tax provide financial assistance using tax preferences. Most states with an income tax, including states that are socioeconomically similar to Virginia, have similar preferences intended to provide financial assistance (Table 13). However, the structure and value of the

Table 13: Many of Virginia's Financial Tax Preferences Align With Other States

Tax Preference	Does Virginia Align With Majority of Similar States[a]	# of Similar States with Preference (Out of 10)
Tiered tax rate	Yes	6
Age deduction	Yes	7
Social Security and tier 1 railroad benefits subtraction	Yes	9
Low Income Tax Credit	Yes	8
Child and dependent care deduction	No[b]	4
Unemployment compensation benefits subtraction	No	3
Basic military pay subtraction	No	4
Disability income subtraction	Yes	5
Federal and State employee subtraction	No	0

[a] Nine of the ten states most socioeconomically similar to Virginia have an individual income tax.
[b.] Although many states similar to Virginia do not have this deduction, the majority of states with an income tax have this preference.

Source: JLARC staff analysis of other states' statutes.

preferences vary. For example, many states offer some form of financial assistance for older taxpayers. However, no state other than Virginia appears to offer a personal exemption in addition to an age deduction for taxpayers over 65. Further, many states base their low income tax credits on the federal EITC, but those are often refundable, whereas Virginia's credit is not refundable.

Although the State's tax preferences are largely consistent with those offered in other states, Virginia does offer several tax preferences that few other states have. For example, only eight states (including Virginia) provide a subtraction for unemployment compensation benefits; all other states tax this income.

Of the ten states most socioeconomically similar to Virginia, only California, New Jersey, and Pennsylvania exempt unemployment compensation benefits from taxation as does Virginia. The research literature suggests that unemployment benefits should be taxed as income (Appendix B). According to the Congressional Research Service, the federal taxation of unemployment compensation benefits was phased in based on evidence that the federal exemption might be acting as a disincentive to work. The federal government first began taxing unemployment compensation benefits under a series of means tests and reform efforts to aid lower income taxpayers more broadly. However, it is not clear that Virginia's unemployment subtraction is large enough to create a disincentive to work.

Chapter 4 Not All Virginia Tax Preferences Designed to Promote Activity Achieve Intended Goals

In Summary

Like many other states, Virginia has created tax preferences to promote activities that are generally regarded as desirable. The State currently offers more than 70 tax preferences intended to promote a variety of resource preservation, charitable, economic, and other activities. Based on extensive research and data analysis, some preferences appear to be effective while others show little or no impact on the outcomes they are intended to promote. Specifically, tax preferences that promote resource preservation are generally successful in achieving their goals, whereas preferences that are designed to promote economic activity vary widely in their effectiveness. Tax preferences intended to promote charitable activities have a limited impact and tend to act as recognition for services provided rather than incentives. Similarly, a few tax preferences designed to promote other types of activities, such as saving for college, also appear to have a limited impact on promoting their desired outcomes. Most states offer tax preferences similar to Virginia's, such as those benefiting nonprofits or promoting research and development. However, preferences such as those promoting land preservation are relatively uncommon.

While Chapter 3 focuses on the findings from the evaluation of tax preferences aimed at providing financial assistance, this chapter focuses on preferences that promote specific activities, such as resource preservation or economic development. Twenty-three tax preferences that reduce taxpayer liability by a total of $1 million or more per year were evaluated. These 23 preferences accounted for 97 percent of the reduction in tax liability generated by all tax preferences intended to promote an activity.

PREFERENCES DESIGNED TO PROMOTE ACTIVITY EXPERIENCE MIXED RESULTS IN ACHIEVING GOALS BASED ON THREE CRITERIA AND VARYING LEVELS OF EVALUATION

Because a large number of Virginia tax preferences are aimed at promoting an activity, the preferences that reduced tax liability the most were evaluated in greater depth than smaller preferences. Preferences that resulted in more than $20 million in reduced tax liability were evaluated based on three outcome measures: (1) the extent to which the promoted activity moved in the desired direction over time, (2) whether the change appeared related to the preference, and (3) how large a reduction in tax liability beneficiaries received. A tax preference would not be effective if no change in activity occurred or if other factors had greater influence on changing the activity than the tax preference. The

Figure 14: Virginia Tax Preferences Aimed at Promoting Activity Experience Mixed Results in Achieving Goal, According to Measures of Effectiveness

Tax Preference	Reduced Tax Liability ($ Millions)	Activity Moved in Desired Direction?	Activity Influenced by Preference?	Average % Reduction In Tax Liability[a]	Achieves Goal?
Promotes Preservation				0% 100%	
Land Preservation Tax Credit	$119.6	✓	✓		●
Historic Rehabilitation Tax Credit[b]	60.8	✓	✓		●
Subtraction for gain on sale of public use land	1.4	✓	✗		○
Promotes Charitable Activity				0% 100%	
Nonprofit purchases exemption	178.8	✓	✗	- -	○
Church purchases exemption	6.0	✓	✗	- -	○
Exemptions for property withdrawn from inventory	5.5	- - [c]	- - [d]	- -	○
Neighborhood Assistance Tax Credit	4.8	✗	- - [d]		◍
Promotes Economic Development				0% 100%	
Coal tax credits[e]	31.2	✗	✗		○
Railroad common carrier exemption[f]	20.1	✓	- - [d]	- -	◍
Airline common carrier exemption[g]	10.1	✓	✗	- -	◍
R&D materials and equipment exemption	6.6	✓	- - [d]	- -	◍
Media provider equipment exemption	5.2	✓	- - [d]	- -	◍
Ships and vessels exemption[h]	2.8	✗	- - [d]	- -	○
Major Business Facility Tax Credit	2.2	- - [c]	✗		○
Data center exemptions[i]	2.0	✓	✓	- -	◍
Equity Tax Credit	1.9	- - [c]	✓		◍
Recyclable Materials Tax Credit	1.0	- - [c]	- - [d]		◍
Promotes Other Activity				0% 100%	
College savings plan deduction and subtraction	19.0	✓	✓		◍
Long-term care insurance deduction and tax credit	9.2	✓	✗		○

Legend: ○ Appears unlikely to achieve goal; ◍ appears to achieve goal to limited extent; ● appears to effectively achieve goal

[a] Represents reduction in income tax liability. Reduction in retail sales and use tax liability could not be determined because total retail sales and use taxes paid by beneficiaries for non-exempt purchases are unknown.
[b] Another $53 million in credits is claimed against insurance premium and bank taxes.
[c] Extent to which the desired activity occurred was not determined because only a limited review was conducted and data for assessing this was not readily available.
[d] Extent to which the preference influenced the desired activity was not determined because only a limited review was conducted and data for assessing this was not readily available.
[e] Includes the Coal Employment Enhancement Tax Credit and Coal Employment and Production Incentive Tax Credit.
[f] Although liability reduction from the railroad exemption exceeded $20 million in TY 2008, this exemption was not evaluated in depth because the liability reduction for this year was unusually high compared to surrounding years.
[g] It does not appear that airline service levels are directly influenced by the exemption, but other activities such as aircraft maintenance may be influenced.
[h] The exemption's effectiveness in promoting construction and repair of commercial vessels appears limited , but no determination was made regarding the exemption's impact on ship supply or dredging industries.
[i] Includes the data center exemption active from 2008 to 2011 and the data center exemption active from 2010 to 2020.

Source: JLARC staff analysis of Virginia income tax return data from tax year 2008 and additional data sources as identified in Appendix B (Table B-2).

activities that these tax preferences were designed to promote typically increased (Figure 14); however, findings indicated that the increase was not always clearly influenced by the preference, even when the preference significantly reduced taxpayer liability (for example, coal tax credits).

For preferences that reduced taxpayers' liability between $1 million and $20 million, the evaluation was based on the total and percent reduction in tax liability that beneficiaries received, on average, interviews with stakeholders, and reviews of the research literature. Approximately half of these tax preferences appear to achieve their public policy goals to some extent (Figure 14).

Ten States Virginia Competes With for Jobs

California, the District of Columbia, Georgia Illinois, Maryland, New Jersey, New York, North Carolina, Pennsylvania, and Texas are the states Virginia competes with for jobs, based on analysis of National Establishment Time Series data from 1989 to 2007 (Appendix B).

Other states' practices were also reviewed to determine the extent to which they offered similar preferences for purposes of promoting desired activities. As stated in Chapter 3, the extent to which Virginia offers tax preferences that are similar to preferences offered in other states is important to note. For some preferences, Virginia was compared with the top ten states with which it is most socioeconomically similar. In the case of tax preferences that promote economic development, Virginia was compared with the top ten states with which it competes for jobs. For some preferences no comparative information was available.

VIRGINIA TAX PREFERENCES PROMOTING ENVIRONMENTAL AND HISTORIC PRESERVATION ACHIEVE GOAL

Virginia offers 12 tax preferences designed to promote environmental or historic preservation; however, the majority of these tax preferences were not reviewed because they reduced taxpayer liability by less than $1 million each. The largest preservation tax preferences appear to be effectively accomplishing their public policy goals. Interviews with State preservation officials and other stakeholders indicate that these preferences have been successful because of their high value and usability.

Donations of Interest in Land

With a **fee interest** donation, the donor surrenders all rights to the property, including ownership.

With a **less-than-fee interest** donation, the donor surrenders some rights, such as the right to develop, while retaining ownership of the property. This type of donation is often referred to as a conservation easement.

Land Preservation Tax Credit Effectively Achieves Goal of Promoting Land Preservation in Virginia

In 2000, Virginia adopted an income tax credit intended to encourage individuals and businesses to preserve land in the State (Table 14). The Land Preservation Tax Credit is one of Virginia's largest tax credits, and it appears to effectively promote land preservation in the State. In fact, more than 2,500 donations of interest in land have been made under the credit since 2000. The donations cover approximately 540,000 acres in Virginia with the largest concentration in the northern portion of the State and an appraised value of $2.5 billion (Figure 15). The Department of Taxation (TAX) has issued $1.2 billion in credits since 2000, and the Land Preservation Tax Credit reduced taxpayer liability by $120 million in tax year

(TY) 2008. An analysis of the change in land preservation over time indicates that the tax credit is effectively achieving its public policy goal of promoting land preservation (Figure16).

JLARC staff also conducted a limited review of the subtraction for the gain on the sale of land for open space use, which provides an alternative incentive for land preservation. The subtraction reduced taxpayer liability by $1.4 million in TY 2008. The impact of this preference appears limited given the number of taxpayers that use the preference and the total amount claimed relative to the Land Preservation Tax Credit.

Increases in Virginia Land Preservation Appear Related to the Tax Credit. According to data from the Virginia Outdoors Foundation and TAX, the number of acres preserved in Virginia per year increased substantially following the adoption of the tax credit in 2000 (Figure 16). While the initial increase in land preservation was modest, donations increased dramatically when the credit was made transferrable in 2002, allowing donors to sell their excess credits. Donations continued to increase until peaking in 2006, which was the last year the credit was worth 50 percent of fair market value (FMV) and uncapped. The credit is currently 40 percent of FMV and capped at approximately $100 million per year. Although total donations have decreased since 2006, the decrease appears attributable to the credit cap, which limits the total amount of credits issued in a year, rather than the reduced credit value, since the cap has been reached each year since its adoption.

Although other incentives and programs to promote land preservation in Virginia exist, the increase in land donation appears to have been impacted primarily by the Land Preservation Tax

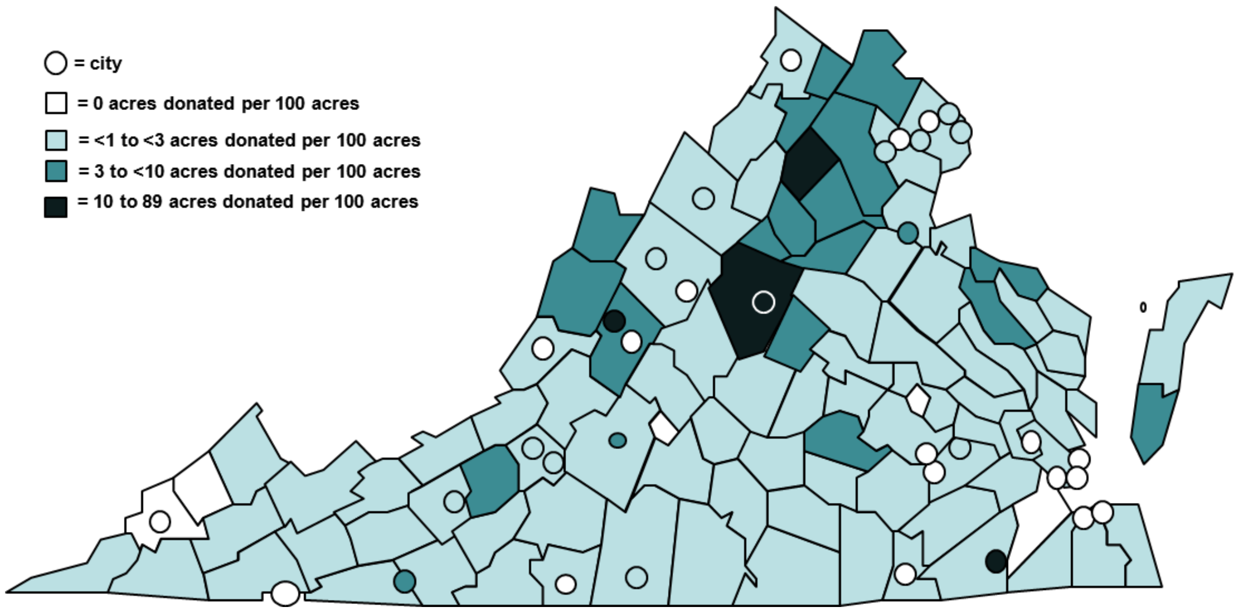
Table 14: Two Tax Preferences Promote Land Preservation

Preference *(Reduced Tax Liability[a])*	**Public Policy Purpose**	**Description**
Land Preservation Tax Credit (*$119.6 million*)	Supplement existing land conservation programs to further promote the preservation and sustainability of Virginia's unique natural resources, wildlife habitats, open spaces, and forested resources.	Individuals and corporations who permanently preserve land are granted tax credits worth 40% of the fair market value of the donation. Taxpayers are limited in the amount of credit they can claim; however, donors may transfer the credits to other taxpayers. The tax credit was capped at $100M and indexed to the Consumer Price Index in 2007.
Gain on the sale of land for open space use subtraction (*$1.4 million*)	Provide incentive to preserve open-space land for at least 30 years.	Individuals and corporations may subtract gains from the sale of real property or an easement of that property if the property is being devoted to open-space for at least 30 years.

[a] Based on income tax returns for TY 2008.

Source: JLARC staff analysis of the *Code of Virginia* and interviews with State officials and industry representatives.

Figure 15: Localities in Northern Portion of the State Have Highest Rates of Land Preservation Under Credit

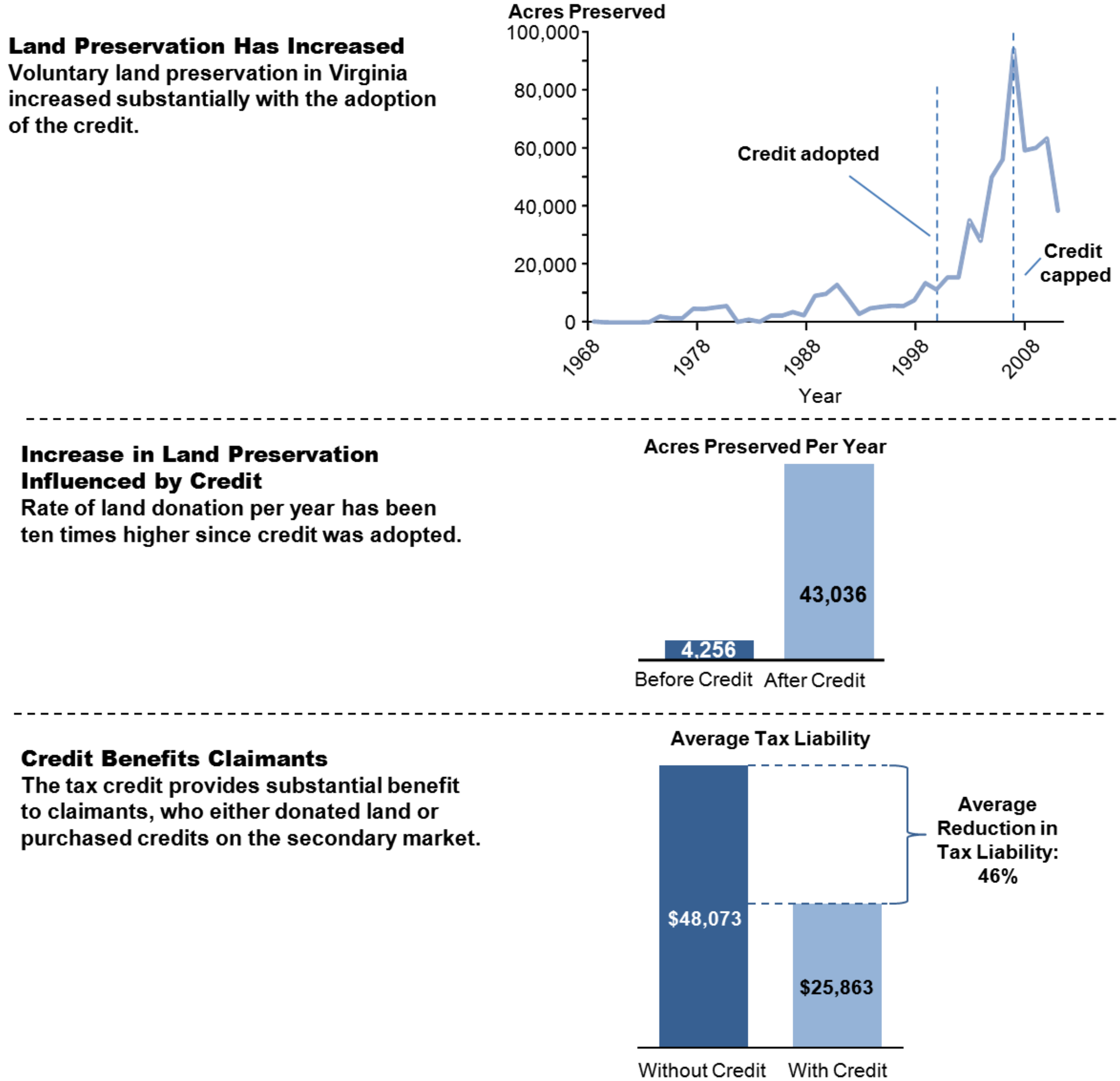


Source: JLARC staff analysis of Department of Taxation Land Preservation Tax Credit data.

Credit. In fact, voluntary land preservation in Virginia has increased tenfold since the credit was adopted. As indicated in Table 14, Virginia also offers a subtraction for the gain on the sale of land for open space use, but the number of taxpayers that use the preference appear insufficient to be the cause of this increase. In addition to tax preferences, Virginia acquires interests in land for preservation using dedicated revenue sources, bonds, and other financing mechanisms and provides funds for the direct acquisition of land through various other State programs. However, funding for these mechanisms and programs is substantially lower and less reliable than the credit.

Taxpayers can also claim a federal charitable gift deduction for the land they donate for preservation. The federal deduction allows eligible donors to deduct the value of the donated land from their federal adjusted gross income (FAGI). The deduction is limited to 50 percent of FAGI minus other charitable gift deductions per year for non-farmers and 100 percent for farmers and ranchers. While the federal program, which has been in place since 1964, may not have greatly influenced land preservation prior to 2000 (Figure 16), it may contribute to the success of Virginia's credit by enhancing its value. Ultimately, a taxpayer making a donation can receive a total benefit of up to 75 percent of FMV through the State and federal tax preferences combined.

Figure 16: Increase in Virginia Land Preservation Likely Due to Tax Credit



Source: JLARC staff analysis of data provided by the Virginia Outdoors Foundation and TAX, including income tax return data for TY 2008.

In addition, it appears that the credit is an adequate incentive for land preservation because of its average value to taxpayers claiming it. The value of the credit per claimant was nearly $22,000 in TY 2008, and claimants' tax liability was reduced by 46 percent, on average (Figure 16). The value of the tax credit is enhanced because it is transferrable, allowing other taxpayers to purchase and claim it. Transferability has increased the value of the credit because it allows donors to receive the benefit more quickly. Based on an analysis of TAX data, it would take average donors almost five years to receive the full benefit of the credit, but only if they had sufficient tax liability. Because the credit is transferable, donors are able to convert their credits into cash and benefit immediately. Even though donors will not receive full face value for credits sold on the secondary market, TAX data indicate most claimants are transferring at least a portion of their credit. According to TAX, $1.0 billion of the $1.2 billion in credits issued to donors to date have been transferred to other taxpayers.

While Credit Achieves Goal, Several Concerns Have Been Raised. Several concerns which could impact the effectiveness or administrative efficiency of the Land Preservation Tax Credit were raised during this review. However, TAX and Department of Conservation and Recreation (DCR) staff indicate that many of these concerns are being addressed. For example, stakeholders noted concerns have been expressed that appraisers may inflate the FMV of some donations to allow donors to claim additional credits, which results in increased costs to the State. TAX officials acknowledge that some appraisals have been excessive, but the department has exercised its authority to audit and adjust them. While TAX has always had authority to require a second appraisal, its authority to audit appraisals was codified in 2011, which strengthened their authority. In addition, donations of the interest in land that are deducted from federal income are also subject to auditing by the Internal Revenue Service. Nevertheless, TAX reports that there are challenges in evaluating appraisals, especially in instances of unique properties where sales of comparable land are unavailable.

Internal Revenue Code, Section 170(h)

To qualify for the Land Preservation Tax Credit, a donation must be considered a qualified conservation contribution under IRC Section 170(h), which specifies acceptable donations, conservation purposes, and donation recipients.

Another concern that has been raised with the Land Preservation Tax Credit is the conservation value of the land that is donated. It has been suggested that the most valuable lands are not being conserved under the credit. Because the credit is a voluntary program, donors, not the State, decide which lands are conserved. However, there are formal and informal checks working to ensure that donated lands have conservation value, such as historic, watershed, or natural habitat preservation. According to stakeholders, donations have always been required to be in compliance with federal regulations, which specify acceptable donations of interest in land. Beginning in 2007, DCR also became responsible for verifying the conservation value of all donations appraised at more than $2.5 million. According to TAX records, approximately eight percent of donations since 2007 have been over this threshold, but these larger donations represent 48 percent of credit amounts awarded. In addition to the formal checks on conservation value, land conservation organizations have restrictions on the types of donations they will receive, and multiple groups reported refusing to accept donations that did not meet their conservation standards. Land conservation organizations receive donations of land and easements, provide stewardship for donations, and enforce conservation easements.

Finally, TAX staff and a review of the research literature indicate that transferrable credits can be more administratively complex than other types of tax preferences. In fact, both TAX and DCR incur costs in administering the Land Preservation Tax Credit. However, the costs of administering this credit appear to be at least partially offset by a fee of five percent of the credit value (or two percent of the donation value) which was placed on all transfers of the credit beginning in 2007. Initially the fee was capped at $10,000, but that cap was removed in 2010. Half of the fees raised can be used by TAX and DCR for their expenses in administering the credit, while the remaining fees are transferred to the Virginia Land Conservation Fund to be distributed to public and private land conservation agencies.

Virginia Is One of Only 15 States That Offer Land Preservation Tax Credits. Unlike Virginia, most states with income taxes do not provide a tax credit for land preservation. Of the 15 states that offer this credit, Virginia's is one of the most generous due to the credit value, transferability, and unlimited credit per donation (Table 15). While nine states have higher credit values (as a percent of FMV) than Virginia, none also has both transferrable credits and an unlimited credit value. In fact, Virginia is the only state that allows the credit to be transferred without restricting the overall amount of credit that a single donation can garner.

Table 15: Virginia's Land Preservation Tax Credit Is One of The Most Generous Compared to Other States

State	Credit Value (% of FMV)[a]	Transferable	Per Donation Credit Ceiling
Virginia	**40%**	**Yes**	**No**
Arkansas	50	No	$25,000
California[b]	55	No	No
Colorado	50	Yes	375,000
Connecticut	50[c]	No	No
Delaware	40	No	50,000
Georgia	25	Yes	250,000/500,000[d]
Iowa	50	No	100,000
Maryland	100	No	80,000/160,000[e]
Massachusetts	50	No	50,000
Mississippi	50[f]	No	10,000
New Mexico	50	Yes	250,000
New York	25[g]	No	5,000
North Carolina	25	No	250,000/500,000[c]
South Carolina	25	No	No

[a] Credits are generally awarded as a percentage of the fair market value of the donation.
[b] State resource agencies must provide funds to replace any tax credit claimed by a landowner.
[c] Corporate income tax only.
[d] Individual/corporate.
[e] Individual/joint.
[f] An alternative credit of $5.50 per acre is also offered.
[g] Credit is 25 percent of property tax paid on easement.

Source: JLARC staff analysis of Land Trust Alliance data.

Virginia's Historic Rehabilitation Tax Credit Effectively Achieves Goal of Promoting Rehabilitation of Historic Structures

Implemented in 1997, the Historic Rehabilitation Tax Credit is the State's second largest credit in terms of total reduction in taxpayer liability, in part because it can be claimed through multiple taxes rather than just income taxes (Table 16). Data provided by TAX and the State Corporation Commission indicate that the credit reduced taxpayers' liability by $114 million in TY 2008, $60.8 million of which was attributable to reductions in income taxes and $53.3 million of which was attributable to reductions in the insurance premium and bank taxes. According to a recent study conducted by faculty at Virginia Commonwealth University (VCU) and additional analyses conducted by JLARC staff, the credit appears to effectively achieve its public policy goal of encouraging historic rehabilitation in the State.

Table 16: Virginia Provides a Tax Credit for Rehabilitating Historic Structures

Public Policy Purpose	Encourage individual and businesses to restore certified historic structures in Virginia.
Description	Grants owners of certified historic structures the ability to receive a tax credit against their income, insurance premium, or bank franchise tax for 25 percent of eligible expenses incurred during rehabilitation projects. Owners are not awarded the credit until the project is completed.
Beneficiaries	Any individual or business that owns the historic structure that was rehabilitated. In tax year 2008, 1,173 returns claimed the credit.

Source: JLARC staff analysis of § 58.1-339.2 of the *Code of Virginia,* the Virginia Administrative Code, and TAX documents.

Certified Historic Structures

A historic structure is certified in Virginia if it is listed on the Virginia Landmarks Register.

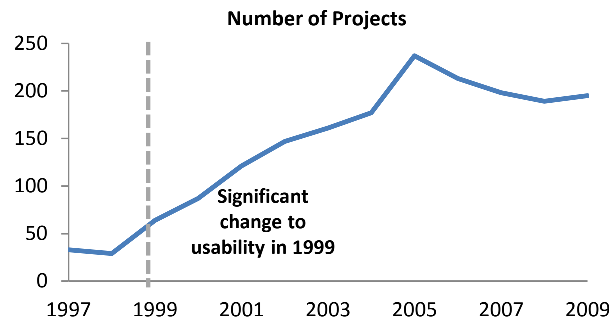
Historic Rehabilitation Credit Appears to Promote Rehabilitation Activity. The number of certified historic rehabilitation projects in Virginia has increased by 330 percent since the credit was enacted in 1997. As demonstrated in Figure 17, growth in historic rehabilitation activity is particularly evident after 1999 when legislative changes made the credit more usable. Specifically, businesses structured as partnerships received authority over how to allocate these tax credits. This change attracted investors to join partnerships involved in rehabilitation projects because it allowed them to receive credit amounts that are disproportionate to their share of ownership, if owners mutually agree. In addition, a ten-year carry forward period was added to the credit in 2000.

Evidence from several sources suggests that the credit influenced the growth in rehabilitation projects. In particular, a 2007 VCU survey asked credit claimants to rate the credit's importance in their decisions to rehabilitate historic structures. As shown in Figure 17, a total of 67 percent of survey respondents reported that the credit was "very important" and 26 percent reported that the credit was "somewhat important." When asked whether they would have rehabilitated a historic structure without the credit, almost two-thirds of survey respondents said that they would not have done so.

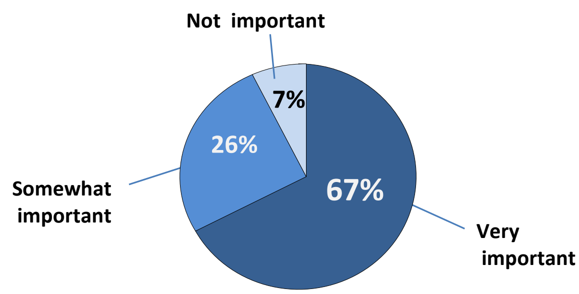
In addition to the VCU survey, several other sources suggest that the credit influences historic rehabilitation activity. First, the number of commercial rehabilitation projects using the federal

Figure 17: Historic Rehabilitation Tax Credit Appears to Effectively Promote Restoration of Virginia Certified Historic Structures

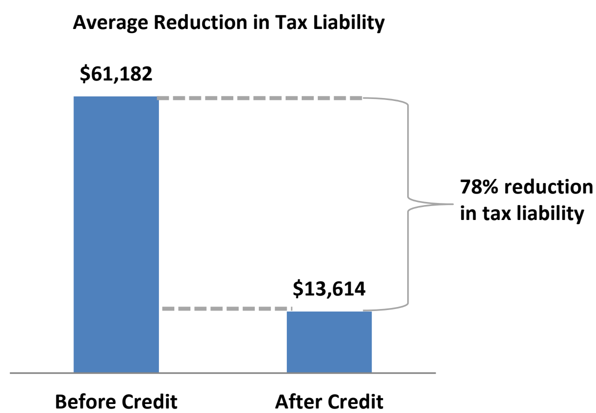
Historic Rehabilitation Activity Has Increased
A substantial number of structures have been rehabilitated using the credit, particularly after changes in 1999.



Historic Rehabilitation is Influenced by the Credit
The majority of stakeholders reported that the credit was very important in taking on a rehabilitation project.



Credit Benefits Claimants
Credit appears sizable enough to encourage behavior for taxpayers of all income levels.



Source: JLARC staff analysis of Department of Historic Resources data, 2007 Virginia Commonwealth University report, and income tax return data from TY 2008.

credit increased after the State credit was enacted in 1997. Prior to 1997, the federal rehabilitation tax credit was the only credit available to rehabilitate commercial structures. According to Department of Historic Resources (DHR) data, commercial rehabilitation projects grew 190 percent between 1997 and 2001, suggesting that the State tax credit, or the combination of State and federal credits, promoted more commercial rehabilitation projects than the federal tax credit alone had done in previous years. In addition, the number of residential remodeling businesses in the State increased at an average rate of five percent per year during the seven-year period after the credit was adopted, compared to an average rate of three percent per year during the seven-year period before the credit. Finally, the tax credit is the only program focused specifically on historic rehabilitation. Virginia's Historic Preservation Easement Program and the Main Street Program also incentivize rehabilitation, but they are not specifically focused on historic properties and have geographic restrictions that limit the projects that can qualify.

Federal Historic Preservation Tax Credit

Adopted in 1976, the credit is administered by the National Park Service, and is a 20 percent credit available to individuals who own and are rehabilitating historic income-producing properties, including commercial, industrial, agricultural, and rental properties. The federal credit can be used in conjunction with the State credit.

The reduction in tax liability for the average claimant appears sufficiently generous for the Historic Rehabilitation Tax Credit to encourage rehabilitation. As shown in Figure 17, the credit reduced individual tax liability by 78 percent, on average, in tax year 2008. Although the credit is neither refundable nor transferrable, it is usable because of its lengthy carry forward period (ten years) and the aforementioned rules regarding credit allocation for partnerships. Moreover, owners of commercial structures may be reimbursed for up to 45 percent of their rehabilitation expenditures if they use both the State and federal tax credits, making historic rehabilitation of commercial properties particularly attractive in Virginia. Based on the average investment in projects that were approved for the credit in 2010, owners of commercial structures could receive a combined federal and State award of $928,182 compared to an award of $412,525 if only the federal credit was claimed.

According to DHR staff, the Historic Rehabilitation Tax Credit also provides numerous social benefits to the State. The credit has contributed to area revitalization, as projects funded with the credit have served as catalysts for development and rehabilitation in previously neglected areas. Further, the credit has been used to preserve valuable landmarks that define Virginia's historic identity and attract tourists to the State.

Importantly, the future effectiveness of the credit may be impacted by fraudulent claims as well as a 2011 court case questioning the legality of the credit's distribution among partnerships. A recent case involving a Virginia developer who significantly overstated rehabilitation costs for multiple developments in Richmond exemplifies how fraudulent activity can occur despite the fact that this credit has a three-stage certification process. It is unknown what, if any, effect this misuse will have on the credit. In addition, the legality of allocating credit benefits disproportionately to partners was recently challenged in *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*. The U.S. Court of Appeals ruled in 2011 that the disproportionate distributions of credits to the limited partners were "sales" in this particular case and should be taxed as income on the federal level. DHR staff raised concerns that the court's ruling may apply to other partnerships, which would reduce the value of the credit because it would be taxed. However, it is not yet clear what impact, if any, the case will have on future rehabilitation activity in the State.

Presence of Credit in Virginia Similar to Other States With Income Taxes. Consistent with Virginia, the majority of states with income taxes promote historic rehabilitation activity with a state tax credit. According to data published by the National Trust for Historic Preservation, a total of 30 states currently offer rehabilitation tax credits. Of the states that are most socioeconomically similar to Virginia, four of the nine with income taxes have a historic rehabilitation credit, including Colorado, North Carolina, Maryland, and Minnesota.

VIRGINIA TAX PREFERENCES DESIGNED TO PROMOTE CHARITABLE ACTIVITY DO NOT PROMOTE ACTIVITY, BUT RECOGNIZE VALUE OF THEIR SERVICES

Virginia tax preferences may have limited impact on promoting charitable activity in Virginia, and may serve instead to recognize that the charitable activities performed by preference beneficiaries are valuable.

Virginia tax preferences may have a limited impact on promoting charitable activity, and may serve instead to recognize that the charitable activities performed by preference beneficiaries are valuable. Virginia grants five retail sales and use tax exemptions and one income tax credit that are designed to promote charitable activity. As part of this review, JLARC staff conducted an in-depth review of the exemption of tangible personal property purchased by nonprofits, and a more limited review of two other exemptions and the tax credit.

Nonprofit Exemption Does Not Appear to Effectively Promote Charitable Activity, but May Serve Alternate Purpose

In 2004, Virginia implemented a process by which nonprofits could become exempt from the retail sales and use tax for the tangible personal property that they purchase (Table 17). According to data provided by TAX, the exemption reduced the sales tax liability of nonprofits by approximately $179 million in TY 2008. An analysis of the change in nonprofit activity over time and the impact of the exemption on some nonprofits indicate that the increase in nonprofit activity in Virginia is not linked to the exemption. However, the exemption may serve to recognize the services that nonprofits provide, which may otherwise not be available or have to be delivered through public programs.

Exemption of Nonprofits

Prior to 2004, nonprofits were required to receive approval from the General Assembly to be exempt from paying the retail sales and use tax. Over time, this policy resulted in several hundreds of separate exemptions for nonprofits in the *Code of Virginia*. To reduce the burden on the General Assembly of approving exemptions, TAX was granted the authority to grant approval, beginning in 2004.

Table 17: Nonprofits in Virginia Qualify for Exemption From Paying Sales Tax

Public Policy Purpose	Promote activity by nonprofits that provide charitable services such as relief to the poor and advancement of education or science, promote social welfare, and reduce the burdens of government.
Description	501(c)(3)[a] and 501(c)(4)[b] nonprofits with charitable purposes are granted an exemption from paying the sales taxes on purchases of tangible personal property. Smaller nonprofits that are not required to file with the IRS[c] are also exempt if they have a charitable purpose. Select nonprofits are granted an exemption from purchases of taxable services and collecting taxes on their sales of tangible goods. Nonprofits must submit an application and be approved by TAX to use the exemption.
Beneficiaries	Approximately 5,773 nonprofits had been issued a certificate from TAX allowing them to use the exemption as of FY 2010.

[a.] 501(c)(3) nonprofits are corporations, community chests, funds, trusts, or foundations organized for religious, charitable, scientific, public safety, or educational purposes.
[b.] 501(c)(4) nonprofit organizations are civic leagues and social welfare organizations that devote their net earnings to only charitable, educational, or recreational purposes.
[c.] Exempt from federal income taxes pursuant to sections 501(c)(3) and 501(c)(4) or other sections of the Internal Revenue Code.

Source: JLARC staff analysis of § 58.1-609.11 of the *Code of Virginia* and TAX documents.

Tangible Personal Property

Tangible personal property includes property that can be seen, touched, or felt.

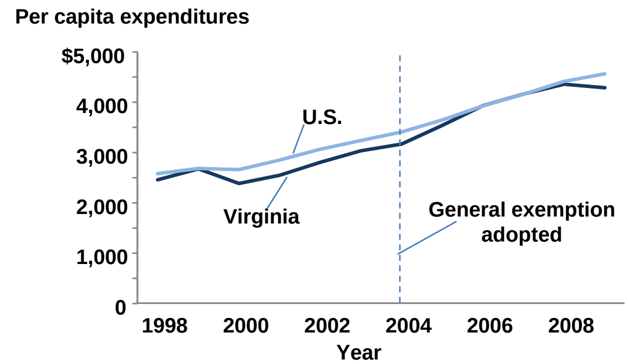
Nonprofit Activity in Virginia Has Increased but This Change Is Not Likely Due to Exemption. According to data from the National Center for Charitable Statistics (NCCS), nonprofit activity (as measured by per capita expenditures) has increased substantially in Virginia over the past decade. However, the rate of increase has not changed significantly since 2004, when legislative changes allowed a broader number of charitable nonprofits to obtain exempt status (Figure 18).

Other factors may better explain the increase in nonprofit activity in Virginia than the exemption. First, general growth in the population and economy appears to be a primary driver, as nonprofit activity nationwide and in states that are socioeconomically similar to Virginia has generally increased at comparable rates, both over the past decade and since 2004. In particular, nonprofit activity since 2004 has increased at higher rates in Arizona (51 percent) and Washington (46 percent) than in Virginia (35 percent), though these states have narrower exemption policies. Increases in government funding and contracting with service providers, particularly in the health and human resources sectors which tend to contain many nonprofit organizations, and increases in charitable donations by private individuals and businesses may better explain increases in nonprofit activity over the past several decades, according to the research literature.

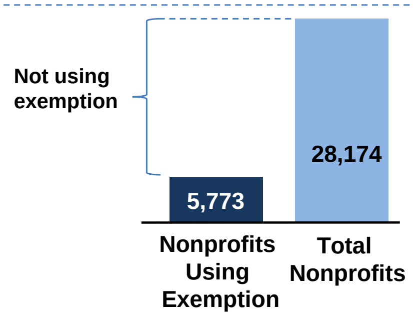
In addition, many charitable nonprofits operating in Virginia are not using the exemption, which reduces the overall impact that it can have in promoting charitable activity. According to data provided by TAX, approximately 5,773 charitable nonprofits had filed for exempt status with the State as of 2010, but NCCS data

Figure 18: Nonprofit Activity in Virginia Has Increased Over Time, but Not Likely Due to Sales Tax Exemption

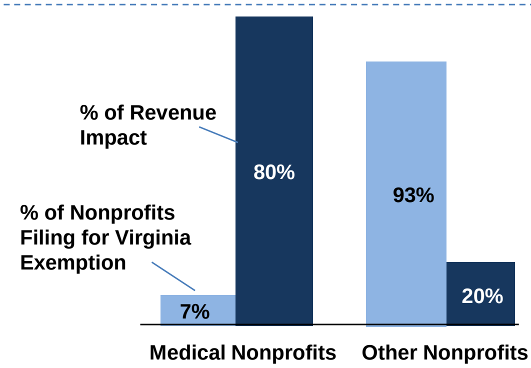
Activity Increased
Activity (per capita expenditures) of charitable nonprofits in Virginia has increased over time, but is comparable to the national trend.



Activity Not Linked to Exemption
Most charitable nonprofits in Virginia are not using the exemption, based on comparison of nonprofits that have received exemption certificates from TAX and those registered with the IRS.



Exemption Provides Sizable Reduction
Exemption appears to provide sizable reduction in tax liability only for medical nonprofits, which represent a small portion of all nonprofits. For other nonprofits, the reduction may not be sufficient compared to costs of financial audit and other compliance requirements.



	Medical Nonprofits	Other Nonprofits
Average Reduced Tax Liability	$222,600	$3,900
Number of nonprofits[a]	84	1,208

[a]Number of nonprofits that filed or renewed an exemption certificate with TAX in 2009.

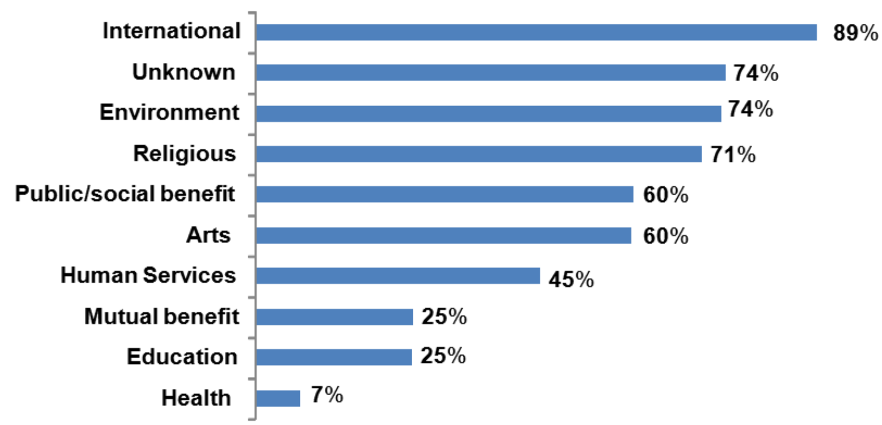
Source: JLARC staff analysis of National Center for Charitable Statistics data (1998-2009) and information provided by TAX.

indicates that more than 28,000 charitable nonprofits in Virginia had registered with the IRS as of that year (Figure 18). It is important to note that the NCCS estimate may not reflect the true number of nonprofits that could be exempt in Virginia because it excludes 501(c)(4) nonprofits that have charitable purposes and may include some entities that have ceased operations. Virginia's charitable nonprofits may not be using the exemption for several reasons, according to staff from the largest community foundation in Virginia and TAX. Many smaller nonprofits are likely unaware of the exemption process and thus do not file with TAX for exempt status. In addition, nonprofits with annual revenues greater than $750,000 must undergo a financial review or audit to become exempt and may determine that complying with this requirement is too burdensome or costly relative to the reduced tax liability they could achieve from the exemption. Further, some nonprofits may not qualify for the exemption because their administrative costs are greater than the 40 percent limit.

The benefit provided by the exemption may also not be generous enough to encourage nonprofits to use it, further impacting its effectiveness in promoting charitable activity. Based on an analysis of exempt purchases that nonprofits reported to TAX on their exemption applications, average annual benefits derived from these purchases are relatively small for most nonprofits except for the small group that is categorized as medical organizations (seven percent of nonprofits that filed in 2009). As shown in Figure 18, the annual reduced tax liability received by medical organizations was approximately $222,600, on average, but annual reductions for other nonprofits ranged from only $652 (cultural organizations) to $4,750 (civic and community organizations). This reduction in tax liability represented less than 0.01 percent of the gross receipts that all organizations reported to TAX in that year.

Nonprofit Exemption May Serve to Recognize Value of Services. Although the nonprofit exemption may not have triggered the increase in charitable activity in the State, the exemption appears to serve other purposes. In fact, prior TAX studies of exemptions for specific nonprofits indicated that the purpose of some of these exemptions was to provide financial relief to specific organizations because they provided necessary services such as emergency medical services, food or housing assistance, and educational or other supportive services that may otherwise not be available to Virginians. Overall, charitable nonprofits operating in Virginia appear to provide needed services. Specifically, 64 percent of charitable nonprofits in Virginia provided education, health, or human services in 2009, according to an analysis of data from the NCCS. Through the provision of these services, charitable nonprofits also reduce the State's burden of directly providing or funding these services. As shown in Figure 19, Virginia charitable nonprofits of all types receive a sizable portion of their revenue from charitable donations, gifts, or grants rather than from government sources.

Figure 19: Most Types of Nonprofits Operating in Virginia Derive Over One-Third of Revenue From Charitable Donations (2009)



Source: JLARC staff analysis of National Center for Charitable Statistics data for 2009.

Nonprofit Exemption Is Consistent With Most Other States. Like Virginia, most states with broad sales taxes provide exemptions to nonprofit organizations for purchases of tangible goods. Only five states with sales taxes do not allow exemptions for nonprofits (Alabama, California, Louisiana, Mississippi, and North Carolina). Of the states that grant nonprofit exemptions, Virginia is one of 27 states that grants a general exemption to a broad range of nonprofits, usually those with at least a 501(c)(3) status. Of the ten states that are most socioeconomically similar to Virginia, six (Colorado, Maryland, Michigan, Minnesota, New Jersey, and Pennsylvania) have broad exemptions. While North Carolina does not grant an exemption, it allows nonprofits to file with the Department of Revenue to receive a refund.

Three Smaller Tax Preferences Also Likely Have Limited Impact on Promoting Charitable Activity

Virginia also provides sales tax exemptions for churches and donations to nonprofits, as well as an income tax credit for encouraging businesses to make donations to certain neighborhood programs (Table 18). Rather than promoting increases in charitable activity, the exemptions appear more likely to serve as a reward for the charitable activity that is conducted. While the tax credit appears to promote donations to neighborhood organizations, its effectiveness at achieving this goal may be limited, particularly in the future.

Table 18: Three Smaller Virginia Tax Preferences Promote Charitable Activity

Tax Preference *(Reduced Tax Liability[a])*	**Public Policy Purpose**	**Description**
Church Purchases Exemption *($6.0 million)*	Promote community, civic, and other charitable activity by churches.	Grants churches an exemption from the retail sales and use tax for their purchases of tangible goods that are used in the religious worship service or other gatherings and used to maintain the property. A church must be exempt from federal taxation under 501(c)(3) or local property taxation in Virginia and meet at a single location for regularly scheduled worship services to qualify.
Exemption for Donations of Tangible Goods to Nonprofits *($5.5 million)*	Promote donations by businesses to entities that are serving a charitable purpose or providing other public services.	Grants exemption from the retail sales and use tax for tangible personal property that is withdrawn from inventory and donated to a 501(c)(3) nonprofit, the State, or a political subdivision. Exemption applies to any business that makes a qualifying donation.
Neighborhood Assistance Tax Credit *($4.8 million)*	Promote donations by businesses and individuals to neighborhood organizations for the benefit of impoverished people.	Grants individuals and business firms a tax credit equal to 40 percent of charitable contributions to approved Neighborhood Assistance Program (NAP) organizations. Business firms can donate cash, stock, goods, real estate, rent/lease of a non-profit facility, and select healthcare and contracting services, and individuals can donate cash or marketable securities.

[a] Estimates are for TY 2008. Estimates for the church purchases exemption and exemption for donations of tangible goods to nonprofits were based on a 2007 TAX sales and use tax expenditure study. The estimate for the Neighborhood Assistance Tax Credit is based on an analysis of income tax return data from TY 2008 and other information provided by TAX.

Source: JLARC staff analysis of the *Code of Virginia* and interviews with State officials and stakeholders.

Sales Tax Exemption for Churches Appears to Serve Largely as a Recognition for Services. Virginia churches qualify for one of two exemptions that they can use to purchase tangible goods without paying retail sales and use taxes. First, churches can file with TAX to use the nonprofit exemption discussed in the previous section. Alternatively, churches can use another exemption that does not require filing with TAX and is granted only to churches (church exemption). While the precise reason the General Assembly granted churches exempt status is unknown, TAX documents suggest that it was because some churches provide community assistance, including relief to the poor. To be eligible for the church exemption, a church must be exempt from paying federal income taxes under section 501(c)(3), or exempt from paying local real property taxes under the *Code of Virginia*. Based on a survey of churches in Virginia, TAX estimated that churches reduced their tax liability by $6.0 million in TY 2008 due to the exemption. A limited review of this exemption found that while it may not promote churches' community assistance activities, it may serve to recognize the value of the services that churches provide that might not otherwise exist, or would have to be funded by the State.

Virginia's church exemption does not appear to be an effective mechanism for substantially promoting charitable or community assistance on behalf of churches. Although the number of Virginia churches that had filed with the IRS doubled between 2000 and 2010, and therefore churches likely provided more community assistance, this trend has not likely been the result of the church exemption. While some churches received sizable benefits by not paying sales taxes on certain purchases, reduced tax liability varied dramatically by church size and appears too low to have caused new churches to open. Based on an analysis of data provided by TAX, the exemption was estimated to reduce the sales tax liability of churches by approximately $600 in fiscal year (FY) 2006, on average, assuming all purchases were for non-food items that are subject to the full sales tax rate. However, churches with fewer than 50 members saved only $64 while churches with 1,000 or more members saved $3,100, on average. In addition, some churches may be more likely to use the nonprofit exemption instead in order for all purchases of tangible property to be exempt rather than only those related to their religious instruction and worship services.

Instead of spurring growth in charitable activity, the church exemption may serve instead to recognize the value of church services to the community, which may not otherwise be available. These services may also reduce costs that the State would otherwise have to incur. In fact, churches and other religious organizations received approximately 71 percent of their revenue from charitable donations, gifts, or grants, which may be a reasonable measure of their value to the community and the benefits that they provide.

Virginia's church exemption is similar to most other states. Most states appear to provide a broad exemption for churches although some provide limited exemptions. Of the ten states that are most socioeconomically similar to Virginia, California, North Carolina, and Washington provide no exemption or an exemption under very narrow circumstances. Similar to nonprofits in North Carolina, churches in the state can file with the Department of Revenue to receive a tax refund on certain purchases.

Exemption for Donating Property Withdrawn From Inventory Likely Has Marginal Impact on Donations. Since 1986, Virginia has allowed businesses to donate tangible personal property that has been withdrawn from their inventory to nonprofits without paying sales tax on these items. When businesses purchase tangible personal property that is to be placed in their inventory, they are exempt from paying the sales tax under Virginia's resale exemption. However, Virginia law requires businesses to pay taxes on goods once they are withdrawn from inventory for purposes other than making a sale or another exempt purpose. In order to promote charitable donations, Virginia and other states typically provide an exemption if goods are withdrawn for purposes of donating to a charitable nonprofit (exempt under 501(c)(3)). Virginia also grants the exemption for donations made to the Commonwealth as well as its local governments or other political subdivisions. According to TAX estimates, the tax liability of businesses was reduced by approximately $5.5 million in TY 2008 because of the exemption.

It appears that the exemption likely has a marginal impact on promoting donations. In fact, businesses are more likely to receive a greater reduction in tax liability from other tax preferences, particularly the charitable deduction at the federal level. Table 19 illustrates the reduced tax liability a business could receive from the federal income tax deduction, compared to Virginia's sales tax exemption. In addition, business taxpayers may also be eligible for the Neighborhood Assistance Tax Credit if they donate to an eligible neighborhood organization.

Table 19: Businesses Likely Receive Greater Incentive to Donate Inventory From Preferences Other Than Sales Tax Exemptions

Tax Preference	Potential Savings, $1,000 Donation
Neighborhood Assistance Act Tax Credit	$400
Federal corporate income tax deduction *(taxable income of $100,000[a]*	$223
Federal individual income tax deduction *(sole proprietorship, taxable income of $100,000, single filer)[b]*	$217
Sales and use tax exemption [c]	**$50**

[a] The amount of deduction that a corporate taxpayer can claim is limited to ten percent of taxable income.
[b] Individuals can deduct up to 50 percent of adjusted gross income, which would also apply to businesses structured as partnerships or limited liability companies.
[c] Assuming the donated good is a non-food item.

Source: JLARC staff analysis of Internal Revenue Service tax forms and instructions for individual and corporate taxpayers.

This exemption is consistent with the tax treatment of this activity in other states. Half of the states with a sales tax have a comparable exemption, including socioeconomically similar states such as Maryland, Michigan, North Carolina, and Washington. Neighboring jurisdictions such as West Virginia and the District of Columbia also grant a similar exemption.

Neighborhood Assistance Tax Credit Promotes Donations to Neighborhood Programs, but Effectiveness May Be Limited. In 1981, Virginia adopted the Neighborhood Assistance Act Tax Credit to encourage businesses and individuals to make donations to neighborhood assistance programs (NAPs) for the benefit of impoverished people. In TY 2008, the credit reduced taxpayers' liability by approximately $4.8 million. According to Virginia Department of Social Services (DSS) staff, the tax credit effectively encourages businesses and individuals to donate to approved NAPs, as many donors reported that they would not make charitable contributions to these programs if they were not eligible for the credit. These donations are largely important because many NAPs lack consistent funding sources and rely on charitable contributions to stay open.

NAP Organizations

Neighborhood Assistance Program (NAP) organizations assist impoverished people with necessities like housing, food, and healthcare. NAPs are approved for the Neighborhood Assistance Tax Credit each year by the Department of Social Services or the Department of Education. To be approved, NAPs must show that 50 percent of the population that they serve is impoverished people with annual incomes not in excess of 200 percent of the current poverty guidelines. Currently, this amount equates to approximately $30,000 for a family of two.

However, the impact of the credit may be limited, as utilization of the credit has decreased. According to data collected by DSS, the amount of credits issued to NAPs has declined for the past three fiscal years. In FY 2008, approximately $6.7 million in credits was issued to NAP organizations, compared to only $4.7 million in FY 2010.

The recent decline in the utilization of the credit may be a result of current economic conditions. Between FY 2004 and FY 2008, the total amount of credits issued increased annually. The decrease in the amount of neighborhood assistance tax credits issued coincided with an economic downturn, and this decrease has occurred despite a recent legislative change to the credit's eligibility criteria which expanded the number of programs that could issue credits to donors. In 2011, the General Assembly broadened the definition of "impoverished" so that NAPs serving individuals at 200 percent of the federal poverty line would be eligible for tax credits. Prior to the change, 50 percent of the individuals served by NAPs were required to be at or below 150 percent of the federal poverty line (non-educational NAPs) or 180 percent of the federal poverty line (educational NAPS) to be eligible for the credit. Due to the possible influence of economic conditions and lack of available data to analyze long-term trends, the reason for the decline in credit utilization in recent years remains inconclusive.

DSS staff have voiced concerns that recent legislative changes to the Neighborhood Assistance Act Tax Credit may hinder its future effectiveness. In particular, DSS staff claim that broadening the definition of "impoverished" may cause NAPs to place less emphasis on serving the most impoverished people. Additionally, legislative changes resulted in credits being allocated disproportionately between educational (59 percent) and non-educational (41 percent) programs. A total of 201 non-educational NAPs have a combined credit cap of $7 million. In contrast, 24 educational NAPs have a credit cap of $4.9 million. Despite the fact that neither educational nor non-educational programs currently use all of their available tax credit allocations, stakeholders note that the disproportionate allocation of credits could potentially limit funding for non-educational NAPs in the future.

Finally, Virginia's Neighborhood Assistance Act Tax Credit is not consistent with the majority of states to which it is socioeconomically similar. Of the nine states with income taxes that are most socioeconomically similar to Virginia, Pennsylvania, Maryland, and New Jersey have neighborhood assistance tax credits, whereas Arizona, California, Colorado, Michigan, Minnesota, and North Carolina do not.

EFFECTIVENESS OF VIRGINIA PREFERENCES PROMOTING ECONOMIC DEVELOPMENT IS MIXED

The effectiveness of Virginia's tax preferences is mixed in promoting economic activity. Some tax preferences appear to successfully promote their intended activities, others appear to have little impact on the outcomes they are intended to promote.

Virginia grants over 40 tax preferences that are intended to promote economic activity, such as jobs creation or capital investment. An in-depth review of the State's coal tax credits and more limited reviews of seven retail sales and use tax exemptions and three income tax credits reveal that the effectiveness of Virginia's tax preferences is mixed in promoting economic activity. While some tax preferences appear to successfully promote their intended activities, others, including the largest preference examined, appear to have little impact on the outcomes they are intended to promote.

Virginia's Coal Tax Credits May Not Be Effectively Promoting Coal Production and Employment in Virginia

The State has two income tax credits that were adopted to slow the decline of Virginia coal employment and production by incentivizing both the production and consumption of Virginia coal (Table 20). Specifically, the Coalfield Employment Enhancement Tax Credit was adopted to provide an incentive to coal mine operators to produce Virginia coal and coal bed methane and employ miners, while the Virginia Coal Employment and Production Incentive Tax

Table 20: Virginia Offers Two Credits Designed to Promote Coal Production, Employment, and Consumption

Preference *(Reduced Tax Liability[a])*	**Public Policy Purpose**	**Description**
Coalfield Employment Enhancement Tax Credit (*$31.2 million*)	Provide incentive for coal mine operators to produce Virginia coal and coal bed methane and employ miners and in turn slow the decline in Virginia coal production and employment.	Provides a tax credit for each ton of coal or MMBTU of coal bed methane produced in Virginia[b]. Credit values range from $0.40 to $2.00 per ton and $0.05 per MMBTU. Credits are delayed three years and are refundable at 85% of face value. Credits can be applied to any State tax.
Virginia Coal Production and Employment Incentive Tax Credit *(estimate included above)*	Provide incentive for electricity producers to purchase Virginia coal and in turn slow the decline in Virginia coal production and employment.	Provides a tax credit of $3 for each ton of Virginia coal used to generate electricity in the State. The credit can be transferred from electricity generators to mine operators and has been refundable since 2006.

[a] Estimate based on JLARC staff analysis of income tax return data from TY 2008.
[b] MMBTU is equivalent to one million British Thermal Units (BTU).

Source: JLARC staff analysis of the *Code of Virginia* and interviews with State officials and industry representatives.

Credit was adopted to provide an incentive for electricity producers to purchase Virginia coal. The coal credits significantly reduce the tax liability of corporate and individual taxpayers, particularly when compared to the reduction provided by other economic development tax preferences. In fact, the two coal credits reduced tax liability by $31 million for TY 2008. An analysis of the change in coal production and employment over time indicates that the State's coal tax credits may not have achieved their public policy goal of slowing the decline in coal mining activity and employment (Figure 20). It appears the credits may have promoted economic diversification in the region, but coal tax credits may not be the most effective mechanism for accomplishing this goal.

Declines in Virginia Coal Mining Activity Appear Unaffected by the Tax Credits. Coal production and employment have declined substantially since 1990 (Figure 20). According to data provided by the Department of Mines, Minerals, and Energy (DMME), Virginia coal production and employment have declined by 52 and 54 percent, respectively, since their historic highs in 1990. The precursor to one of the current coal credits was in place before the decline began, while the other was enacted shortly thereafter. It is important to note that with or without the credits, the decline in Virginia coal production was predicted by numerous analysts because over two-thirds of recoverable coal reserves in Virginia have already been mined.

While it is difficult to isolate the true impact of the credits on slowing the decline of coal production and employment, several factors suggest it is at best limited. Coal production and employment have declined at the same or faster rates than was predicted if the Coalfield Employment Enhancement Tax Credit had not been enacted (Figure 20). In the process of developing and refining the credit, analysts projected that coal employment and production would decline by 28 percent between 1996 and 2005 without the credit. However, actual mining employment was substantially lower than expected during this period, declining 36 percent. Production was slightly better than was projected without the credit, despite the fact that the credit was further modified to enhance its effectiveness.

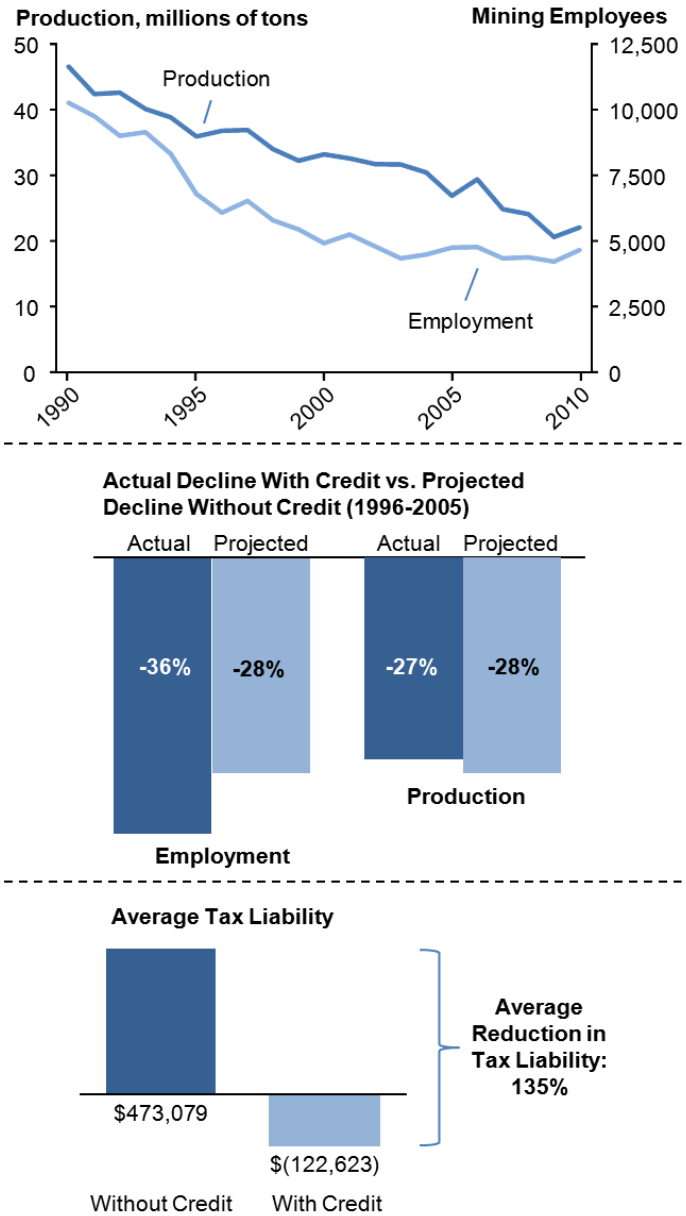
External and largely uncontrollable factors also appear to drive coal production and employment, suggesting that the credit could only have limited impact. According to coal industry experts and the research literature, coal production and employment are primarily dependent upon available coal reserves, production and transportation costs, and market prices. Virginia faces unfavorable conditions in each of these areas, suggesting that tax credits are unlikely to meaningfully counteract these negative factors. In

Figure 20: Virginia Coal Production and Employment Declines Appear Unaffected by Coal Tax Credits

Coal Mining Activity Has Decreased
Coal production and employment in Virginia decreased substantially during the last 20 years.

Decreases in Coal Mining Activity Appear Uninfluenced by Credits
Decreases in coal employment from 1996 to 2005 were greater than predicted without the Coalfield Employment Enhancement Tax Credit. Decreases in coal production were six percent lower than predicted without the credit.

Credits Provide Significant Benefit
The average tax credit claimed exceeds the tax liability of the claimant, resulting in a refund. Credit claimants either produced coal or consumed it to produce electricity.



Source: JLARC staff analysis of Department of Mines Minerals and Energy, Virginia Center for Coal and Energy Research, Virginia Employment Commission, and TAX data.

particular, less than one-third of the State's coal reserves remain (according to the U.S. Energy Information Administration) and tend to be located in remote locations and in deep, thin seams. The combination of these factors increases production and transportation costs.

Virginia's production and transportation costs are higher than other nearby coal states, especially Kentucky and West Virginia, making it challenging for in-state mine operators to compete in the steam coal market where competition is high and based largely on cost, not quality. The credits can decrease the differences in cost between Virginia and other states; however, evidence suggests that a substantial difference remains. Specifically, the majority (54 percent) of coal used in Virginia to generate electricity comes from Kentucky and West Virginia where production and transportation costs are lower; in-state mines supply only 25 percent of steam coal used in Virginia.

Steam vs. Metallurgical Coal

The two most common grades of coal are *steam* and *metallurgical.* Steam coal is used to make steam and electricity. Metallurgical coal is used for making steel and generally has a higher energy value, lower ash, and higher volatility than steam coal. Metallurgical coal typically has a higher market value than steam coal.

Market prices may also have a greater impact on coal production and employment than tax credits. Recent increases in international demand for steel have driven up the price of metallurgical coal, which is also mined in Virginia. In addition to increased demand, metallurgical coal typically has a higher market price than steam coal, which allows Virginia mine operators who face relatively higher production and transportation costs to be profitable. However, only seven percent of U.S. coal demand is for metallurgical coal, which limits Virginia mine operators' ability to compete and be profitable in domestic markets. When demand and market prices drop for metallurgical coal, Virginia coal mine operators are faced with competing in the steam coal market, where they may not earn a profit and be forced to reduce coal production and employment, despite the availability of tax credits.

Although the coal credits can significantly reduce tax liability for mine operators, it does not appear to be sufficient to counteract the negative impact of other factors on Virginia coal production and employment, such as the high costs of production and transportation. In TY 2008, individual and corporate tax returns claimed an average of $473,000 in coal tax credits, which reduced tax liability by 135 percent (Figure 20). The credit fully eliminated the tax liability of all but seven individual and three corporate taxpayers claiming the credits. Because the coal credits can be refunded, individual and corporate income tax filers received refunds totaling $14.2 million, or 45 percent of the value of the credit.

Portion of Refunded Credits for Economic Diversification Benefit Coalfield Region, but Unemployment Remains High. Although the primary purpose of the coal credits is to slow the decline in coal production and employment, coal industry representatives indicated that the credits are also intended to promote economic diversification in the coalfield region. Data reported by the Virginia Employment Commission show that employment in the region has diversified to some extent; however, the area's unemployment rate of 7.2 percent is substantially higher than the statewide average of 6.2 percent (as of July 2011). Taxpayers can elect to claim their refundable coal credits rather than carrying them forward, but most forgo 15 percent of the credit if they choose this option. The 15 percent is transferred to the Virginia Coalfield Economic Development Authority (VCEDA), which is responsible for economic development in the coalfield region. Since 2001, VCEDA has received approximately $28 million from the refundable coal credits. VCEDA reports that the funding from the tax credits has been especially beneficial, and $8.2 million of the funding has been utilized to close deals with large employers, provide worker retraining, and develop infrastructure for industrial parks. While the funds may effectively promote economic diversification in the coalfield region, coal tax credits may not be the most efficient mechanism to fund this goal.

Virginia's Coal Credits Similar to Other Large Coal-Producing States, but Incentivized Activity Varies. Like Virginia, most states that are major coal producers provide a tax credit for coal mining operations. However, some of the credits apply to taxes other than income taxes, and many are targeted at promoting different types of coal industry activities, such as encouraging development of coal loading facilities, clean coal technology, and coal waste removal. Of the top 15 coal producing states including Virginia, six do not have active coal tax credits (Table 21). Three of the six have had coal credits during the past decade.

Table 21: Use of Coal Credits Aligns Virginia With Other Top Coal-Producing States

State	Coal Production Rank(2009)	Credit	Activity Incentivized
Wyoming	1	No	
West Virginia	2	Yes	Coal loading facilities
Kentucky	3	Expired	
Pennsylvania	4	Yes	Coal gasification technology investment
Montana	5	Yes	Coal exploration
Indiana	6	Yes	Coal gasification technology investment
Texas	7	No	
Illinois	8	Expired	
North Dakota	9	No	
Colorado	10	Expired	
Ohio	11	Yes	Use Ohio coal to generate electricity
New Mexico	12	Yes	New coal-based power plants
Utah	13	Yes	Use Utah coal to generate electricity
Virginia	14	Yes	Coal production and employment Use Virginia coal to generate electricity
Alabama	15	Yes	Coal production

Source: JLARC staff analysis of Land Trust Alliance data.

Sales Tax Preferences Have Mixed Effectiveness in Encouraging Economic Activity

Virginia exempts certain purchases made by companies in select industries in order to promote their economic activity (Table 22). These industries include railroads, airlines, certain media providers (broadcasting, cable, Internet), and maritime shipping (ships and vessels), as well as companies performing research and development (R&D) and constructing large-scale data centers in Virginia. Some exemptions, such as those for airlines, R&D, and maritime shipping industries, have been in place since 1966, while the first exemption for data center construction was enacted in 2008. Estimates collectively indicate that these exemptions reduced taxpayer liability by $46.7 million in TY 2008. A limited review of these exemptions indicates that exempting certain railroad, media provider, and data center purchases appears to be at least partially effective in promoting their economic activity. However, the exemptions for airlines, R&D, and maritime shipping may not effectively promote all intended objectives.

Exemptions for Railroads, Media Providers, and Data Centers Appear to Partially Promote Policy Goals. According to industry stakeholders, exemptions for railroads and media providers are effective incentives because they substantially reduce the cost of operations and capital investment for companies that benefit. Representatives from the railroad and media industries indicated that their industries are capital intensive and require regular reinvestment to maintain the most up-to-date equipment and infrastructure. Data provided by railroads and media providers indicate that the exemptions reduce the tax liabilities of the largest beneficiaries by millions of dollars, suggesting that the exemptions greatly reduce the cost of expanding or maintaining their networks and equipment (Table 23). For example, representatives from Virginia's major railroads said that the railroad exemption reduces the cost of developing rail lines to manufacturing plants, thereby encouraging the expansion of Virginia businesses that require rail access. Similarly, representatives from the Virginia Cable Television Association stated that the media provider exemption helped expand cable networks to rural or underserved areas, benefiting residents and local businesses by providing access to broadband Internet services. In addition, smaller railroad and broadcasting company representatives said that they have slim profit margins and that the exemptions help them maintain profitability and stay in business. In fact, one small railroad company said that the reduced tax liability from the railroad exemption can equal its profits in a given year. Given that the exemptions for railroads and media providers reduce operations and investment costs for both large and small companies, they appear to be at least partially

Table 22: Six Sales Tax Exemptions That Promote Economic Development Were Evaluated[a]

Tax Preference *(Reduced Tax Liability[b])*	Public Policy Purpose	Description
Railroad common carrier exemption *($20.1 million[c])*	Promote maintenance and expansion of Virginia railroads.	Grants a broad exemption for purchases of tangible personal property used directly in railroad operations. All common carrier railroads operating in Virginia benefit.
Media provider equipment exemption *($5.2 million)*	Promote radio and television broadcasters, cable television, and alternative video and Internet service providers.	Grants an exemption for purchases of equipment used directly in transmission of radio and television signals and, under limited circumstances, provision of Internet access and content. All radio and television broadcasters and cable companies benefit, as well as other companies that distribute television services to subscribers. Companies that provide Internet access and content also appear to benefit. The exemption does not appear to apply to companies that provide Internet access only or Internet content only, and does not extend to periodical publishers, such as newspaper publishers.
Data centers exemptions[d] *($2.0 million)*	Attract construction of new, large-scale data centers.	Grant a broad exemption for purchases of computer servers and other types of equipment used in data centers. Any company entering into an agreement with Virginia Economic Development Partnership, investing at least $150 million, and creating from 25 to 50 new jobs, depending on the location, qualifies. A narrow version of the exemption was active from 2008 to 2011, and a broader version went into effect in 2009.
Airline common carrier exemption *($10.1 million)*	Promote commercial airline service to Virginia airports.	Grants a broad exemption for purchases of tangible personal property used directly in commercial airline operations. All common carrier airlines with over one flight per week to Virginia benefit.
Research and development exemption *($6.6 million)*	Promote research and development activities.	Grants a broad exemption for purchases of tangible personal property used directly and exclusively in research and development activities aimed at the development of new products or processes. Any company engaged in qualifying research and development activities may benefit, including but not limited to manufacturers, technology companies, and private research labs. Government entities, such as universities or federal laboratories, theoretically qualify but are also covered under other exemptions and so were not considered beneficiaries.
Ships and vessels exemption *($2.8 million)*	Promote maritime shipping industries, including commercial ship building, repair, supplying, and dredging.	Grants a broad exemption for purchases of tangible personal property used directly in construction, repair, or supplying of commercial maritime ships and vessels as well as dredging of commercial waterways. Exemption does not apply to items used in construction, repair, or supply of naval or other government ships and vessels.

[a] Virginia also has two other major exemptions (estimated savings over $1 million) for purchases of pollution control and equipment and certain sales by companies in the printing industry, but insufficient data was available for analyzing them.
[b] Estimates are for TY 2008 and are based on data from TAX and other data sources as identified in Appendix B (Table B-2). Total reported in text and sum of values reported for preferences in this table differ due to rounding error.
[c] Although liability reduction from the railroad exemption exceeded $20 million in TY 2008, this exemption was not evaluated in depth because the liability reduction for this year was unusually high compared to surrounding years.
[d] Estimate for reduction in liability is from TY 2008 and so only includes taxpayers qualifying under the older, narrower exemption that expired in 2011. The total reduction in liability from the broader exemption that is currently in place appears to be much higher.

Source: JLARC staff analysis of § 58.1-609.3 of the *Code of Virginia*, the Virginia Administrative Code, and interviews with State officials and industry representatives as noted under Appendix B (Table B-1).

Table 23: Exemptions for Railroads, Media Providers, and Data Centers Provide Substantial Benefits to a Few Companies

	Number of Beneficiaries	Average Reduction in Tax Liability per Beneficiary (TY 2010)[a]
Railroad common carrier exemption	11 companies	>$1 million per company[b]
Media provider equipment exemption	286 companies	<$100,000 per company[c]
Data centers exemptions	3 companies	>$1 million per company

[a] The exact average reduction in tax liability per beneficiary is withheld to protect taxpayer confidentiality.
[b] A few large companies receive majority of liability reduction.
[c] Although all companies benefit, large media companies receive reduction in tax liability that greatly exceed this average.

Source: JLARC staff survey of industry and data provided by industry to the Virginia Economic Development Partnership and the Department of Taxation.

successful in promoting these industries. However, the extent to which the exemptions have resulted in maintenance or expansion activities that would not otherwise have occurred was not determined.

Similarly, according to staff at the Virginia Economic Development Partnership (VEDP), the data center exemptions significantly reduce the cost of constructing large-scale data centers, which must be equipped with millions of dollars' worth of computers, servers, and other equipment, and therefore helps attract new data centers to Virginia. Since the first of the two data center exemptions was enacted in 2008, eight qualifying projects have been launched. Given that Virginia's data center sales tax exemptions reduce a company's costs by over $1 million on average (Table 23), and that several companies have entered into agreements to construct large-scale data centers in Virginia, the exemptions appear to be at least partially successful in achieving their goal. A review of industry literature indicates that several factors other than tax environment, such as utility costs and geographic considerations, may also impact a company's decision on where to locate a data center.

Exemption for Airline Purchases Appears to Have Limited Effect on Air Service Levels, but May Promote Maintenance Activities. The State's exemption for commercial airline purchases of tangible personal property used in direct support of aircraft operations appears to have a limited effect on promoting air service to Virginia. In 2010, the exemption reduced taxpayer liability by an average of $165,000 per airline, assuming all eligible airlines took advantage of the exemption. However, the exemption appears to have only a minor impact on the cost of providing flight service, resulting in average savings of only $14 per flight to or from Virginia. The relatively low savings provided by the exemption indicates that the exemption may not be effective in promoting air service to Virginia airports.

The airline common carrier exemption may have little impact on promoting air service to Virginia airports because, in practice, it does not apply to major operating expenses of airlines, primarily jet fuel and employee salaries. In 2010, fuel costs accounted for 24 percent of total operating costs for airlines serving Virginia, and salaries accounted for 25 percent. In contrast, expenses covered under the airlines exemption accounted for only four percent.

Purchases Qualifying for Airline Exemption

Exemption includes purchases of equipment, parts, and supplies used in maintenance and repair of aircraft, as well as ground or terminal equipment used directly in support of aircraft operations, such as baggage handling equipment, taxing vehicles, and ticketing terminals.

In practice, the exemption does not apply to most purchases of jet fuel because most fuels are exempted from the sales tax under a separate, broad exemption.

While the airline common carrier exemption technically includes jet fuel, in practice most purchases of jet fuel are covered under a broad sales tax exemption for fuels. The purpose of the broad fuels exemption is to avoid double taxation of fuel purchases, which are intended to be taxed under the Virginia fuels tax instead of the retail sales and use tax. The Virginia fuels tax includes its own preferences that reduce or eliminate the tax that applies to fuel purchased by commercial airlines, and these preferences appear to benefit airlines more than the airline common carrier sales tax exemption. However, TAX officials stated that a technical interpretation of the *Code* could construe the airline common carrier exemption to be the only sales tax exemption that applies to certain types of jet fuel used on international flights. According to Dulles Airport officials, the exemption of this type of jet fuel from both the State's sales and fuels taxes better enables them to attract foreign carriers, indicating that the airline common carrier exemption could play a role in promoting this type of air service.

Although the airline common carrier exemption appears to have limited impact on promoting flight service, it may help attract or retain some types of aircraft maintenance and repair operations. According to an analysis of airline financial data, the majority of the reduction in tax liability (52 percent) from the sales tax exemption for airlines is attributable to maintenance equipment, parts, and supplies. Because the exemption reduces the cost of maintenance and repair operations, it may help to attract repair facilities owned by airlines to Virginia. Officials with the Virginia Department of Aviation and Dulles Airport concurred that the exemption encourages airlines to locate their maintenance facilities in Virginia. However, the exemption only applies to maintenance facilities owned by commercial airlines and does not exempt third-party maintenance operations, which form a growing part of the aircraft maintenance and repair industry.

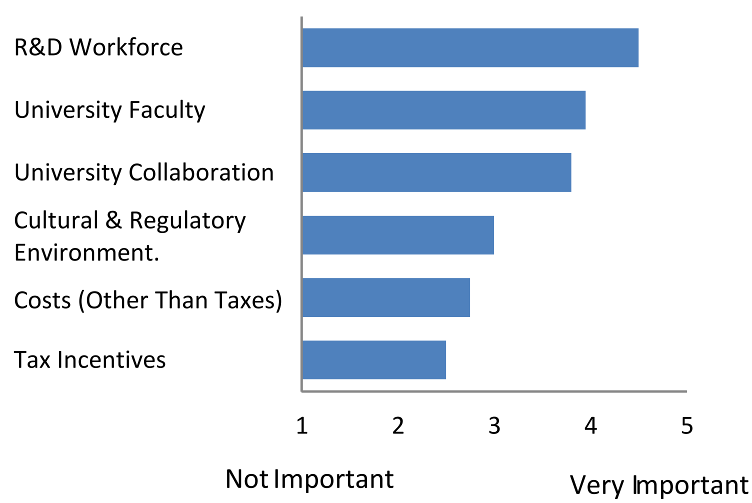
Virginia's airline common carrier exemption appears consistent with the majority of states. Of those states with broad sales taxes, 40 exempt purchases of aircraft parts and equipment, including Virginia. Virginia's exemption also extends to equipment and other tangible personal property used directly in aircraft operations, but it is not clear to what extent other states' exemptions cover such items.

Purchases Qualifying for R&D Exemption

Only purchases of equipment, materials, and supplies used or consumed directly and exclusively in the R&D process qualify for exemption. R&D efforts must be directed toward new knowledge or new understanding of a particular scientific or technical subject and its gradual transformation into a new or improved product or process.

Research and Development Exemption Is Partially Effective but Success is Limited by Other Factors. Analysis conducted for this review indicates that the exemption for tangible personal property used in research and development (R&D) may be partially effective at encouraging such activities, but other factors tend to have a much greater impact on companies' R&D spending decisions. Industry studies indicate that while overall tax environment is a major consideration, R&D business decisions are primarily driven by factors other than tax incentives. A 2006 *Survey of Factors in Multinational R&D Location* by the National Academy of Sciences found that tax incentives were the least important of six major factors affecting a company's decision on where to locate an R&D facility, which is used as a proxy for R&D activity for purposes of this analysis (Figure 21). The most important factors identified in the survey were the availability of highly qualified research personnel and expertise of university faculty. Industry representatives and a review of industry literature support the survey's findings, and also found that considerations such as the cost of utilities and the availability of suitable, ready-built research space can have a greater impact on start-up and operating costs than taxes.

Figure 21: Tax Incentives Are Least Important Factor for Attracting New R&D Activity



Source: National Academy of Sciences' *Survey of Factors in Multinational R&D Location* (2006), importance of factor for companies selecting R&D sites inside their home country. Figure omits results for three factors that appear to be mostly affected by federal rather than state law (ability to spin-off new companies and ability to protect or negotiate ownership of intellectual property rights), each of which was rated of greater importance than tax incentives.

The R&D sales tax exemption's effectiveness is also limited because it may have only a small impact on taxpayer liability, suggesting that the exemption may provide only a small incentive for encouraging companies to perform R&D activities. For example, the majority of Virginia's $4.8 billion R&D spending in 2007 occurred in the manufacturing ($1.6 billion), professional, scientific, and technical services ($2.4 billion), and information ($0.6 billion) sectors, and companies in these sectors spent on average one to four percent of their R&D budgets on equipment, materials, and supplies. However, because only tangible personal property used directly and exclusively in R&D qualifies, and the exemption only reduces purchase costs by five percent, the average net benefit to these companies is a reduction of one-quarter of a percent or less of their total R&D expense. Even so, officials with the Virginia Biotechnology Association (VaBio) indicated that the exemption may provide value to companies starting up a new facility because it reduces, even if marginally, high up-front costs such as stocking equipment and supplies.

Virginia's R&D exemption by itself may not have significant value for companies, but it is a part of a larger group of State tax and grant incentives which collectively attempt to influence companies' business decisions. According to VEDP, Virginia's R&D tax incentives also include the recently enacted R&D Expenses Tax Credit and the recently modified Qualified Equity and Subordinated Debt Investments Credit. Virginia also offers other incentives for attracting companies in technology industries that are R&D reliant, such as the Virginia Investment Partnership Grant and the Major Eligible Employer Grant. Additionally, Virginia's local governments are authorized to create Technology Zones to help attract R&D-reliant industries. Virginia's mix of incentives for technology and R&D companies is consistent with most other states. According to VEDP and VaBio, Virginia would likely be at a competitive disadvantage with other states without its array of R&D-related incentives.

Exemption for Ships and Vessels Has Little Impact on Most Virginia Shipyards but Does Benefit Smaller Maritime Industries. The ships and vessels exemption is intended to promote several maritime industries, including ship construction, repair, supply, and dredging, and reduced taxpayers' liability by $2.8 million in TY 2008. However, the exemption appears to be ineffective in promoting the largest maritime industry (ship construction and repair) because it only applies to equipment and materials used in constructing or repairing commercial vessels. According to officials with the Virginia Maritime Association (VMA) and the Virginia Ship Repair Association (VSRA), the vast majority of Virginia's shipyard work is related to building and repairing non-commercial ships and vessels for the U.S. Navy. Consequently, most of the State's shipyards do not benefit from the exemption. No Virginia shipyard appears to currently construct the types of commercial vessels covered under the exemption, and few appear to conduct repair work on such vessels. Based on discussions with VMA, VSRA, and major Virginia shipyards, it appears that three of Virginia's seven major shipyards have performed repair work on commercial vessels within the past two years. Of the three, only one indicated the exemption provides them with important benefits. This shipyard indicated that the exemption is vital in helping them compete for business with shipyards in other states. In contrast, the largest of the three shipyards reported it is not currently performing any repair work on commercial vessels and therefore is not deriving benefit from the exemption. Similarly, the third shipyard reported that although it continues to perform repair work on commercial vessels, the exemption provides them with few, if any, benefits.

Purchases Covered Under Ships and Vessels Exemption

Exemption includes equipment, materials, and supplies used in construction or repair of commercial shipping vessels or dredges, as well as supplies consumed by such vessels, such as food or ship maintenance supplies.

The exemption specifically exempts fuel used aboard commercial vessels from the retail sales and use tax, however fuel used by commercial watercraft is already exempt from the tax under § 58.1-609.1 and is alternatively taxed under the Virginia fuel tax.

In addition to having little impact on most of Virginia shipyards, the ships and vessels exemption appears ineffective at encouraging construction of commercial vessels because this activity has declined. Reports issued by the U.S. Maritime Administration indicate that Virginia's commercial shipbuilding activities declined from four orders for large commercial vessels in 1995 to zero orders in 1999, at which point construction of large commercial vessels in Virginia ceased. In contrast, a few shipyards in other states have maintained low levels of commercial shipbuilding activity up to the present. Despite the limited impact the exemption appears to have had, representatives from Virginia's largest shipyard said that it could be useful if they decide to resume commercial shipbuilding activities in the future.

In addition to shipyard activities, the ships and vessels exemption is also intended to promote two other activities—commercial vessel supply operations (ship chandlers) and dredging of commercial waterways. Companies involved in these activities appear to benefit from the exemption to some extent. For example, in response to the proposed elimination of the exemption in 2004, ship chandlers noted that the exemption keeps their businesses competitive with other states. Without the exemption, ship chandlers indicated that commercial vessels would have to pay more for supplies in Virginia and therefore may instead purchase supplies from ports in other states. Dredging companies also appear to derive some benefit from the exemption. In a 2004 survey, dredging companies reported to TAX that the purchases made under the exemption reduced their tax liability by a substantial amount.

Other Income Tax Preferences Have Mixed Effectiveness in Encouraging Economic Development

Three additional income tax credits that are designed to promote economic development were reviewed (Table 24). These credits reduced taxpayer liability moderately and appear to have mixed effectiveness. In fact, the mixed success of these credits is likely attributable to their limited value and inadequate targeting, according to interviews with State economic development officials and stakeholders. Although action has been taken in recent years to improve the effectiveness of these tax preferences, some issues still remain.

Credit Can Be Recaptured If Jobs Are Not Maintained

The Major Business Facility Job Tax Credit can be recaptured if the number of jobs decreases below the number used to qualify for the credit in any of the five years after the credit is awarded.

The recapture provision ensures that the jobs created remain in Virginia or the State is reimbursed for the credits. Only one other credit had a recapture provision in 2008.

Major Business Facility Job Tax Credit Is Likely Too Small to Effectively Promote Job Growth. The Major Business Facility Job Tax Credit was designed to incentivize employers to relocate or expand in Virginia by rewarding job creation, but the credit is likely too small to achieve its goal. While businesses are required to create a relatively low number of jobs (50 or 100 in TY 2008) to claim the credit, several factors appear to limit the impact of the credit. First, the credit of $1,000 per job created above the threshold is relatively small compared to the cost of hiring, training, and retaining an employee. Moreover, companies may not claim the full credit in the first year because they must claim it over a three-year period, which lowers its immediate value. Stakeholders reported that the credit is likely not a major factor spurring companies' business decisions and instead functions more as a reward.

Table 24: Other Economic Development Tax Preferences Promote Jobs and Investments

Tax Preference *(Reduced Tax Liability[a])*	**Public Policy Purpose**	**Description**
Major Business Facility Job Tax Credit (*$2.2 million*)	Provide incentive to employers to relocate or expand their business facilities or operations in Virginia by rewarding job creation.	Individuals and businesses may claim a tax credit of $1,000 per full-time job created over the threshold. The threshold in TY 2008 was 50 jobs in economically distressed areas and 100 elsewhere. The credit is distributed over three years and can be recaptured if the jobs are not maintained.
Qualified Equity and Subordinated Debt Investment Income Tax Credit (*$1.9 million*)	Provide incentive to invest in small Virginia businesses engaged in emerging technologies.	Individuals may claim a tax credit equal to 50 percent of investments in small Virginia businesses involved in emerging technologies. Taxpayers cannot claim more than $50,000 in credits per year, and total credits are capped at $5 million per year.
Recyclable Materials Processing Equipment Tax Credit (*$1.0 million*)	Provide incentive for manufacturers and processors to purchase equipment for use in Virginia to produce tangible goods from recyclable materials.	Individuals and businesses may claim a tax credit equal to ten percent of the capital investment in new recyclable materials processing equipment. The Department of Environmental Quality must certify the equipment. Credits claimed in a given year cannot exceed 40% of taxpayer liability.

[a]Estimates based on JLARC staff analysis of income tax return data from TY 2008.

Source: JLARC staff analysis of the *Code of Virginia* and interviews with State officials and industry representatives.

Although the credit has a low value, several changes may increase its ability to promote major expansions and relocations. The threshold amount was lowered in 2010 from 100 jobs to 50 in most areas and from 50 to 25 in economically distressed areas. By lowering the threshold, the credit may attract smaller businesses, which have been a significant source of job growth in Virginia. Moreover, the lower threshold raises the size of credit a company receives for creating jobs. Because the credit amount is based on the number of jobs above the threshold, a company that created 150 new jobs would have been eligible for $50,000 in credits under the higher threshold, whereas now the company would be eligible for a credit of $100,000. Additionally, VEDP staff indicated that the credit became more attractive in the late 2000s when the value of grants under the Enterprise Zone program was cut in half. Because companies may only claim one of the incentives, some began electing to claim the credit instead because it was not subject to proration. However, changes to the Enterprise Zone program in 2011 ensured that the jobs creation portion of the program would receive priority funding, making the grant program an attractive option once again.

While Virginia's Major Business Facility Job Tax Credit aligns the State with its competitor's tax preferences for economic development, most competitor states offer larger jobs creation tax credits than Virginia. In fact, the Virginia's job credit is one of the smallest at $1,000 per job (Table 25). In contrast, competitors provide credits ranging from $750 to $12,500 per job created. In several states, the size of the credit varies based on the average

Table 25: Most of Virginia's Competitors Have Larger Jobs Tax Credits Than Virginia

State	Eligibility	Credit Amount
California	Creating new jobs	$3,000/job
District of Columbia	N/A	N/A
Florida	Retaining/creating high wage, technology jobs	$3,000-6,000/job
Georgia	Creating new jobs, mega projects	$750-3,500, 5,250/job
Illinois	Investment and job growth	Varies
Maryland	Creating new jobs	$1,000-1,500/job
North Carolina	Creating new jobs	$750-12,500/job
New Jersey	Manufacturing and other investment and job growth	Varies
New York	Investment and job growth	Varies
Pennsylvania	Creating new jobs	$1,000/job
Virginia	Creating > 25–50 new jobs	$1,000/job

Source: JLARC staff analysis of 2010 Multistate Corporate Tax Guide, states' department of revenue and taxation websites.

compensation and the location of the added jobs, as well as capital investments made. The District of Columbia is Virginia's only competitor that does not have a general jobs creation tax credit.

Qualified Equity and Subordinated Debt Investment Income Tax Credit May Help Start-Ups Acquire Necessary, Difficult to Obtain Capital. A limited review of the Qualified Equity and Subordinated Debt Investment Tax Credit indicates that it appears to be achieving its goal of encouraging individuals to invest in small emerging technology firms in Virginia. The credit equals 50 percent of the investment and consequently appears to be a valuable incentive because it substantially reduces investors' financial exposure. VEDP staff indicated that this credit provides an incentive for individuals to invest in companies that struggle to obtain conventional financing because of reliance on unproven technologies or undeveloped markets. Moreover, stakeholders indicated that the effectiveness of the tax credit was enhanced in 2009 by explicitly targeting the emerging technologies sector.

Recyclable Materials Processing Equipment Tax Credit May Have Helped Attract One Large Recycler and Benefitted Others. Virginia offers an income tax credit to promote capital investments in new equipment for processing recyclable materials in the State. Based on a limited review, this credit may be achieving its goal. VEDP staff indicated that this credit was originally adopted as an incentive package for a large recycling company that located in Virginia. Although the credit may have been designed to attract one company, it was claimed on almost 60 returns in TY 2008. The credit equals ten percent of the investment and may not be large enough to spur business decisions, but it still appears to be valuable. In fact, the average credit per return was nearly $18,000 in TY 2008. Moreover, a credit claimant indicated that the tax credit was valuable in getting bank financing for the company and allowed for larger capital investment than would have been possible without the credit.

Although the credit may be effective, TAX staff indicated that the usability of the credit could be improved by expanding when it can be claimed. Currently, the credit must be claimed in the year the equipment is purchased, but the equipment must also be certified by the Department of Environmental Quality (DEQ) before the credit can be claimed. DEQ certification typically occurs within a year, allowing taxpayers to file amended returns claiming the credit in the tax year the equipment was purchased. However, in at least one instance, the certification was delayed several years because recycling operations had yet to begin at the facility. Such a delay presents an issue for claiming the credit because only returns from the last three years can be amended. This issue could be addressed by allowing the credit to be claimed either the year the equipment was purchased or the year it was certified.

TAX PREFERENCES PROMOTING COLLEGE SAVINGS AND LONG-TERM CARE INSURANCE HAVE LIMITED IMPACT

Although saving for college and purchases of long-term care insurance appear to have increased in recent years, evidence suggests that these increases are not the result of Virginia's tax preferences.

A limited review was conducted of four preferences that encourage families to save for college and individuals to purchase long-term health care insurance. Although saving for college and purchases of long-term care insurance appear to have increased in recent years, evidence suggests that these increases may not be the result of Virginia's tax preferences.

College Savings Plan Preferences May Promote Savings, but Impact Is Likely Limited

Two of Virginia's tax preferences encourage families to save for higher education expenses by providing them with tax relief for using Virginia College Savings Plans (Table 26). The education savings trust deduction is the larger of the two preferences that promotes college savings, as it reduced taxpayers' liability by a total of $17.9 million in TY 2008, while the college savings plan tax subtraction reduced taxpayers' liability by $1.1 million in the same year. Despite the reduction in liability to taxpayers, these preferences appear to have only a limited impact on encouraging college savings.

Virginia 529

Virginia 529 is the organization that administers and collects data on Virginia's four college savings plans: Virginia Prepaid Education Plan, Virginia Education Savings Trust, College America, and College Wealth.

Tax Preferences Contribute to College Savings Decisions. While Virginia's college savings plan tax deduction and subtraction appear to play a role in encouraging college savings, Virginia 529 staff report that individuals save for other reasons as well. Participation in college savings plans has increased over time, as shown by the 53 percent growth in the number of unique active accounts and the 103 percent growth in total assets invested in Virginia 529

Table 26: Two College Savings Tax Preferences Were Evaluated

Tax Preference *(Reduced Tax Liability[a])*	Public Policy Purpose	Description
Education Savings Trust Deduction *($17.9 million)*	Encourage families to save for higher education expenses.	Grants individuals a deduction of up to $4,000 per account for the amount contributed each year to a prepaid tuition contract or savings trust account.
College Savings Plan Subtraction *($1.1 million)*	Encourage families to save for higher education expenses.	Grants individuals a tax subtraction on any income attributable to a distribution of benefits from a prepaid tuition contract or savings trust account in the event of a beneficiary's death, disability, or receipt of a scholarship.

[a] Estimates based on JLARC staff analysis of income tax return data from TY 2008.

Source: JLARC staff analysis of the *Code of Virginia* and TAX documents.

plans in the past five years. However, accounts are often opened by relatives, family friends, and the parents of children expected to attend college as an easy mechanism to save money for college. Virginia 529 staff report that Virginia's $4,000 deduction is an attractive option for contributions to college savings plans, as the tax advantages provided equate to a strong return on the investments. However, Virginia 529 staff note that some individuals may invest their money for other purposes when opportunities promise a greater financial return.

Overall, the tax benefits that Virginia's deduction and subtraction provide individuals appear to be material, especially among individuals earning $100,000 or more per year. However, it is unclear whether these reductions in tax liability are sufficient to promote college savings. As shown in Table 27, average individual tax benefits vary depending on income level, especially for the subtraction. Although individuals making under $100,000 per year receive a greater percent reduction in tax liability from the preferences, individuals earning $100,000 or more receive larger amounts of tax relief. Additionally, individuals making $100,000 or more per year make up the majority of deduction (76 percent) and subtraction (57 percent) claimants, and their tax benefits account for over half of the preferences' total reduction in taxpayers' liability. However, taxpayers making $100,000 or more represent only 17 percent of all taxpayers. These findings suggest that the deduction and subtraction may not be as effective in encouraging individuals earning less than $100,000 per year to contribute to college savings plans.

Table 27: Higher Income Individuals Receive Larger Tax Benefits From Virginia's College Savings Plan Deduction and Subtraction

	College Savings Plan Deduction		**College Savings Plan Subtraction**	
	Income		*Income*	
	<$100,000	*≥$100,000*	*<$100,000*	*≥$100,000*
Average $ reduction in tax liability (2008)	$225	$239	$134	$284
Average % reduction in tax liability (2008)	14%	3%	12%	4%

Source: JLARC staff analysis of individual tax returns from TY 2008.

Tax Preferences May Not Be Most Effective Way to Promote College Savings. According to the research literature, other programs may promote college savings more effectively than tax preferences. A 2009 Gallup Poll survey found that employer-sponsored matching programs are the most likely to promote college savings, especially among individuals making less than $35,000 per year. A total of 52 percent of these individuals rated employer matching programs as "very likely savings motivators." In contrast, only 29 percent claimed that tax benefits are "very likely savings motivators." However, tax benefits were found to be more popular among higher income individuals, as 68 percent of individuals making over $150,000 per year reported that tax savings are "very likely savings motivators." In addition to employer matching programs, poll results also show that excluding college savings from affecting financial eligibility for benefits programs (such as food stamps) would motivate savings among individuals with lower incomes more effectively than tax preferences. Many states have begun implementing programs that attempt to promote college savings in ways other than offering tax benefits. Currently, 11 states offer some form of employer-matching incentive for college savings, in some cases in addition to college savings tax incentives.

Other States Also Have College Savings Tax Preferences. Having a college savings plan deduction and subtraction appears to align Virginia with most states. In total, 30 states offer a tax deduction for college savings. However, of the ten states that are most socioeconomically similar to Virginia, only California and Minnesota have a college savings plan tax deduction or subtraction.

Long-Term Care Insurance Deduction and Credit Do Not Appear to Effectively Encourage Individuals to Purchase Insurance

Virginia has a tax deduction and credit intended to encourage individuals to purchase private long-term care health insurance (Table 28). Both preferences were enacted to reduce long-term care costs to individuals and/or the State. Of the two, the deduction provides a greater reduction in taxpayers' liability ($8.0 million in TY 2008). In comparison, the credit reduced taxpayers' liability by $1 million in TY 2008. Although utilization of private long-term care insurance has increased in recent years, these preferences do not appear to be responsible for such increases.

Long-Term Care Insurance Coverage Is Increasing, but Coverage Not Greatly Influenced by Preferences. Individual utilization of private long-term care insurance has grown in recent years. According to TAX records, the total dollar amount of long-term care tax deductions increased over 3,000 percent between 2000 and 2008. Additionally, TAX data show that the number of deduction claimants has increased in recent years. From 2005 to 2008 alone, the number of tax returns filed claiming the long-term care deduction rose by 22 percent.

Despite recent increases, Virginia's tax preferences may not promote greater long-term care insurance utilization than would occur in their absence. According to the research literature, long-term

Table 28: Two Tax Preferences That Promote Long-Term Care Insurance Were Evaluated

Tax Preference *(Reduced Tax Liability[a])*	Public Policy Purpose	Description
Long-Term Health Care Deduction *($8.0 million)*	Encourage individuals to purchase long-term care insurance, thereby reducing costs to individuals and/or the State.	Grants individuals a tax deduction on the amount paid annually in long-term care insurance premiums.
Long-Term Health Care Credit *($1.1 million)*	Encourage individuals to purchase long-term care insurance, thereby reducing costs to individuals and/or the State.	Grants individuals a tax credit for 15 percent[b] of the insurance premium paid on long-term care insurance during the first 12 months of coverage.

[a] Estimates based on JLARC staff analysis of income tax return data from tax year 2008.
[b] Legislation to increase the credit to 30 percent of the premium paid was passed by the 2011 General Assembly but will only take effect if reenacted by the 2012 General Assembly.

Source: JLARC staff analysis of the *Code of Virginia* and TAX documents.

care tax preferences have a limited impact on the rate at which individuals purchase insurance. In 2006, the University of Hawaii assessed long-term care insurance sales across states and found that tax preferences did not promote any more sales of insurance policies than those that would have otherwise occurred. Similarly, a 2009 analysis of long-term care insurance by researchers from Harvard Medical School found that tax incentives, namely deductions, are not associated with a statistically significant difference in sales of insurance policies. Although some studies claim that tax preferences positively impact individuals' decisions to purchase long-term care insurance, the majority of the research literature maintains that preferences have little effect on these purchases.

Long-Term Care Preferences Do Not Significantly Reduce Costs to Individuals and State. Virginia's long-term care tax deduction and credit do not appear to significantly reduce costs for most individuals, as appears to be both preferences' public policy goal. TAX data show that the average reduction in tax liability that individuals receive from Virginia's long-term care preferences ranges from $62 to $315, depending on income level (Table 29). Compared to the average annual premium for long-term care insurance of $2,200, these preferences reduce the cost of insurance by only three to 14 percent. For some individuals, particularly those with lower incomes, these tax benefits may not be enough to make this type of insurance affordable or promote its purchase.

According to the research literature, long-term care tax preferences are also not a cost-effective means of reducing state Medicaid costs. A study recently published in the *Journal of Economics* calculated that each dollar of foregone revenue caused by long-term care tax preferences results in only $0.84 of Medicaid savings. Further, Virginia has historically funded 50 percent of State Medicaid expenses while the federal government has funded the remaining half. Therefore, for every $1 that the State foregoes on long-term care tax preferences, Virginia would only save $0.42 in Medicaid costs, indicating that the State spends more on incentivizing long-term care through tax preferences than it saves as a result. It is also noteworthy that most long-term care preference claimants are not lower income taxpayers and thus may not have needs for publicly funded long-term care through Medicaid. Rather, the majority of deduction (83 percent) and credit (88 percent) claimants have annual incomes above $50,000 per year, and may not be Medicaid-eligible unless their income dramatically decreases and/or they have very high medical expenses and no substantial assets.

Table 29: Higher Income Individuals Receive Greater Tax Benefits from Long-Term Care Preferences (TY 2008)

	Long-Term Care Deduction		Long-Term Care Tax Credit	
	Income		*Income*	
	<$100,000	*≥$100,000*	*<$100,000*	*≥$100,000*
Average $ reduction in tax liability (2008)	$62	$145	$210	$315
Average % reduction in tax liability (2008)	15%	3%	14%	4%

Source: JLARC staff analysis of individual tax returns from TY 2008.

Federal vs. State Deduction

The federal deduction requires individuals to itemize their medical expenses and have medical expenses that exceed 7.5 percent of their federal adjusted gross income. Virginia's unique State deduction does not require individuals to itemize or have a certain amount of medical expense.

Virginia Offers Tax Credit in Addition to Deductions Available in Most Other States to Promote Long-Term Care Insurance Coverage. Unlike most states, Virginia has three tax preferences to encourage individuals to purchase long-term care insurance. In Virginia, individuals can claim the federal tax deduction, the unique State tax deduction, or the State tax credit, though only one preference can be claimed for each dollar of long-term care insurance premium paid. The majority of other states only have two long-term care tax preferences, namely the federal deduction and a unique state deduction. Of the ten states that share similar socioeconomic characteristics with Virginia, four offer both the federal deduction and a state tax credit, including Colorado, North Carolina, Maryland, and Minnesota. Two states, Arizona and New Jersey, offer only a state deduction, while California offers only the federal deduction. Finally, four states offer no tax preferences at all: Pennsylvania, Michigan, Illinois, and Washington.

Chapter 5

Several Factors May Hinder Effectiveness of Virginia Tax Preferences in Achieving Public Policy Goals

In Summary

The effectiveness of tax preferences in achieving public policy goals appears to be hindered by several common factors, many of which could be addressed by the State. The structure of a tax preference and the tax through which it is administered may impact how its benefits are distributed across intended beneficiaries. Moreover, the value and usability of a tax preference have significant bearing on whether it is claimed and can effectively achieve its public policy goal. Potential solutions could be implemented to address these internal barriers to effectiveness. However, Virginia's current mechanisms for overseeing tax preferences are inadequate to ensure that preferences are achieving their goals. There is no formal process in place for evaluating the effectiveness of tax preferences, and, as a result, the General Assembly is not provided with comprehensive information needed to take appropriate action in order to improve, revise, or eliminate tax preferences. Sunset dates could be used to trigger evaluations of tax preferences, but they have rarely resulted in a tax preference being allowed to expire in Virginia.

Multiple factors appear to hinder the ability of some Virginia tax preferences to effectively accomplish their public policy goals, as described in Chapters 3 and 4. While external factors such as economic conditions can impact the ability of a tax preference to achieve its goals, these factors are beyond the control of the State. In contrast, other factors are inherent in the structure of tax preferences or the taxes used to grant them and can be changed. Combined with periodic oversight of tax preferences and the use of sunset provisions, Virginia could consider several options to help ensure that preferences are structured in a way that promotes the outcomes desired by policymakers, and ensure that preferences remain relevant over time.

SOME PUBLIC POLICY TAX PREFERENCES MAY NOT BE VALUABLE, USABLE, OR WELL TARGETED

Some Virginia tax preferences may not be effectively meeting their intended goals because of inadequate value, usability, or targeting. To be effective, a tax preference should be considered valuable enough by potential beneficiaries to make claiming it worthwhile. Effectiveness also depends on the ability of intended beneficiaries to use the tax preference. Moreover, targeting tax preferences increases efficiency by ensuring that intended beneficiaries receive benefits.

Some Tax Preferences May Not Be Valuable Enough to Be Effective

The value of some of Virginia's tax preferences may be insufficient to be effective. For example, the Worker Retraining Tax Credit has been historically underutilized because, according to businesses interviewed by JLARC staff, the $100 credit for non-community college retraining is not large enough to encourage companies to retrain workers. Similarly, although Virginia's sales tax holiday on hurricane preparedness items appears to provide financial assistance to consumers, a reduced tax liability of $50 on a $1,000 generator may not be sufficient to make it affordable for most individuals.

In addition, preferences may become less valuable over time. In particular, the value of income tax preferences that provide a set dollar benefit, such as $1,000 per job created, or have a cap on benefits, such as $100 per retrained worker, decrease over time if not indexed to inflation. While the Major Business Facility Job Tax Credit is worth $1,000 per job created, the value provided to taxpayers by the credit in 2011 is 53 percent less than in 1994 when the credit was enacted because of inflation. Erosion of the value of preferences over time could be prevented by indexing the benefit or cap to increase with inflation or by routinely reviewing preferences, as discussed in Chapter 6. At least one of Virginia's preferences, the Land Preservation Tax Credit, has a component indexed to the Consumer Price Index to limit its value from eroding over time.

Some types of tax preferences may also be more valuable for higher income taxpayers. For example, the value of the $12,000 age deduction is $690 for individuals with income greater than $29,000, but less than that for lower income individuals. Subtractions and deductions may provide higher income taxpayers more value because of the tiered tax rate used in Virginia's individual income tax system. The value of subtractions and deductions is calculated based on a taxpayer's tax rate, which increases with income up to $17,000 in Virginia. As a result, subtractions and deductions provide greater value to higher income taxpayers, all other things being equal.

Credits could be used instead of subtractions and deductions to improve the value provided to taxpayers by tax preferences. Credits offer the same value to taxpayers of all income levels because they are calculated independently of the tiered tax rate. However, non-refundable credits, like subtractions and deductions, may provide less value for some taxpayers because the value of these preferences cannot exceed the amount of taxes due. Only refundable tax credits allow taxpayers to receive the credit's full value regardless of tax liability, which in turn provides the same value to all taxpayers regardless of income.

Income Tax Preferences Have Limited Usability for Taxpayers With Minimal Tax Liability

Taxpayers with limited income tax liability may not be able to use income tax preferences, which may reduce the extent to which the public policy goals of the preferences can be achieved. For example, Virginia's Low Income Tax Credit is intended to provide financial assistance to lower income individuals. However, the credit is non-refundable, which means that the savings taxpayers can achieve are limited by their tax liability, which is minimal in this case since the beneficiaries must have low incomes. Generally, the benefits of non-refundable income tax preferences, including subtractions, deductions, and credits, are limited by tax liability. In addition to individuals with low incomes, businesses that are small, newly created, or have recently made significant capital investments also typically have low income tax liabilities and may not be able to use Virginia tax preferences aimed at promoting certain activities. Although the usability of preferences structured as subtractions, deductions, and non-refundable credits may be limited for taxpayers with limited income tax liabilities, preferences could be structured as refundable credits or changed to grants to increase usability.

Some Tax Preferences Providing Financial Assistance May Not Be Efficiently Targeted to Lower Income Individuals When Intended as Beneficiaries

As noted in Chapter 3, the distribution across taxpayers of reduced tax liability from financial assistance tax preferences suggests that many of these preferences have a greater impact on higher income taxpayers than lower income taxpayers. For those financial assistance preferences that are specifically or primarily intended to benefit lower income individuals, this finding suggests that the target population is not being efficiently reached. For example, the partial exemption for food is intended to assist lower income individuals in purchasing food for home consumption, but for every $1 in tax reductions provided to households earning under $20,000, more than $8 goes to households with incomes of $70,000 or more per year.

The partial exemption for food is intended to assist lower income individuals in purchasing food for home consumption, but for every $1 in tax reductions provided to households earning under $20,000, more than $8 goes to households with incomes of $70,000 or more per year.

The pattern of higher income taxpayers benefitting more than those with lower incomes arises because of consumption patterns and the structure of Virginia's tax systems and preferences. The partial exemption for food and other similar sales tax exemptions for basic necessities generally provide higher income individuals more benefit because spending on food increases with income. The tiered tax rate and non-refundability of credits may preclude lower income taxpayers from being able to use tax preferences.

While preferences may reach their target populations, they may be doing so inefficiently because they are not well targeted. For example, some income tax preferences are means tested based only on the eligible claimants' income, which allows some higher income households to benefit. For example, the two preferences for government employees are means tested at $15,000 of income, but the means tests only apply to the income of the individuals who claim the subtraction and are unaffected by joint filers' total income. As a result, taxpayers with joint incomes substantially above the income cutoffs claimed the government employee subtractions in 2008. Imposing a cutoff based on total income, like the age deduction has, may improve the efficiency of these provisions. However, joint filers affected by such a cutoff might elect to file separately in order to continue claiming the government employee subtractions, which could increase administrative costs for the State. These findings also suggest that the revenue impact of tax preferences that provide financial assistance could be significantly reduced if the preferences were better targeted to those intended to receive assistance.

There are several changes that policymakers could consider to better target financial assistance to certain populations. However, all possible changes present trade-offs that would have to be balanced against the importance of achieving the tax preferences' goals. First, stricter eligibility criteria could be used to better target preferences. For example, 99 percent of the distribution of reduced taxpayer liability from the Social Security subtraction was attributable to taxpayers with incomes of $25,000 or more. Virginia could means test the Social Security subtraction, as does the federal government. However, retail sales and use tax exemptions providing financial assistance are more difficult to target. Allowing only those individuals that meet certain eligibility criteria to use retail sales and use tax exemptions could be burdensome on businesses and unpopular with consumers if businesses were required to verify consumer eligibility when purchases are made.

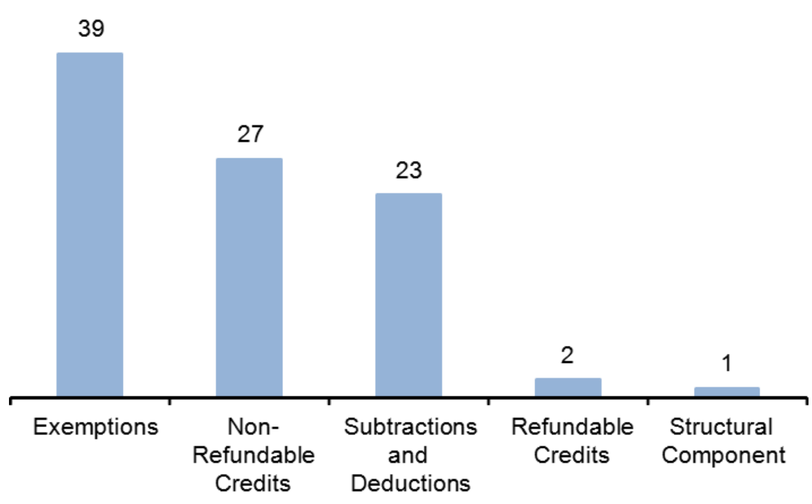
Alternatively, exemptions could be structured as rebate programs or refundable tax credits. For example, a rebate on food items could provide targeted assistance to lower income individuals that meet certain eligibility requirements. However, this policy could be more complex to administer than an exemption because taxpayers would need to apply for the rebates and State personnel would need to review applications and issue rebates accordingly. A refundable income tax credit could also be targeted to lower income taxpayers and may be less complex to administer than a rebate program, but the benefits would be delayed. Moreover, many of the lowest income taxpayers typically do not file an income tax return because their income is lower than the filing thresholds. A refundable credit could therefore result in an increased administrative burden to the State because it could result in more taxpayers filing returns. The effectiveness of the credit could also be limited because taxpayers qualifying for assistance may not know that the credit exists or that they must file a return to receive benefits.

REFUNDABLE CREDITS COULD HELP IMPROVE EFFECTIVENESS, BUT DISADVANTAGES EXIST

Most of Virginia's tax preferences are structured as exemptions, deductions, subtractions, and non-refundable credits (Figure 22). As described in the previous sections, certain types of tax preferences have shortcomings because they may only have limited value, lack usability, or are not targeted. Using refundable income tax credits instead could help address some of these concerns, but this mechanism also presents potential disadvantages that should be considered.

The tax literature suggests that a refundable tax credit may be the most effective and efficient form of tax preference and recommends that these credits be used instead of sales tax exemptions. In particular, refundable tax credits can be structured to provide the same financial benefit to taxpayers regardless of income, are more easily limited to intended beneficiaries than exemptions, and can

Figure 22: Only Two of Virginia's 92 Public Policy Tax Preferences Were Refundable Credits as of TY 2008



Note: Only includes tax preferences active in TY 2008.

Source: JLARC staff analysis of *Code of Virginia*.

be used regardless of tax liability. Non-refundable credits share many of these features when they have carry forward provisions that allow taxpayers to claim them over a number of years. However, the ability to use credits with a carry forward period requires future tax liability and also delays the benefit of the tax preference. Department of Taxation (TAX) data are not available to determine how frequently credits expire because taxpayers are unable to use them, but land preservation experts indicated that credit expiration was an issue with the Land Preservation Tax Credit, and was a primary factor in making it transferrable in 2002.

Still, refundable tax credits present several disadvantages that may offset potential benefits. Refundable tax credits may place a greater administrative burden on taxpayers and the State than other preferences, particularly sales tax exemptions. A new refundable credit may mean that individuals who do not normally file an income tax return could begin filing. The administrative burden on the State could increase as TAX receives additional returns that would not have otherwise been filed, and issues additional refunds. Moreover, refundable tax credits function in a similar way as direct payments to taxpayers. In part because of this similarity, TAX staff indicated that some tax preferences should not or cannot be structured as refundable credits. In particular, they noted it would be imprudent to structure tax preferences for charitable donations as refundable credits because it would appear that the State is paying for donations, which negates the charitable intent of the donations.

Perhaps more importantly, refundable tax credits could have a significant revenue impact on the State. In particular, refundable tax credits increase and accelerate the impact of tax preferences on State revenue when compared to subtractions, deductions, and non-refundable credits because they allow taxpayers to benefit immediately rather than over a number of years or not at all. Refundable tax credits could pose significant revenue liability to the State without controls to minimize their impact, such as an annual cap. Although refundable credits are noted as having significant advantages over other forms of preferences, their potential for significant revenue impact and administrative costs indicate that additional review and potentially significant changes to Virginia's use of tax preferences may be warranted before refundable credits are more widely used in the State.

GRANT PROGRAMS MAY BE PREFERABLE TO REFUNDABLE CREDITS AND OTHER PREFERENCES, BUT ALSO HAVE DISADVANTAGES

The research literature and other stakeholders, including members of the General Assembly, have indicated that grant programs may be preferable to tax preferences, particularly refundable credits, but grants also have drawbacks. Grant programs receive funding through appropriations, increasing the legislature's ability to control expenditures. Moreover, replacing tax preferences with grants administered independently of Virginia's income tax systems could improve the effectiveness of the incentives offered. Grants can also provide the same benefit to intended beneficiaries, regardless of tax liability, which may be especially beneficial for new or small business or lower income individuals. However, the dependence upon biennial appropriations creates uncertainty for beneficiaries about the value of grant programs. For new programs with many eligible beneficiaries, the administrative complexity could be substantial and the funding distributed to each recipient may be limited.

Discretionary and Statutorily Defined Grants

The value of each discretionary grant awarded is determined by the administering agency based on input from the grant recipient and can vary based on a variety of factors. Statutorily defined grants are predetermined by the enabling legislation and do not vary.

Tax preferences designed to encourage economic development could be replaced with discretionary grants like those administered by the Virginia Economic Development Partnership (VEDP), while other types of preferences could be administered as statutorily defined grants. Discretionary grants may be more effective and efficient in promoting economic development because each project is evaluated by the VEDP for its expected return on investment. In contrast, no such analysis is currently performed before tax preferences are awarded because all qualifying taxpayers are eligible to receive the benefits. Statutorily defined grants, such as a rebate program for food purchases, could also target intended beneficiaries more efficiently based on application processes to verify eligibility using defined criteria.

SOME PUBLIC POLICY TAX PREFERENCES WITH LOW REDUCTIONS IN TAX LIABILITY OR FEW BENEFICIARIES ARE LIKELY INEFFECTIVE

Twelve of Virginia's tax preferences appear to be underutilized, which is a potential indicator that they are not effectively accomplishing their intended public policy goals (Table 30). Preferences may not be valuable enough, usable, or relevant, and thus few taxpayers are claiming or using them. For example, businesses and economic development officials indicated that the Worker Retraining Tax Credit, which in some instances is capped at $100 per employee, is not valuable enough to encourage the activity. The credit for employers of TANF recipients cannot be used because it requires direct appropriations to fund the credit, and funds have never been provided. Other incentives may not be used because they are no longer relevant. For example, the Cigarette Export Tax Credit was designed to promote the exportation of cigarettes manufactured in Virginia, but TAX staff indicate that there are no longer any companies in the State involved in that activity. Each

Table 30: Twelve Tax Preferences Had a Value of Less Than $100,000 and Fewer Than 100 Beneficiaries in TY 2008

Tax Preference	Total Reduced Tax Liability	Number of Beneficiaires
Retail Sales and Use Tax Exemptions		
Communications Equipment for the Disabled	$357	n.d.
Individual Income Tax Deductions and Subtractions		
Organ Donor	4,185	60
Holocaust Victims	2,826	7
Individual and Corporate Income Tax Credits		
Biodiesel and Green Diesel Fuels Producers	78,354	17
Worker Retraining	26,075	7
Home Accessibility Features for the Disabled	24,469	50
Vehicle Emissions Testing Equipment	12,974	36
Clean Fuel Vehicle and Refueling	5,929	11
Daycare Facility Investment	0	0
Cigarette Export	0	0
Clean Fuel Vehicle Job Creation	0	0
Employers of TANF Recipients	0	0

Note: n.d., no data available; n.r., not reported.

Source: JLARC staff analysis of TAX data (2008).

preference should be evaluated to determine the reason for the underutilization and whether the preference should be revised to increase its use, eliminated, or phased out with a sunset date.

There are other tax preferences that may be underutilized but were not identified by JLARC staff because of insufficient data or duplication. For example, taxpayers who claim the crime solver reward subtraction include the amount claimed under a generic miscellaneous category, which makes it difficult to determine the extent to which it is claimed. At least two sales tax exemptions appear to be duplicative by exempting the same types of purchases that are covered under other, broader exemptions. Specifically, there is an exemption for purchases of semiconductor wafers for use or consumption by a semiconductor manufacturer. However, these items are also included under a broader exemption for purchasing tangible goods used in the integrated process of designing, developing, manufacturing, or testing a semiconductor product. Similarly, nonprofits fostering interstate cooperation and excellence in government are exempted under their own provision, but these organizations would also qualify for the general nonprofit exemption administered by TAX, assuming that they meet the general requirements for approval.

Because it is unclear the extent to which these preferences are used, it is difficult to assess their effectiveness or to determine if they are underutilized. One mechanism to address the lack of information about these preferences is to place sunset dates on them.

If stakeholders would like a preference to be extended, a sunset date may prompt them to present evidence to policymakers that the preference is used and beneficial before it is set to expire.

VIRGINIA DOES NOT MAXIMIZE USE OF SUNSET DATES TO ELIMINATE INEFFECTIVE PREFERENCES

Sunset dates are oversight mechanisms that can be used for two primary purposes. First, they can cause tax preferences to expire on a certain date unless they are reauthorized by the legislature. Their objective in this instance is to ensure that preferences are automatically discontinued if the legislature determines that they are no longer relevant or desirable. Second, sunset dates can be used to trigger regular evaluations of tax preferences. Such evaluations often examine the utilization and effectiveness of preferences and occur annually or biennially. According to TAX staff and the research literature, the effectiveness of sunset dates as an oversight mechanism depends upon the extent to which they are linked to a meaningful review process.

Sunset Dates Are Inconsistently Applied to Virginia Tax Preferences and Rarely Result in Their Elimination

Virginia makes limited use of sunset dates, which could hinder the State's ability to consistently identify preferences in need of greater scrutiny. Virginia does not formally require that tax preferences have sunset dates, and most preferences with either public policy or tax goals do not have them (Figure 23). Even though sunset dates are not a statutory requirement, legislators do assign sunset dates to certain tax preferences. In fact, many of the tax preferences adopted in recent years appear to have been assigned sunset dates. However, because only a limited number of Virginia tax preferences have sunset dates that cause them to expire after a certain number of years unless they are reauthorized, the vast majority of preferences are allowed to continue indefinitely with little or no consideration of their use, revenue impact, effectiveness, or administrative efficiency.

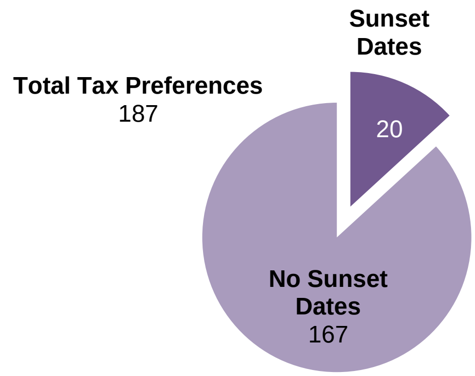
Public Policy Tax Preferences Expired Due to Sunset Dates (2006-2011)

1. Investment in Technology Industries in Tobacco-Dependent Localities Tax Credit (§58.1-439.13)
2. Low-Income Housing Credit (§58.1-435)
3. Rent Reduction Tax Credit (§58.1-339.9)
4. Research and Development Activity Occurring in Tobacco-Dependent Localities Tax Credit (§58.1-439.14)
5. Data Centers Exemption (replaced with new exemption)(§58.1-609. 3(17))

Even in instances where sunset dates are used, they appear to be largely ineffective at eliminating tax preferences. Only five public policy tax preferences with sunset dates have been allowed to expire during the past five years.

One reason why so few preferences with sunset dates are eliminated could be because Virginia does not use them to trigger an evaluation that would identify and address ineffective tax preferences before they are set to expire. Only limited information on expiring preferences is reported to legislators when preferences are being

Figure 23: Roughly Ten Percent of Virginia's Tax Preferences Currently Have Sunset Provisions



Note: Totals include all tax preferences that were active as of November 2011. A list of the tax preferences found to have sunset dates is located in Appendix E.

Source: JLARC staff analysis of the *Code of Virginia.*

considered for renewal, which prevents legislators from assessing their effectiveness in a meaningful way. As a result, sunset dates appear to prompt a nearly automatic renewal of most tax preferences. According to legislative staff and a review of the legislative record, preferences with sunset dates are frequently continued without debate, further confirming that sunset dates are not often used as an oversight mechanism.

Virginia's Use of Sunset Dates Is Similar to That in Other States

Although many states apply sunset dates to tax preferences, most use them inconsistently. However, a few states, including Oregon and Nevada, use sunset dates more systematically. In 2009, Oregon passed a law assigning sunset dates to most corporate and personal income tax credits. Consequently, relatively all new tax credits within the tax system are now scheduled to sunset six years after they are enacted. Similarly, Nevada amended its constitution in 2008 to specify that exemption legislation cannot be adopted without a sunset date. Unlike in Oregon where preferences typically sunset every six years, Nevada does not have a standard number of years before preferences sunset. Other states that make frequent use of sunset dates include Alaska, Illinois, and North Carolina.

Most states do not appear to use sunset dates to trigger an evaluation process. Despite the regular use of sunset dates in the states mentioned above, it appears that only Oregon uses sunset dates to trigger tax preference evaluations. Oregon evaluates tax preferences that are scheduled to sunset on a biennial basis. Although the governor of Oregon appears to review and issue recommendations for all expiring tax preferences, the nature of the review seems limited because the effectiveness of the preference is not evaluated.

Sunset dates do not appear to frequently result in the elimination of tax preferences in states that use them. Both Oregon and North Carolina list preferences that have expired in their routine tax preference reports. Between 2009 and 2011, only one tax preference out of 380 preferences was eliminated in Oregon as a result of a sunset date. Similarly, as of 2009, only three tax preferences out of 302 preferences had been eliminated in North Carolina due to sunset dates. Rather than allowing them to expire, both Oregon and North Carolina appear to consistently renew tax preferences on their allotted sunset dates. One reason why sunset dates have not resulted in the expiration of preferences in these states may be that they do not trigger an in-depth review of the effectiveness of tax preferences.

POLICYMAKERS LACK COMPREHENSIVE INFORMATION TO IMPROVE OR ELIMINATE INEFFECTIVE TAX PREFERENCES

Policymakers lack information on the effectiveness of tax preferences, which hinders their ability to identify, revise, or eliminate ones that are ineffective. TAX collects information on taxpayers' use of over 100 of the State's 187 preferences through tax returns and sales tax expenditure studies. However, information on only 56 of these preferences is publicly reported, meaning that there is no formal oversight of 70 percent of the State's tax preferences. Current reporting processes are further limited because they do not evaluate the effectiveness of tax preferences in achieving their policy goals. Of those preferences which are subject to formal reporting, 20 are evaluated based on a set of defined criteria, but none are evaluated to determine if their goals are being achieved (Figure 24). While TAX staff reported that they review tax preferences to provide legislators and other policymakers with requested information, this type of review is typically done on an informal basis.

Only Limited Information on Tax Preferences Is Reported to State Policymakers

No information is formally reported on 131 active tax preferences that reduced taxpayer liability by $11.3 billion in 2008.

Virginia publicly reports information on only a small portion of its tax preferences. As of 2011, TAX was the only State entity regularly reporting on tax preferences. TAX's reporting processes currently covers 56 preferences which were estimated to reduce taxpayer liability by $1.2 billion in TY 2008, the latest year for which complete data is available. However, no information is formally reported on another 131 active tax preferences that reduced taxpayer liability by $11.3 billion, indicating that little or no information is

Reporting on Tax Preferences

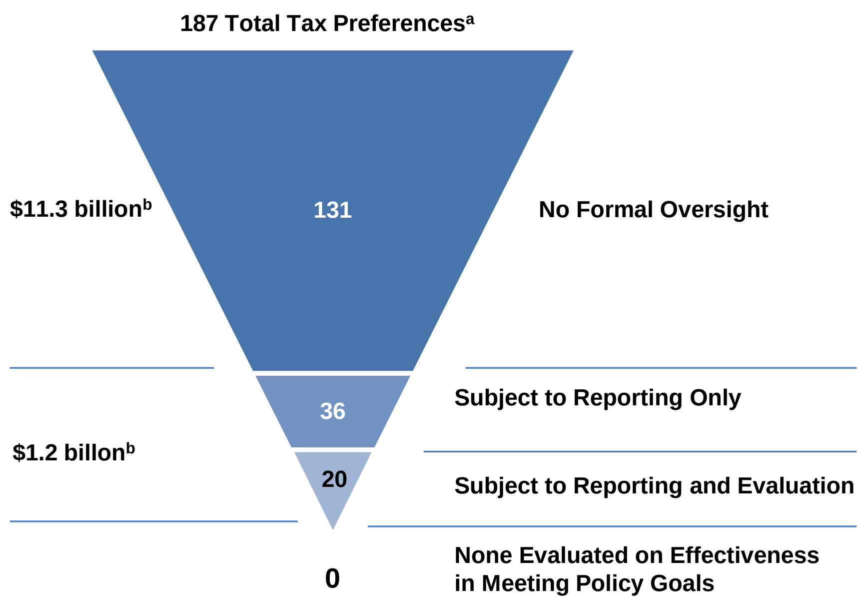
Information on income tax preferences is reported in TAX's Report on Corporate Tax Preferences, required under § 58.1-202 of the *Code of Virginia*, and TAX's Annual Report to the Governor. Reports only provide detail on tax credits, and as of 2011, there are 37 income tax credits.

Information on sales tax preferences is reported in TAX's annual sales tax expenditure studies required under § 58.1-609.12 of the *Code*. Each study examines several of the preferences found under §§ 58.1-609.10 & 58.1-609.11 of the *Code*, and each preference is examined at least once every five years. As of 2011, these sections included 19 provisions that were considered to be tax preferences.

reported to the legislature on dozens of tax preferences which are likely to have a substantial impact on State revenue collections.

The limited information that is reported to legislators regarding Virginia's tax preferences appears to be inadequate for identifying ineffective ones and assessing how to revise or eliminate them. TAX reports include usage statistics for income tax preferences, such as revenue impact and number of claimants, but do not examine critical aspects of tax preferences such as their intended goals and whether they are being achieved. For example, TAX's Annual Report for 2010 shows that four preferences were not claimed but does not explain the reasons why or discuss what this indicates about their effectiveness. TAX's annual report on corporate tax preferences is similarly limited. TAX's sales tax expenditure studies provide more information than these other reports, but the information that is provided also does not appear adequate for identifying ineffective tax preferences because there is no assessment of whether policy goals are being achieved.

Figure 24: Few Public Policy or Tax Policy Preferences Are Subject to Formal Evaluation or Reporting



a. Includes all preferences that were active as of November 2011.
b. Estimates of taxpayer liability are the TY 2008 totals for these preferences, as this is the last year for which complete data was available. The estimates do not include the reduction in liability from 16 new preferences that have been added since 2008 or the reduction in liability from the eight preferences that have expired or been repealed since 2008.

Source: JLARC staff analysis of Title 58.1 of the *Code of Virginia*, TAX sales tax studies from 2007 to 2010, and TAX annual reports.

No Comprehensive Evaluation of Tax Preferences Is Performed

Evaluation of Tax Preferences

TAX's annual sales tax expenditure studies required under § 58.1-609.12 of the *Code* are tasked with determining the fiscal, economic, and policy impact of 19 sales tax preferences.

In 2007 and 2011, Virginia Commonwealth University worked with the Department of Historic Resources to evaluate the importance of the Historic Rehabilitation Credit to its beneficiaries and its economic impact on the State. These evaluations are performed on a voluntary, ad-hoc basis and are not required under State statute or policy.

As shown in Figure 24, only a small portion of Virginia's tax preferences are subject to formal evaluation. In addition, the evaluations that are routinely conducted are limited in their scope. Only one of the State's 104 active income tax preferences is subject to evaluation, while 19 of the State's 83 active sales tax preferences are evaluated under TAX's sales tax expenditure studies. Although the 20 tax preferences that are evaluated accounted for a substantial $0.76 billion impact on taxpayer liability in tax year 2008, they cumulatively represented only six percent of the reduced liability provided by all tax preferences, indicating that many major tax preferences of substantial value are omitted. For example, no evaluations are performed of four of the State's five largest public policy tax preferences, which include the tiered individual income tax rate ($869 million), the partial sales tax exemption for food ($346 million), and the individual income tax age deduction ($285 million) and Social Security and tier I railroad retirement benefits subtraction ($244 million).

The evaluations performed under TAX's sales tax expenditure studies may also be of limited use to legislators because they do not consider whether preferences are achieving their intended goals. The *Code of Virginia* outlines eight criteria that TAX is to include in these evaluations:

- estimate of foregone revenues as a direct result of the exemption,
- beneficiaries of the exemption,
- other government assistance provided to beneficiaries,
- extent to which other states offer similar exemptions,
- external mandates requiring the exemption,
- other taxes that apply to exemption beneficiaries,
- description of similar taxpayers who are not entitled to an exemption, and
- other criteria, as appropriate.

TAX is not required to identify the extent to which intended goals are being achieved. Because evaluations do not consider whether preferences are achieving their public policy goals, findings that are reported to the legislature may not be useful for drawing conclusions regarding the effectiveness of preferences. In addition, TAX does not make recommendations for eliminating or changing preferences to improve their effectiveness as part of its evaluation process. As a result, policymakers are provided with limited information to form conclusions about tax preferences and their effectiveness, and they are given little guidance as to what changes may be needed.

Chapter

6 Recommended Structure for Ongoing Evaluation of Virginia Tax Preferences

In Summary

Senate Joint Resolution 21 directed JLARC to propose a process for the ongoing review of the effectiveness of Virginia's tax preferences. Based on reviews of the research literature and other states' practices, several elements appear integral to maximizing the effectiveness of the evaluation process and promoting action being taken to continue, revise, or eliminate tax preferences. These elements are legislative involvement as well as dedicated staffing resources with expertise in tax policy, legal, and performance evaluation. Accordingly, Virginia should consider establishing a joint subcommittee to oversee the evaluation process and directing the Department of Taxation (TAX) to conduct routine evaluations. A technical advisory group could be assembled to provide guidance and review findings. Procedures will also have to be developed to ensure that evaluations are conducted comprehensively and consistently.

In addition to directing JLARC to evaluate the effectiveness of Virginia's tax preferences in achieving their intended purpose, Senate Joint Resolution 21 calls for a proposed process for their ongoing evaluation. Currently, most tax preferences in Virginia are not regularly reviewed and minimal information is reported about them, leading to policymakers having little objective data on which they can rely to determine which preferences are effective, could be more effective if they were revised, or should be eliminated.

To develop a proposed evaluation process, extensive research was conducted into the practices adopted in several states that perform ongoing evaluations of tax preferences. Based on this research, it appears that effective evaluation processes include several elements that, collectively, ensure that evaluations are conducted comprehensively and in a consistent manner, and also promote the revision or elimination of tax preferences that are found to be ineffective.

LEGISLATIVE SUBCOMMITTEE COULD OVERSEE EVALUATION PROCESS AND PROMOTE ACTION TO IMPROVE PREFERENCES

Because the General Assembly must approve all tax preference legislation and is responsible for the stewardship of public funds, members of the legislature should be responsible for their ongoing evaluation. To this end, a joint subcommittee could be established to oversee the evaluation process. As part of this oversight function, the joint subcommittee could be involved in setting the parameters of the evaluations to ensure that the information necessary to justify taking action on tax preferences is made available. Ultimately, the joint subcommittee could be required to make recommendations to the General Assembly about tax preferences that should be maintained, revised, or eliminated.

Legislature Is Best Positioned to Define the Structure of the Evaluation Process

The structure of the evaluation process will likely have a significant influence on whether legislative action is taken on Virginia's tax preferences. In particular, the legislature should determine which tax preferences should be reviewed. Although this review was limited to tax preferences within the income and retail sales and use tax systems, other major State and local tax systems such as the insurance premiums tax and local property tax could be included in the evaluation process. In addition, this review focused on preferences with public policy goals, but consideration could also be given to including preferences with tax policy goals.

The legislature should also provide input in other areas of the evaluation process, such as indicating what information it requires to justify making recommendations to continue, eliminate, or revise tax preferences that are reviewed. Having legislative input will help evaluators in determining what information to collect and what research methods to use to meet the legislature's needs. Moreover, legislative input on how evaluations should be scheduled, including how many preferences should be evaluated within a given period, would be beneficial to ensure that the legislature can focus on the findings and recommendations for each preference without being overwhelmed by information that is often technical in nature. Lastly, the legislature is best suited to articulate the reasons for which tax preferences should exist as well as what outcomes each tax preference is expected to achieve. The legislature could work with evaluators to ensure that tax preferences have clear and measurable goals that match legislative expectations.

Joint Subcommittee Could Oversee Tax Preference Evaluations

Several states that conduct ongoing evaluations of tax preferences have a committee that oversees the evaluation process. However, the composition of these committees' membership varies greatly. Out of the seven states with an ongoing process, Arizona and Iowa both have oversight committees comprised strictly of legislative members. Washington created a citizen commission comprised of stakeholders and experts to oversee the process. In addition, the chair of the state's legislative audit and review committee and the state auditor are also members that represent the legislature. Oklahoma's review committee consists mostly of stakeholders and tax experts. California's Franchise Tax Board regularly reviews tax preferences and is comprised of executive branch officials. Table 31 describes the evaluation process oversight committees that have been adopted by these states.

A joint subcommittee appears to be the option that best fits Virginia's particular legislative structure and requirements. The joint subcommittee should be comprised of members of the House and Senate Finance committees, which already review all tax-related legislation, as well as members of the House Appropriations Committee, which sometimes considers tax preferences legislation. Although the House Finance Committee does not have full-time staff, Senate Finance and House Appropriations staff supporting these committees could assist the joint subcommittee in an advisory capacity.

Joint Subcommittee Could Hold Public Comment Sessions and Formally Report Recommendations

Because legislative action is required to alter tax preferences, information about the effectiveness of tax preferences, as well as any recommendations for action, should be conveyed directly to the General Assembly. Several factors can enhance the likelihood of legislative action on tax preferences, based on a review of past efforts in Virginia, ongoing evaluation efforts in other states, and the research literature.

Table 31: Two of the Seven States That Conduct Ongoing Evaluations of Tax Preferences Have an Oversight Committee Comprised of Legislators

State	Oversight of Evaluation Process	Members
Arizona	Joint Legislative Income Tax Credit Review Committee	10 legislative members, 5 each from the finance and ways and means committees
California	California Franchise Tax Board	State Controller, Director of the Department of Finance, and Chairman of California Board of Equalization
Delaware	Secretary of Finance	n/a
Iowa	Legislative Tax Expenditure Committee	10 legislative members, 5 from each house
Oklahoma	Incentive Review Committee	9 members, including stakeholders and university staff
Oregon	Department of Revenue	n/a
Washington	Citizen Commission for Performance Measurement of Tax Preferences	7 members, including stakeholders, university staff, tax policy and economic experts, the chair of the legislative audit and review committee, and the state auditor

Note: Missouri reviews tax preferences, but the process was established by a governor's initiative and may not continue under a new governor.

Source: JLARC staff analysis of tax preference review processes in other states.

Based on experiences in other states, the joint subcommittee should hold public comment sessions to receive input from stakeholders. The joint subcommittee may be more willing to adopt recommendations to continue, revise, or eliminate tax preferences if stakeholders support or do not strongly oppose the recommended action. While the evaluators may survey or interview stakeholders as part of their research, holding public comment sessions would give stakeholders additional opportunities to express their support or opposition to various proposals, and provide an avenue for stakeholders to interact directly with the legislature. Public comment sessions would allow stakeholders to provide additional context on how tax preferences benefit them, and to what extent changing or eliminating tax preferences may positively or negatively impact them. According to evaluators of tax preferences in the state of Washington, having public comment sessions is an important component of their evaluation process. Their citizen commission receives public comments and often incorporates information received into its decision to endorse staff recommendations.

Requesting the joint subcommittee to make formal and specific recommendations to the General Assembly could also promote action and be more likely to result in the revision or elimination of tax preferences that were found to be ineffective. Several legislative committees in Virginia, such as the Virginia State Crime Commission and Joint Commission on Health Care, are required to make formal recommendations to the General Assembly. With these two commissions, staff conduct the research and present findings and policy options to their respective commissions. Commission members vote on which options, if any, they want to pursue through legislative changes, and one or more members agree to sponsor the legislation during the upcoming General Assembly session.

It is important to consider ways to ensure that evaluations trigger action because several stakeholders interviewed by JLARC staff noted concerns that little action has been taken in the past to revise or eliminate Virginia's tax preferences after their evaluation. For example, the Secretary of Finance was required to evaluate retail sales and use tax exemptions in the 1990s and report findings to the House and Senate Finance committees. According to staff from the Department of Taxation (TAX), only one legislative change resulted. Some of the reasons why these studies may not have triggered action include that the Secretary's report did not suggest or recommend changes for the legislative committees to consider, and that the committees receiving the report are responsible for legislation related to all areas of taxation and revenue rather than specializing in tax preference legislation. Similarly, three other legislative groups reviewed Virginia tax preferences between 1999 and 2004. With the exception of changing the process by which nonprofits file for exemption from the sales tax, few, if any, other changes to eliminate or revise tax preferences resulted. There may have been only limited action because two of the groups focused on Virginia's tax system broadly rather than on tax preferences specifically, and the third group was given only a year to review all of Virginia's retail sales and use as well as income tax preferences.

DEDICATED STAFFING RESOURCES WITH REQUISITE EXPERTISE WOULD ENABLE MORE COMPREHENSIVE REVIEWS

Based on the experiences of JLARC staff during this review and of evaluators in other states, evaluating tax preferences entails several challenges that dedicated and knowledgeable staffing resources could best overcome. Dedicated resources could be best secured by hiring staff to conduct the evaluations on a full-time basis. In addition, robust evaluations will require individuals with tax policy, legal, and performance evaluation expertise to ensure that evaluations are well designed, thorough, and accurately conducted.

Dedicated Staffing Resources Needed to Address Data and Other Limitations to Ensure Comprehensive Reviews

In addition to the sheer number of tax preferences that exist in Virginia, the lack of data on most retail sales and use tax preferences is a primary obstacle. Dedicated staffing resources could reduce the burden this issue places on evaluators. In particular, evaluators could spend a portion of their time identifying additional information that could be collected on sales tax returns to make the evaluation of retail sales and use tax exemptions easier, yet not unduly burdensome for the businesses and other entities that must file returns. Based on a review of practices across the nation, several states such as Tennessee, Washington, and West Virginia appear to routinely collect more comprehensive information about certain retail sales and use tax exemptions on tax returns than does Virginia.

Another obstacle is the significant amount of time that is required to identify and collect information to measure whether tax preferences are achieving their goals. State-level data is not always available from national sources such as the U.S. Census Bureau, Bureau of Labor Statistics, or industry sources. In some cases, surveys of exemption beneficiaries must be conducted to collect information that is not available from other sources, as TAX staff did for prior evaluations. In addition, dedicated staffing resources could be instrumental in working with the legislature and other experts to design the evaluation process. Table 32 describes the primary challenges that evaluators are likely to face based on the experience of JLARC staff in evaluating tax preferences for this review, and discusses how dedicated staffing resources could address them.

Expert and Skilled Evaluators Needed to Ensure Evaluations Are Robust

According to staff in Washington who evaluate tax preferences, tax policy and legal expertise are two of the most important skills for evaluating tax preferences. This expertise is critical to understanding the purpose of the tax preference and how it works within the tax system before the preference can be evaluated. In most cases, the purpose of a tax preference is not stated in its enabling legislation. In fact, JLARC staff had to deduce the purpose of most tax preferences by conducting extensive reviews of legislative documents and reports, and interviews with legislative staff, TAX staff, and stakeholders. In addition, tax policy and legal expertise are critical for understanding how changes to a tax preference could impact Virginia's tax system, as well as for determining whether changes or reforms to tax preferences in other states could be adopted in Virginia.

In addition, evaluators should have expertise in conducting performance evaluations, including conducting survey research and

Table 32: Dedicated Staffing Resources Could Best Address Challenges in Evaluating Tax Preferences

Challenge	How Dedicated Staffing Resources Could Address Challenge
Large number of preferences	Enhance ability to review larger number of tax preferences and in greater depth during a given period
Lack of clearly stated policy purpose and measurable goals	Review documentation on the purposes of Virginia's tax preferences and work with the legislature to ensure that goals are appropriate, clear, and measurable
Lack of comprehensive data sources on revenue impact and beneficiaries of retail sales and use tax preferences	Make recommendations regarding collecting additional information on tax returns or applications for exemption certificates to enhance the evaluation process Collect information from various sources such as the U.S. Census and other national or industry databases
Time intensity of collecting and analyzing data to measure outcomes	Greater ability to identify best sources for outcome data and use greater number of outcome measures in evaluations Greater ability to conduct routine and thorough analyses using a variety of data sources Conduct comprehensive surveys of stakeholders to supplement information on the utilization of tax preferences and determine outcomes

Source: JLARC staff evaluations of tax preferences and reviews of the research literature and other states' practices.

data analysis. Staff need this expertise to design evaluations that are comprehensive and accurately conducted. Evaluators should have the necessary skills to identify appropriate data sources to measure outcomes and to conduct various evaluation techniques such as cost-benefit analyses and economic impact analyses. As part of the research process, evaluators will need to conduct data analyses using large and complex datasets. For example, Virginia's individual income tax return data contains over three million records and is maintained in multiple databases corresponding to each tax return form.

TAX Staff Are Best Suited to Lead the Evaluation Process

TAX staff is best positioned to conduct the research and analysis needed to produce accurate and comprehensive evaluations of tax preferences.

While a separate entity could be created to evaluate tax preferences, and evaluations could be conducted by contracted staff from the private sector, the level of expertise that is needed already exists in TAX and appears well suited to support the evaluation process. Combined with the agency's authority and existing working relationships with the business community, TAX staff is best positioned to conduct the research and analysis needed to produce accurate and comprehensive evaluations of tax preferences. As shown in Table 33. TAX has the most experience in collecting and analyzing information from tax returns. In addition, TAX is the only agency that has authorization to access tax return information. While another agency could be granted access, the potential for a breach of taxpayer information increases when other entities in addition to TAX access confidential tax return data. It is important to note that TAX will need to hire additional staff to assume this new responsibility. The exact number of staff for performing evaluations and additional administrative costs will depend upon the scope of the evaluations established by the joint subcommittee.

While TAX should independently conduct the evaluations, a technical advisory group could be established to provide additional guidance and review findings to ensure that evaluations are conducted as comprehensively, accurately, and objectively as possible. Technical advisory groups are used for other research efforts in Virginia, including the process for forecasting the State and local inmate population. In this model, agencies' methodologies and forecasts are reviewed by a technical advisory committee made up of staff from all correctional agencies in the executive branch, JLARC in the legislative branch, the Virginia Criminal Sentencing Commission, the Supreme Court of Virginia, and an economics professor from a nearby university. Another policy work group serves in an advisory capacity to the forecasting process; this group consists of agency directors, legislative staff, and other stakeholders such as a local sheriff and commonwealth's attorney.

Table 33: TAX Staff Are Best Suited to Evaluate Virginia's Tax Preferences Based on Comparison of Advantages and Disadvantages With Other Staffing Options

Staffing Options	Potential Advantages	Potential Disadvantages
TAX staff	Have data, policy, legal, fiscal and economic analysts on staff Have policy division which works closely with legislature Have access to confidential tax return data Have relationship with business and individual taxpayers Have authority to require businesses to submit detailed sales tax exemption information	Will require additional staff May not have experience in performance evaluations
Staff in current legislative agencies	Work directly for legislature and have understanding of legislative process Have knowledge of tax legislation Have experience in data and policy analysis Have experience in conducting objective research Have performance and policy evaluation staff	No agency currently has staffing with all necessary skills Would require hiring additional staff with appropriate skills Would duplicate expertise and functions existing already in TAX Would require another entity to have access to tax return data May have difficulty obtaining tax information directly from taxpayers Lack of tax policy expertise by agency management to provide adequate quality assurance
Create legislative agency to staff or contract with evaluators	Would work directly for legislature and gain knowledge of legislative process Could hire staff with necessary skills Could be required to perform objective, nonpartisan research Could contract with private or university evaluators	Duplicative of existing capabilities in other agencies High start-up costs and slow ramp-up May require significant resources to hire staff or contract with evaluators Would require another entity to have access to tax return data May have difficulty obtaining tax information directly from taxpayers

Source: JLARC staff analysis of research literature, documentation of past evaluation efforts in Virginia, discussions with TAX and Virginia legislative staff, and other states' practices.

An advisory group that combines the concept of the groups involved in inmate forecasting could be established to provide outside technical expertise from knowledgeable parties which have a variety of perspectives. Such an advisory group could consist of staff from various State entities, including staff from the Department of Planning and Budget and legislative staff. In addition, the group could include university staff with expertise in tax policy and/or economics. Stakeholder groups could also be involved and differ from year to year, depending on the types of preferences being evaluated.

ESTABLISHING EVALUATION PERFORMANCE MEASURES AND REVIEW SCHEDULE WOULD ENHANCE THE EVALUATION PROCESS

A significant number of evaluation staff would be required to effectively evaluate the entire array of Virginia tax preferences on an annual or biennial basis. In an effort to reduce both the number of evaluators as well as the burden placed upon them and the joint subcommittee, Virginia could follow the example of other states and subject tax preferences to different levels of review. Criteria could be established to determine which preferences fall within each level and with what measures preferences in each level should be evaluated. Establishing evaluation measures could also ensure that tax preferences are evaluated consistently and in an objective manner. In addition, a schedule could be established so that not all tax preferences are evaluated every year, but that all tax preferences are evaluated over time.

Tax Preferences Could Be Subject to Different Levels of Review

According to proposals in the research literature and practices used in other states, not all preferences may require the same level of review. Evaluating tax preferences at different levels appears warranted for several reasons. First, the legislature and other policymakers may have greater interest in some preferences than others, such as preferences with a substantial revenue impact or those that provide benefits to a large number of taxpayers. The legislature may want evaluators to conduct a detailed analysis of these preferences to determine the benefits that they provide to the State and the impact potential changes could have on taxpayers and the overall achievement of the desired goal. Likewise, an in-depth evaluation may not be necessary to fully understand the impact of tax preferences that either have few beneficiaries or a small impact on revenue. Further, subjecting only certain preferences to in-depth reviews could reduce the workload of evaluators significantly. Previous efforts in Virginia to review retail sales and use tax exemptions were characterized as overly burdensome, possibly because all exemptions were subject to the same review criteria. In fact, the need for extensive staffing resources to conduct these reviews was one reason why TAX requested that these studies be discontinued.

Based on a review of other states' evaluation processes, revenue impact appears to be a common factor used to designate the level of detail and priority for review. In particular, Washington uses three levels of evaluation. Tax preferences with a revenue impact over $10 million receive a full review that uses ten measures, while preferences with a revenue impact between $2 million and $10 million are reviewed using fewer measures (Table 34). Additionally, the departments of revenue in both Maine and Minnesota also recommended that proposed reviews in those states prioritize preferences based on revenue impact, although Minnesota's proposal included multiple criteria in addition to revenue impact.

Table 34: Washington Subjects Tax Preferences to Different Levels of Review Based on Revenue Impact

Level	Determining Factor	Extent of Evaluation
Full	Revenue impact >$10M	10 measures
Expedited	$2M < revenue impact <$10M	4 measures
Light Expedited	Revenue impact < $2M	DOR data

Note: Revenue impact is for the biennium. DOR, Department of Revenue.

Source: JLARC staff analysis of documents of the Washington Joint Legislative Audit and Review Commission.

Performance Measures Could Be Established to Ensure That Evaluations Are Thorough and Consistent

To ensure that tax preferences are reviewed consistently, either during a given period or over time, specific measures used to gauge the effectiveness of tax preferences should be established. Based on a review of performance measures used by other states that have evaluated tax preferences, multiple options exist. Washington conducts the most extensive ongoing reviews of tax preferences and uses ten performance measures for evaluating preferences with a revenue impact greater than $10 million. The performance measures used by Washington are listed in Figure 25. The first four measures are used for tax preferences that undergo both a full and expedited review, and they correspond with measures that are commonly used in other states' evaluations of tax preferences. In addition, some states also assess preferences based on whether they are the most fiscally effective means of achieving the public policy objective.

Tax Preferences Could Be Evaluated According to Set Schedule

States with an ongoing review process often develop a schedule to limit the number of preferences reviewed at one time but ensuring that all preferences are reviewed over a given period of time. Although three states (California, Delaware, and Oregon) that conduct ongoing evaluations of tax preferences review each preference annually or biennially, these evaluations do not appear to be as in-depth as the ones conducted by states that use longer evaluation cycles. In contrast, preferences are required to be reviewed at least every ten years in Washington, which produces in-depth reports.

Figure 25: Virginia Could Consider Using Performance Measures Similar to Washington State to Evaluate Tax Preferences

Performance Measures Used to Evaluate Tax Preferences	
Full and Expedited Reviews (4 Measures)	
1.	What are the public policy objectives that provide a justification for the tax preference? Is there any documentation on its purpose or intent?
2.	What evidence exists to show that the tax preference has contributed to the achievement of any of its public policy objectives?
3.	Who are the entities whose state tax liabilities are directly affected by the tax preference?
4.	What are the past and future tax revenue and economic impacts of the tax preference to the government if it is continued?
Full Reviews (6 Additional Measures)	
5.	To what extent will continuation of the tax preference contribute to these public policy objectives?
6.	If the public policy objectives are not being fulfilled, what is the feasibility of modifying the tax preference for adjustment of the tax benefits?
7.	To what extent is the tax preference providing unintended benefits to entities other than those the Legislature intended?
8.	If the tax preference were to be terminated, what would be the negative effects on the taxpayers who currently benefit from it and the extent to which the resulting higher taxes would have an effect on employment and the economy?
9.	If the tax preference were to be terminated, what would be the effect on the distribution of liability for payment of state taxes?
10.	Do other states have a similar tax preference and what potential public policy benefits might be gained by incorporating a corresponding provision in Washington?
Light Expedited Reviews	
The description of the tax preference and its purpose, year enacted, description of primary beneficiaries, possible program inconsistencies, and taxpayer savings.	

Source: JLARC staff review of documents and reports of tax preference evaluations prepared by the Washington Joint Legislative Audit and Review Commission.

While several methods could be used for scheduling preferences, scheduling them based on program area may be the best option. In particular, evaluating all preferences within a government program area during the same time period could allow evaluators to examine similar preferences together. In addition, this approach could enable evaluators to compare the costs and benefits of preferences with other government programs that have similar goals. For example, evaluators could compare the costs and benefits of tax preferences with grant programs that are under the Education secretariat and have similar goals. It is important to note that many tax preferences may exist within program areas, which could result in a large number of preferences scheduled for review during a given period unless they are further subcategorized. For example, numerous tax preferences in Virginia are designed to promote economic development. Preferences within this broad category could be subdivided based on the tax system through which they are offered or whether they are intended to incentivize jobs, capital investment, or particular industries, and evaluated in different years.

Several states use other approaches for scheduling evaluations, but these approaches may not be as desirable as scheduling preferences according to program area. For example, one or more tax preferences within a tax system are evaluated every year in Oklahoma. Given the number of preferences within Virginia's income and retail sales and use tax systems, this option does not appear feasible to ensure that all preferences are evaluated over time. In Washington, tax preferences are selected for review by year of enactment, with older preferences being evaluated first. However, a task force that recently reviewed that state's evaluation process recommended that other criteria such as grouping preferences by type of industry, economic sector, or policy area be used for scheduling tax preferences.

Some states schedule reviews based on sunset dates, but this option alone may not be a suitable mechanism for Virginia to use to schedule reviews because many preferences do not have sunset dates. While sunset dates could be applied to existing preferences that lack them, some rationale for assigning sunset dates would first need to be established, and then legislation would need to be adopted. It may be less complex for the joint subcommittee to establish a review schedule in another manner, such as by program area. However, consideration could be given to applying sunset dates to preferences that lack them if the joint subcommittee decides to exclude them from the review process.

PROPOSAL FOR A TAX PREFERENCES EVALUATION PROCESS

As directed by Senate Joint Resolution 21 (2010), JLARC staff have developed a proposed process for the ongoing evaluation of Virginia's tax preferences for the General Assembly's consideration. This proposal consists of four recommended elements that together would result in thorough evaluations upon which the legislature could rely to continue, revise, or eliminate Virginia tax preferences. These four elements are:

- establishing a joint subcommittee to oversee the evaluation of tax preferences,
- directing TAX staff to conduct the evaluations,
- establishing a technical advisory group to assist the joint subcommittee and TAX staff, and
- requiring the joint subcommittee and TAX staff to develop procedures for the evaluation of tax preferences.

Recommendation (1). The General Assembly may wish to consider creating a joint subcommittee to oversee the evaluation of Virginia's tax preferences on an ongoing basis. The subcommittee should be comprised of members from the House Finance, House Appropriations, and Senate Finance committees. The joint subcommittee should meet at least annually to consider action for continuing, revising, or eliminating tax preferences; conduct public hearings on tax preferences; and submit an annual report of its recommendations to the General Assembly prior to each regular session of the General Assembly.

Recommendation (2). The General Assembly may wish to require staff from the Department of Taxation to conduct independent evaluations of tax preferences, as directed by the joint subcommittee charged with overseeing the evaluation of tax preferences on an ongoing basis.

Recommendation (3). The General Assembly may wish to establish a technical advisory group to assist the joint subcommittee and Department of Taxation staff. Members of the advisory committee should include individuals with tax policy and economic expertise as well as legislative staff.

Recommendation (4). The General Assembly may wish to consider requiring the joint subcommittee that is tasked with overseeing the evaluation of Virginia's tax preferences to develop procedures, including which tax preferences should be reviewed, how often they should be reviewed, and what performance measures should be used.

JLARC Recommendations:

Review of the Effectiveness of Virginia Tax Preferences

1. The General Assembly may wish to consider creating a joint subcommittee to oversee the evaluation of Virginia's tax preferences on an ongoing basis. The subcommittee should be comprised of members from the House Finance, House Appropriations, and Senate Finance committees. The joint subcommittee should meet at least annually to consider action for continuing, revising, or eliminating tax preferences; conduct public hearings on tax preferences; and submit an annual report of its recommendations to the General Assembly prior to each regular session of the General Assembly. (p. 113)
2. The General Assembly may wish to require staff from the Department of Taxation to conduct independent evaluations of tax preferences, as directed by the joint subcommittee charged with overseeing the evaluation of tax preferences on an ongoing basis. (p. 113)
3. The General Assembly may wish to establish a technical advisory group to assist the joint subcommittee and Department of Taxation staff. Members of the advisory committee should include individuals with tax policy and economic expertise as well as legislative staff. (p. 113)
4. The General Assembly may wish to consider requiring the joint subcommittee that is tasked with overseeing the evaluation of Virginia's tax preferences to develop procedures, including which tax preferences should be reviewed, how often they should be reviewed, and what performance measures should be used. (p. 113)

Appendix A Study Mandate

SENATE JOINT RESOLUTION NO. 21

Directing the Joint Legislative Audit and Review Commission to study the effectiveness of tax preferences. Report.

Agreed to by the Senate, February 16, 2010
Agreed to by the House of Delegates, March 9, 2010

WHEREAS, there are numerous business and individual income tax credits, income tax deductions and subtractions, retail sales and use tax exemptions, and other tax preferences allowed under the Code of Virginia; and

WHEREAS, on October 1, 2009, the Department of Taxation reported that the fiscal impact of corporate income tax subtractions, deductions, and credits through September 1, 2009, for taxable year 2007 was $224 million. This amount did not include the fiscal impact of tax preferences relating to individual income taxes or retail sales and use taxes; and

WHEREAS, because the majority of business and individual income tax and retail sales and use tax preferences do not require any pre-approval by a state agency or state entity before a taxpayer can claim or take the tax preference; and

WHEREAS, without a pre-approval process, it is exceedingly difficult to determine whether the tax preference is effective in bringing about the desired public policy for which the tax preference was established; now, therefore, be it

RESOLVED by the Senate, the House of Delegates concurring, That the Joint Legislative Audit and Review Commission be directed to study the effectiveness of tax preferences.

In conducting its study, the Joint Legislative Audit and Review Commission shall examine individual income tax (but excluding the deduction for personal exemptions, the standard deduction, and the deduction for itemized deductions claimed on the federal income tax return), corporate income tax, and retail sales and use tax preferences. The Joint Legislative Audit and Review Commission shall (i) determine which individual income, corporate income, and retail sales and use tax preferences are being claimed or taken and to what extent, (ii) provide an estimate of the fiscal impact of all such tax preferences claimed or taken, (iii) examine the public policies for which the tax preferences were established and whether the desired public policies have been achieved, (iv) report on whether other states routinely provide a sunset date for their tax preferences, and (v) establish a proposed mechanism or processes for the ongoing evaluation of the effectiveness of such tax preferences in bringing about the desired public policies for which the tax preferences were established.

Technical assistance shall be provided to the Joint Legislative Audit and Review Commission by the Department of Taxation. All agencies of the Commonwealth shall provide assistance to the Joint Legislative Audit and Review Commission for this study, upon request. The Joint Legislative Audit and Review Commission shall complete its meetings for the first year by November 30, 2010, and for the second year by November 30, 2011, and the Director of the Joint Legislative Audit and Review Commission shall submit to the Division of Legislative Automated Systems an executive summary of its findings and recommendations no later than the first day of the next Regular Session of the General Assembly for each year. Each executive summary shall state whether the Joint Legislative Audit and Review Commission intends to submit to the General Assembly and the Governor a report of its findings and recommendations for publication as a House or Senate document. The executive summaries and reports shall be submitted as provided in the procedures of the Division of Legislative Automated Systems for the processing of legislative documents and reports and shall be posted on the General Assembly's website.

Appendix B Research Activities and Methods

Key research activities for this study included

- quantitative analysis of income tax returns and retail sales and use data for TY 2008;
- selection and evaluation of tax preferences with public policy goals;
- structured interviews with staff from State, legislative, and local agencies; academic centers; industry representatives; advocacy groups; and other stakeholder groups; and
- reviews of documents and the research literature.

QUANTITATIVE ANALYSIS

JLARC staff collected and analyzed data from a variety of sources in order to determine the extent to which Virginia tax preferences are utilized, estimate eligible Virginians' reduction in tax liability, and evaluate the effectiveness of preferences in achieving intended public policy goals. Data used in these analyses were obtained from the Virginia Department of Taxation (TAX) and a variety of other State, federal, and industry sources. Significant data limitations and resource constraints precluded the analysis of some or all aspects of certain tax preferences.

Estimating the Use of Virginia Tax Preferences

To determine the extent to which claimants or beneficiaries use income and retail sales and use tax preferences, data was obtained from various sources (Table B-1). Most data was obtained from TAX, including corporate and individual income tax returns and TAX studies. For some sales tax preferences, data from other State agencies, national repositories, and industry reports was used.

Virginia individual and corporate income tax returns for TY 2008 were the primary data source used to determine the number of returns using income tax subtractions, deductions, and credits. Returns from TY 2008 were used because that is the most recent year for which complete data was available. Estimates of the use of tax preferences are based on the number of returns rather than the number of taxpayers that claimed each preference because taxpayers can file a joint return with their spouse, which makes it difficult to distinguish whether both taxpayers were eligible to claim the preference.

Table B-1: Data Sources Used to Estimate Number of Tax Preference Beneficiaries

Data Source (Year)	Tax Preference(s)[a]
Department of Taxation (TAX)	
Individual/corporate income tax returns (2008)	All income tax subtractions, deductions, and credits
Other TAX data[b] (2008)	Nonprofit organizations exemption Pollution control equipment & facilities exemption
Other	
National Science Foundation data	Research & development exemption
U.S. American Community Survey data (2008)[c]	Food partial exemption Drug and medical product exemptions, except dialysis Residential heating fuels exemption
U.S. Economic Census data (2007)	Certain printed materials for out-of-state distribution exemption
U.S. Bureau of Transportation Statistics data (2010)	Airline common carriers exemption
Mid-Atlantic Renal Coalition data (2009)	Dialysis equipment and supplies exemption
Virginia Economic Development Partnership data (2011)	Data center exemptions
State Council on Higher Education for Virginia data (2009)	College textbooks exemption
Industry or trade associations[c] (2011)	Railroad common carrier exemption Ships and vessels exemption Media provider equipment exemption
No data available/no estimate generated	Communications & motor vehicle equipment for the disabled exemptions Churches exemption Donations from inventory exemption Sales tax holidays Uniform rental & laundry businesses exemption Out-of-state nuclear facility repair exemption Contractor temporary storage exemption Taxi parts & radios exemption Virginia spaceport users exemption Film, television & audio production inputs exemption Donations of educational materials exemption Dept. of the Blind & Vision Impaired & ancillary non-profits exemption Multifuel heating stoves exemption Electrostatic duplicators exemption Semiconductor manufacturer & wafers exemptions Railroad rolling stock exemption[c]

a. Estimates for taxpayers using tax preferences were determined only for preferences that were active in TY 2008 and were intended to achieve a public policy goal.
b. TAX collects estimates of annual purchases made by nonprofits in past and future years through their administration of the nonprofit exemption approval process. Similarly, TAX collects information on the number of companies and projects qualifying for the pollution control equipment and facilities exemption.
c. Industry and trade associations either collected data from members and then provided data to JLARC staff or provided JLARC staff with access to members and assisted with data collection efforts.

Source: JLARC staff analysis.

In contrast, several data sources were used to estimate the number of beneficiaries using each retail sales and use tax preference. Because TAX has never generated estimates of the beneficiaries of many sales tax preferences, some estimates were developed by JLARC staff. Due to the number of preferences and time required to develop estimates, JLARC staff focused on estimating the number of beneficiaries for exemptions with a value of over $1 million. In some cases, adequate data was not available for even these preferences, and no estimate was generated.

Estimates of Reduced Taxpayer Liability Provided By Tax Preferences

In some cases, JLARC staff were able to use the same data sources to estimate the number of beneficiaries as well as the amount of reduced tax liability attributable to a tax preference. For example, individual and corporate income tax returns were used to estimate the reduction in tax liability provided by each income tax preference, per return and overall. While sales tax return data was used to estimate the reduced liability to taxpayers provided by the partial exemption for food, it could not be used for other sales tax exemptions because data specific to other exemptions is not captured. As a result, multiple other data sources were used, which are listed in Table B-2.

JLARC staff were able to determine reduced taxpayer liability provided by many sales and use tax preferences using estimates generated by TAX for purposes of its ongoing sales and use tax expenditure studies, recent legislative fiscal impact statements, and internally generated projections based on data collected from 1991 to 2004. However, estimates included in this report differ slightly from those reported by TAX because they have been converted from fiscal year to tax year, which is the equivalent of a calendar year for sales and use taxes. In addition to building upon TAX estimates, estimates for some sales tax preferences were independently generated using data from other state agencies, national repositories, and surveys of preference beneficiaries conducted by either TAX or JLARC staff. Neither TAX nor JLARC staff were able to generate estimates of the reduction in tax liability attributable to six preferences with public policy goals because readily available data is lacking.

Estimates of Reduced Tax Liability and Beneficiaries Have Several Limitations

Estimates of the number of beneficiaries and magnitude of reduced tax liability included in this report have several limitations that should be considered when using them to guide policy decisions. First, the reported savings may overstate what the actual revenue

Table B-2: Data Sources Used to Estimate Tax Liability Reductions Provided by Tax Preferences

Data Source (Data Year)	Tax Preference(s)[a]
Department of Taxation (TAX)	
Individual/corporate income tax returns (2008)	All income tax subtractions, deductions, and credits
Retail sales and use tax returns (2008)	Food partial exemption
TAX Sales and Use Tax Expenditure Studies (2007-2010)	Drug and medical product exemptions College textbooks exemption Communications & motor vehicle equipment for the disabled exemptions Nonprofit organizations exemption Churches exemption Donations from inventory exemption
TAX fiscal impact statements	Sales tax holidays
TAX projections (internal, projected from various estimates originally developed from 1991-2004 and in 2011)	Certain printed materials for out-of-state distribution exemption Out-of-state nuclear facility repair exemption Contractor temporary storage exemption Taxi parts & radios exemption Virginia spaceport users exemption Film, television & audio production inputs exemption Donations of educational materials exemption Pollution control equipment & facilities exemption All tax policy preferences
TAX surveys (2003, 2010)	Railroad common carrier exemption Ships and vessels exemption
Other	
JLARC staff survey (2010)	Media provider equipment exemption
National Science Foundation data	Research & development exemption
U.S. Energy Information Administration data (2008)[b]	Residential heating fuels exemption
U.S. Bureau of Transportation Statistics data (2010)	Airline common carriers exemption
Virginia Economic Development Partnership data (2008-11)	Data center exemptions
No data available	Uniform rental & laundry businesses exemption Dept. of the Blind & Vision Impaired & ancillary nonprofits exemption Multifuel heating stoves exemption Electrostatic duplicators exemption Semiconductor manufacturer & wafers exemptions Railroad rolling stock exemption[b]

[a.] Reductions in tax liability were estimated only for tax preferences that were active in TY 2008 and were intended to achieve a public policy goal.
[b.] Although analysis indicated that the railroad rolling stock exemption would provide large reductions in tax liability, it is partially redundant to the railroad common carrier exemption, therefore actual reductions are much less. In practice, the exemption extends only to purchases made by other types of companies that own their own rolling stock, such as major chemical companies.

Source: JLARC staff analysis.

impact would be if the preferences were eliminated. Although some estimates of tax liability reductions attempt to account for changes in behavior that might result if a preference were removed, many cannot. For example, the elimination of some income tax preferences could result in taxpayers' claiming an alternative preference that was not previously claimed, meaning that only a portion of the value of the eliminated preference would be collected by the State as new revenue. Similarly, the elimination of a sales tax preference could result in taxpayers reducing the volume of purchases they make in Virginia or discontinuing them altogether, reducing overall tax revenues from those purchases. Lastly, because many tax preferences are intended to promote economic activities, their elimination could result in a decrease in that activity as well as in the tax revenues related to it. However, this situation would only occur if the preference is effectively achieving its goals.

Second, estimates may over- or under-report reductions in tax liability, particularly for retail sales and use tax exemptions, because many rely on assumptions of taxpayer spending habits rather than on data directly reported by beneficiaries on tax returns. For example, federal data on expenditures incurred by companies performing research and development (R&D) was used to estimate reductions in sales tax liability due to the R&D exemption. Not all R&D expenditures qualify for the exemption, and JLARC staff estimated the portion of qualifying R&D expenditures based on several assumptions, including Virginia companies' average spending on R&D materials and supplies being equivalent to 25 percent of the national average. The estimated reduction in tax liability attributable to the R&D exemption may therefore over- or understate the actual reduction that was granted, depending on how closely the assumed proportion of spending on exempt goods matches actual spending on these goods.

Third, the estimated reduction in tax liability for sales tax exemptions may be double counted in some instances. For example, nonprofit hospitals can purchase prescription drugs tax-exempt because of two exemptions: the nonprofit purchases exemption and the prescription drug exemption. The reduced tax liability provided to nonprofits is captured in the total reduction reported for the nonprofit exemption, and again for the prescription drug exemption, and is therefore double counted. When possible and feasible, calculations attempted to avoid double counting.

Fourth, estimates of the beneficiaries of sales tax exemptions may over- or under-state actual beneficiaries. For example, JLARC staff estimated that all taxpayers benefit from the prescription drug exemption because it is available to all consumers and applies to a good that is commonly purchased by many. However, it is likely that a number of Virginians do not purchase prescription drugs in any given year, and so the number of Virginia beneficiaries may be overstated. Conversely, the estimate only accounts for Virginia consumers but does not account for residents of other states who purchase prescription drugs in Virginia and benefit from the exemption. Residents of other states were not accounted for because no adequate data is available for determining how many nonresidents are likely to make prescription drug purchases in Virginia.

The number of beneficiaries for sales tax exemptions can also be underestimated because although exemptions can benefit buyers (through reduced cost) and sellers (through increased sales), estimates only attempt to identify the number of beneficiaries who appear to be specifically targeted by the exemption. For example, Virginia exempts sales of certain printed materials by Virginia printers to out-of-state parties. The intent of the exemption is to benefit Virginia printers by reducing retail prices and thereby increasing sales. However, the out-of-state parties that purchase these printed materials also benefit because they do not have to pay sales tax. In this instance, JLARC staff only attempted to estimate the number of Virginia printers benefiting from the exemption.

Data Analysis for Evaluating Effectiveness of Tax Preferences

JLARC staff collected and analyzed data from the sources shown in Tables B-1 and B-2 to determine if tax preferences were achieving their intended public policy goals. Data for evaluating preferences was obtained from TAX and other State agencies, federal repositories, industry and trade associations, and tax preference beneficiaries. Income tax preferences that provide financial assistance were evaluated exclusively using individual income tax return data, while income tax preferences that promote activity were evaluated with data from tax returns as well as other sources. A variety of data sources were used to evaluate retail sales and use tax exemptions. Table B-3 lists all data sources used to evaluate the effectiveness of tax preferences.

SELECTION AND EVALUATION OF VIRGINIA'S TAX PREFERENCES

Because neither Virginia law nor the study mandate define what constitutes a tax preference, JLARC staff developed their own definition and approach for identifying which provisions in Virginia's tax code are preferences. For purposes of this review, a tax provision was considered a tax preference if it met three criteria

- is specifically included in Virginia's tax code and details the special treatment to be provided,
- results in a reduction in tax revenue, and
- departs from the normal base of the tax.

Table B-3: Multiple State Agencies and Stakeholder Groups Were Interviewed to Determine Tax Preference Effectiveness

Tax Preference	Data Source and Outcome Measure
All preferences providing financial assistance	• The Commonwealth Institute for Fiscal Analysis • Virginia Poverty and Law Center • Virginia Department of Social Services • AARP
Historic Rehabilitation Tax Credit	• Department of Historic Resources • Virginia Commonwealth University, Center for Public Policy
Land Preservation Tax Credit	• Virginia Outdoors Foundation • Department of Conservation and Recreation • Nature Conservancy • Northern Virginia Conservation Trust • Piedmont Environmental Council • Virginia Conservation Credit Pool
Airline common carriers exemption	• Department of Aviation • Dulles Airport
Neighborhood Assistance Act Tax Credit	• Department of Education • Department of Social Services
Nonprofit-related exemptions[a]	• The Community Foundation serving Richmond and Central Virginia
Port of Virginia exemption	• Virginia Port Authority
Railroad common carrier exemption	• Virginia Railroad Association • Class I railroads
Media provider equipment exemption	• NOVA Technology Council • Media Provider Companies • Virginia Cable Television Association • Virginia Association of Broadcasters
Research and development exemption	• Center for Innovative Technology • Virginia Biotechnology Association • Virginia Economic Development Partnership
Ships and vessels exemption	• Virginia Maritime Association • Virginia Ship Repair Association • Virginia shipyards
Drug and medical product exemptions	• Virginia Health Care Foundation
College textbook exemption	• State Council of Higher Education for Virginia
Data center exemptions	• Virginia Economic Development Partnership

[a.] Nonprofit purchases exemption and the exemption for donating property withdrawn from inventory to nonprofits.

Source: JLARC staff interviews.

It was relatively simple to determine whether a tax provision met the first two criteria. It was often less clear whether certain provisions departed from the normal base of the tax. Such provisions were classified as tax policy preferences, and were not evaluated.

Evaluation Focused on Public Policy Tax Preferences

This evaluation focused on the effectiveness of tax preferences intended to achieve public policy goals for two primary reasons. First, Senate Joint Resolution 21 specifically directed JLARC to evaluate the extent to which tax preferences achieve their public policy goals. In addition, it appears that many preferences with tax policy purposes may achieve their goals once adopted. A better approach for evaluating these preferences would include examining whether the tax policy goal continues to be appropriate, and if so, whether a tax preference is the best mechanism to achieve it.

It is important to note that the purposes or goals of most Virginia tax preferences are not stated in statute or other legislative documents. In fact, only two preferences that had purposes specified in statute were identified: the Neighborhood Assistance Act and Land Preservation tax credits. However, multiple steps were used to deduce the purpose of each tax preference including

- reviews of the *Code of Virginia*, Virginia Administrative Code, TAX reports and documents, fiscal impact statements, and other legislative reports;
- discussions with staff from TAX, Senate Finance, and Legislative Services;
- discussions with stakeholder groups; and
- reviews of the research literature and other states' practices.

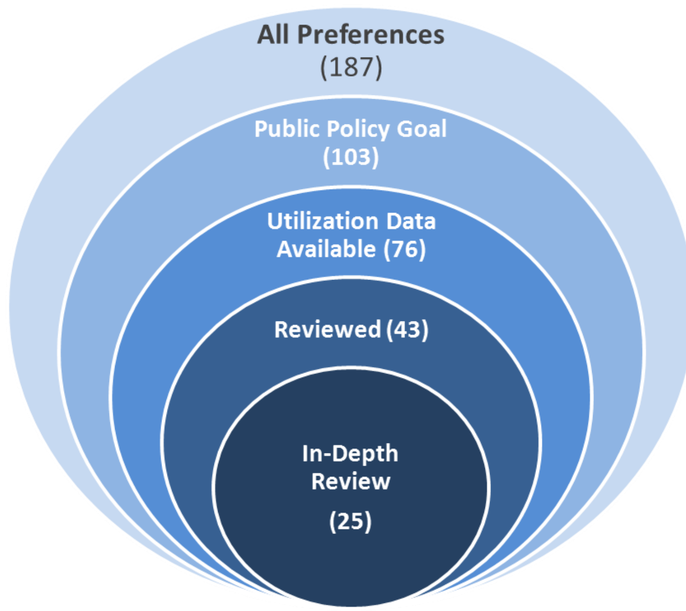
Evaluation Focused on Public Policy Tax Preferences With Reliable Data on Taxpayer Use and Reduction in Tax Liability

In addition, the evaluation was limited to those public policy preferences for which data on taxpayer use and the reduction in tax liability was reasonably obtainable and reliable. Preferences for which data could not be obtained were excluded to allow sufficient time to evaluate other tax preferences. Several factors limited data collection efforts for some preferences. First, the State collects minimal information on retail sales and use tax preferences. Census and industry data was available to estimate the number of beneficiaries and reductions in tax liability provided by many, but not all, sales tax exemptions. Data was also unavailable for income and sales tax preferences that had been recently adopted.

Evaluation Included All Public Policy Tax Preferences That Reduce Tax Liability By Aggregate Amount Exceeding $1 Million

To allow for a more in-depth review of those preferences that impacted the State the most, the evaluations focused on tax preferences with public policy goals providing more than $1 million in tax liability reduction. This approach still allowed staff to evaluate almost half of all public policy preferences for which data was available (Figure B-1).

Figure B-1: Evaluation Focused On Nearly Half of Public Policy Tax Preferences for Which Data Was Available



Source: JLARC staff analysis of income tax return data for TY 2008 and various other data on retail sales and use tax exemptions.

STRUCTURED INTERVIEWS

JLARC staff conducted several interviews with representatives from State agencies to gain an understanding of Virginia's tax preferences. During the beginning phases of the study, interviews were conducted with staff from TAX and the Senate Finance Committee to establish a definition of tax preferences and identify the purpose of preferences that lack clearly stated public policy goals in the *Code of Virginia*. Staff from the Division of Legislative Services also assisted in this endeavor. Furthermore, additional interviews were conducted with TAX staff during the course of the study to verify that utilization calculations for tax preferences and their evaluations were performed properly. In addition, a number of interviews were conducted with State agencies and stakeholder groups to learn about specific tax preferences. During these interviews, questions were asked and information was collected regarding the purpose, value, and effectiveness of a group of tax preferences.

REVIEW OF DOCUMENTS AND RESEARCH LITERATURE

State documents were extensively reviewed to gather information about Virginia's tax preferences. In particular, document reviews were conducted to identify Virginia's tax preferences, their purposes, eligibility requirements, and other details, including whether they have a sunset date. Documents were also reviewed to determine past and current efforts to evaluate and report information about Virginia's tax preferences. Primary sources for this effort included the *Code of Virginia*, Virginia Administrative Code, fiscal impact statements, rulings of the Virginia Tax Commissioner, TAX documents and reports, and legislative studies.

Other states' statutes and documents were also reviewed to determine what processes they had implemented for defining, sunsetting, and evaluating tax preferences. Comparisons were made between Virginia's and other states' definitions of tax preferences, the use and design of specific tax preferences, and use of sunset dates.

Particular emphasis was placed on comparing Virginia's tax preferences with preferences in states that are most socioeconomically similar to Virginia, such as California, North Carolina, and Pennsylvania. Census data (2008) on population, state tax collections and spending, unemployment, poverty rates, and median household income was used to identify the top ten states most socioeconomically similar to Virginia.

For tax preferences intended to promote economic development, primary emphasis was placed on comparing Virginia and the states with which Virginia most closely competes for economic development. Using analyses of the National Establishment Time Series database, JLARC staff identified Virginia's top competitors as some of the larger states from the East Coast, Texas, Illinois, and California. These states had the highest volume of relocations to and from Virginia between 1989 and 2007. JLARC staff also used the 2010 Multistate Tax Guide, surveys conducted by the Federation of Tax Administrators, and comparative information provided by industry as sources for information on states' use of sales tax exemptions.

Finally, tax research literature was reviewed to gain further understanding about specific tax preferences and how tax preferences could be evaluated effectively. Primary sources for this effort included the National Tax Journal, Journal of State Taxation, and

State Tax Notes. Extensive reviews of the research literature were conducted to assist staff in determining which provisions in Virginia's tax code should be considered tax preferences and whether the purpose of certain preferences was primarily to further a tax or public policy purpose. In addition, the research literature was used as a primary source for assessing the effectiveness of preferences like sales tax holiday exemptions, and to supplement quantitative analysis for other preferences.

Appendix C Comprehensive List of Virginia Tax Policy Preferences (TY 2008)

Table C-1: All Preferences with Tax Policy Purposes, by Broad Purpose

Statute	Tax Preference	Reduced Tax Liability TY 08 ($)
Policy Purpose: Prevent Over/Double Taxation Exclude from taxation under one system because it is subject to another comparable tax system.		
§ 58.1-609. 1(5)	Aircraft Sales Exemption	$15,776,996
§ 58.1-322(G)	Allocable Income of S-Corps Subject to Bank Franchise Tax Subtraction	381,798
§ 58.1-401.3	Banks Exemption	n.d.
§ 58.1-371; § 58.1-332	Credit for Taxes Paid Other States	220,688,614
§ 58.1-402(C)(10)	Dividend Subtraction	9,741,211
§ 58.1-401.4	Electing Small Business Corporations Exemption	n.d.
§ 58.1-402(C)(17)	Electric Supplier, Pipeline Distribution Company, Gas Utility and Gas Supplier Subtraction	101,311
§ 58.1-602	Financial Instruments Exemption	n.d.
§ 58.1-401.2	Insurance Companies Exemption	n.d.
§ 58.1-402(C)(21)	Intangible Expenses Subtraction	152,188
§ 58.1-609. 1(1)	Motor Vehicle & Aircraft Fuel Exemption	849,717,260
§ 58.1-609. 1(2)	Motor Vehicle Sales Exemption	808,734,412
§ 58.1-401.1	Public Service Corporations Exemption	n.d.
§ 58.1-322(C)(19)	Retirement Payments Subtraction	2,611,476
§ 58.1-322(C)(5); § 58.1-402(C)(4)	Subtraction for Overpayment	65,171,398
§ 58.1-332.1	Taxes Paid to a Foreign Country on Retirement Income Tax Credit	294,736
§ 58.1-609. 1(3)	Utilities Exemption	345,509,528
§ 58.1-609. 1(6)	Watercraft Fuel Exemption	59,061
§ 58.1-609. 1(9)	Watercraft Sales Exemption	10,879,742
Policy Purpose: Provide Clarification Specify what types of businesses or incomes are not subject to the tax.		
§ 58.1-609. 6(5)	Advertising Exemption	84,819,059
§ 58.1-609. 2(3)	Agricultural Self-Consumption Products Exemption	1,087,974
§ 58.1-322(C)(30)	Avian Influenza Indemnification Payments Subtraction*	41
§ 58.1-602	Certain Manufacturer Machinery & Equipment Transfers Exemption	n.d.
§ 58.1-609. 5(4)	Clothing Alteration Services Exemption	n.d.
§ 58.1-401.7	Contracting with Commercial Printers Exemption	n.d.
§ 58.1-609. 3(7)	Employee Meals Exemption	9,802,276
§ 58.1-609. 5(8)	Extended Lodging Rentals Exemption	n.d.
§ 58.1-315(7)	Federal Investment Credit	n.d.
§ 58.1-402(C)(6); § 58.1-322(C)6	Federal Targeted Jobs Credit Subtraction	335,118

§ 58.1-402(C)(5)	Foreign Dividend Gross-Up Subtraction	10,770,429
§ 58.1-322(C)(29); § 58.1-402(C)(20)	Gains from Peanut Quota Buyout Program Subtraction*	20,029
§ 58.1-604.6	Gifts for Non-Virginia Recipients Exemption	n.d.
§ 58.1-321(B)	Income of Persons Stationed in Virginia on Naval or Military Reservations Exclusion	n.d.
§ 58.1-322(C)(27); § 58.1-402(C)(18)	Income Received as a Result of Payments Made Under the Tobacco Settlement Subtraction	678,072
§ 58.1-609. 5(2)	Installation & Repair of Property Sold Exemption	n.d.
§ 58.1-609. 5(6)	IT Application Modification & Development Services Exemption	n.d.
§ 58.1-609. 5(9)	Maintenance Contracts Partial Exemption	n.d.
§ 58.1-610.1	Modular Building Partial Exemption	766,932
§ 58.1-403 (9)	NOL Addback and Carryback for Gas Supplier Companies	7,147
§ 58.1-403 (3)	NOL Addback and Carryback for Railway Companies	n.d.
§ 58.1-403 (7)	NOL Addback and Carryback for Telecommunications Companies	n.d.
§ 58.1-609. 5 (1)(i)(ii)(iii)	Professional, Insurance, Personal, Repair, & Internet Services Exemption	3,348,978,497
§ 58.1-402(D); § 58.1-322(D)(11)	Quota Tobacco Producer or Holder Subtraction	519,119
§ 58.1-322(C)(17); § 58.1-402(C)(14)	Research And Development Expenses Subtraction	n.d.
§ 58.1-315(5)	Sale of Nondepreciable Property	n.d.
§ 58.1-609. 5(3)	Transportation Services Exemption	83,844,287

Policy Purpose: Ensure Conformity to Federal or State Policy
Conform the State tax code to one of the following: federal requirements, the Internal Revenue Code, or Virginia Constitution.

§ 58.1-322(D)(2)(b)	Blind and Aged Personal Exemption	14,709,657
§ 58.1-370	Credit to Trust Beneficiary Receiving Accumulation Distribution	n.d.
§ 58.1-401.3a	Credit Unions Exemption	n.d.
§ 58.1-322(C)(32)	Death Benefit from Annuity Subtraction	1,886,824
§ 58.1-402(C)(3)	Domestic International Sales Corporation Subtraction	10,768
§ 58.1-401.8	Foreign Sales Corporations Exemption	n.d.
§ 58.1-402(C)(8)	Foreign Source Income Subtraction	33,390,147
§ 58.1-322(C)(2); § 58.1-402(C)(2)	Income from Obligations of the Commonwealth Subtraction	1,481,611
§ 58.1-322(D)(1)(a)	IRC Conformity Itemized Deduction	1,859,033,726
§ 58.1-322(C)(31)	Military Death Gratuity Payments Subtraction	20,369
§ 58.1-322(C)(18)	NATO Joint Endeavor Operation in Yugoslavia Income Subtraction*	135,563
§ 58.1-401.5	Not-for-Profits Exemption	n.d.
§ 58.1-401.6	Not-for-Profits Telephone Companies Exemption	n.d.
§ 58.1-322(D)(2)(a)	Personal Exemption	303,080,935
§ 58.1-322(D)(1)(b)	Standard Deduction	262,564,891
§ 58.1-402(C)(7)	Subpart F Income Subtraction	13,570,868

Policy Purpose: Increase Efficiency
Mitigate the cost of adequately collecting and administering the tax compared to the potential revenue that could be gained.

§ 58.1-604	Catalog Orders Under $100 Exemption	n.d.
§ 58.1-609. 1(8)	Election Document Sales Exemption	n.d.

§ 58.1-301	Fixed Date Conformity	20,163,306
§ 58.1-609. 5(5)	Gift Wrapping Services (by Nonprofit) Exemption	n.d.
§ 58.1-609. 1(7)	Government Flag Sales Exemption	n.d.
§ 58.1-609. 1(4)	Government Purchases Exemption	119,677,164
§ 58.1-321(A)1	Low-Income Individual Exclusion (Filing Threshold – Single)	n.d.
§ 58.1-321(A)2	Low-Income Married Exclusion (Filing Threshold – Married)	n.d.
§ 58.1-609.10(17)	Medicaid Recipient Purchases of Non-durable Medical Supplies Exemption	867,741
§ 58.1-609.10(2)	Occasional Sales Exemption	n.d.
§ 58.1-609. 6(3)	Periodicals (Except Newstand Sales) Exemption	29,126,762
§ 58.1-609. 1(10)	Port of Virginia & Ancillary Nonprofits Exemption	777,124
§ 58.1-609. 1(11)	Prisoner Art Sales Exemption	n.d.
§ 58.1-609. 1(17)	Public Transit Authorities Exemption	510,683
§ 58.1-609.10(8)	School Lunches Exemption	11,981,105
§ 58.1-609. 1(16)	Soil & Conservation Districts Exemption	n.d.[a]
§ 58.1-609. 1(14)	Veteran's Center Canteen Sales Exemption	1,240
Policy Purpose: Reduce the Pyramid Effect Prevent taxes being imposed on a good or service at more than one stage of the production process so that the tax is only imposed on the price of the good or service at the final stage.		
§ 58.1-609. 2(1)	Agricultural Materials & Equipment Exemption	125,002,352
§ 58.1-609. 2(5)	Feed Processing Materials & Equipment Exemption	n.d.[b]
§ 58.1-609. 2(6)	Forestry Materials & Equipment Exemption	3,763,248
§ 58.1-609. 3(2)(i-iv)	Manufacturing Materials & Equipment Exemption	916,876,850
§ 58.1-610.1	Modular Building Account Credit	n.d.[c]
§ 58.1-609. 3(12)	Natural Gas & Oil Materials & Equipment Exemption	11,202,601
§ 58.1-609. 6 (1)(i)(ii)	Movie Theatre & Broadcaster Purchases of Media Exemption	7,468,400
§ 58.1-609. 2(4)	Watermen Materials & Equipment Exemption	1,554,249

Notes: (1) The beneficiary utilization of individual tax policy preferences in tax year 2008 was not reported due to the lack of available data and limited JLARC staff resources. (2) n.d., not determined due to lack of available data.
* Indicates that the tax preference was active in 2008 but has since expired.
[a] Redundant to broader exemption on state and local government entities (§ 58.1-609.1(4)(ii)).
[b] Redundant to broader exemption on manufacturing inputs (§ 58.1-609.2(1)).
[c] Savings included in total for modular building partial exemption.

Source: JLARC staff analysis of the *Code of Virginia,* other legislative and TAX documents, income tax return data from TY 2008, and other estimates provided by TAX.

Appendix D Comprehensive List of Virginia Public Policy Tax Preferences (TY 2008)

Table D-1: Tax Preferences Designed to Provide Financial Assistance (Chapter 3)

Tax Preference	Public Policy Purpose	# Beneficiaries TY 08	Reduced Tax Liability TY 08 ($)
Retail Sales and Use Tax Preferences			
§ 58.1-609.10(9) Prescription Drugs Exemption	Provide financial assistance to Virginia consumers, especially those with low incomes and high medical costs like the elderly, by reducing the cost of prescription drugs.	3,306,473 Virginia households (2008), 13,876 health care providers (2007)[a]	$378,782,714
§ 58.1-611.1 Food Partial Exemption	Provide financial assistance to Virginia consumers, especially those with lower incomes, by reducing the cost of food for home consumption.	3,306,473 Virginia households	346,160,071
§ 58.1-609.10(1) Residential Heating Fuels Exemption	Provide financial assistance to Virginia consumers, especially those with lower incomes, by reducing the cost of residential heating fuels.	372,769 Virginia households	41,949,440
§ 58.1-609.10(14) Nonprescription Drugs Exemption	Provide financial assistance to Virginia consumers, especially those with low incomes and high medical costs like the elderly, by reducing the cost of nonprescription drugs.	3,306,473 (2008) Virginia households, and 13,876 health care providers (2007)[b]	26,695,699
§ 58.1-609.10(9) Prescription Eyewear Exemption	Provide financial assistance to Virginia consumers, especially those with low incomes and high medical costs like the elderly, by reducing the cost of prescription eyewear.	n.d.	24,328,362
§ 58.1-609.10(8) College Textbooks Exemption	Provide financial assistance to Virginia consumers by reducing the cost of college textbooks.	460,434 students[c]	9,905,305
§ 58.1-609.10(9) Prescription Hearing Aids Exemption	Provide financial assistance to Virginia consumers, especially those with low incomes and high medical costs like the elderly, by reducing the cost of prescription hearing aids.	n.d.	4,103,030
§ 58.1-611.2 School Supplies & Clothing Sales Tax Holiday	Provide financial assistance to Virginia consumers by reducing the cost of school supplies and clothing.	n.d.	4,065,041
§ 58.1-609.10(10) Durable Medical Equipment Exemption	Provide financial assistance to Virginia consumers, especially those with low incomes and high medical costs like the elderly, by reducing the cost of durable medical equipment.	3,306,473 Virginia households[d]	2,340,941
§ 58.1-611.3 Hurricane Preparedness Sales Tax Holiday	Provide financial assistance to Virginia consumers by reducing the cost of hurricane preparedness items.	n.d.	2,205,285
§ 58.1-609.10(11) Dialysis Equipment and Supplies Exemption	Provide financial assistance to Virginia consumers, especially those with low incomes and high medical costs like the elderly, by reducing the cost of dialysis equipment.	10,025 dialysis patients (2009), 141 dialysis clinics (2009)[e]	2,153,323

§ 58.1-609.10(12) Motor Vehicle Equipment for the Disabled Exemption	Provide financial assistance to persons with disabilities that purchase essential goods which enable them to operate a motor vehicle.	n.d.	923,943
§ 58.1-609.10(13) Communications Equipment for the Disabled Exemption	Provide financial assistance to persons with disabilities that purchase essential goods to enable them to communicate with others.	n.d.	330
Income Tax Preferences			
§ 58.1-320 Tiered Tax Rate	Provide financial assistance to lower income individuals by taxing lower incomes at lower rates.	3,676,567	869,272,150
§ 58.1-322(D)(5) Age Deduction	Provide financial assistance to older Virginia taxpayers with low to moderate incomes.	429,307	284,865,330
§ 58.1-322(C)(4) Social Security and Railroad Retirement Deduction	Provide financial assistance to retirees receiving Social Security income after the federal government began partially taxing it to comply with federal Railroad Retirement Act of 1974, which prohibits states from taxing these benefits.	391,914	244,038,683
§ 58.1-339.8 Low Income Tax Credit	Provide financial assistance to low-income taxpayers.	287,544	91,688,855
§ 58.1-322(D)(3) Child and Dependent Care Expenses Deduction	Provide financial assistance to taxpayers who need to hire care for their children or dependents in order to be gainfully employed.	192,620	28,356,522
§ 58.1-322(C)(25) Unemployment Compensation Benefits Subtraction	Provide financial assistance to taxpayers receiving unemployment compensation benefits after the federal government began taxing them.	127,244	21,818,801
§ 58.1-322(C)(23) Basic Military Pay Subtraction	Provide financial assistance to low-income military personnel on extended active duty for over 90 days.	23,395	7,812,495
§ 58.1-322(C)(4b) Disability Income Subtraction	Provide financial assistance to permanently and totally disabled Virginia taxpayers.	11,259	5,757,408
§ 58.1-322(C)(24) Federal and State Employees Subtraction	Provide financial assistance to low-income federal and State employees.	5,507	1,252,636
§ 58.1-322(D)(9) Continuing Teacher Education Deduction	Provide financial assistance to teachers who must take continuing education courses as a condition of employment.	3,370	213,188
§ 58.1-322(C)(26) Congressional Medal of Honor Recipient Retirement Income Subtraction	Provide financial assistance and reward Medal of Honor Recipients for their service.	14	37,944
§ 58.1-322(C)(28) Income Received by Holocaust Victims Subtraction	Provide financial assistance to Holocaust victims by not taxing income derived from goods stolen or forced work during the Holocaust.	7	2,826
§ 58.1-322(H); § 58.1-402(F) Installment Method for Dealers	Provide financial assistance to dealers by allowing use of the installment method to account for financial gains.	n.d.	n.d.

Note: n.d., not determined due to lack of available data.
[a.,b.] The number of health insurance providers using these exemptions is unknown.
[c.] Average fall enrollment at Virginia's public and nonprofit colleges and universities for the 2007-2008 and 2008-2009 school years.

As of the 2010-2011 school year the exemption has been expanded to include students at for-profit institutions.
[d.] The number of health insurance providers using these exemptions is unknown.
[e.] Estimate for dialysis patients based on estimated number of Virginians with end-stage renal disease in 2010. In addition to dialysis clinics, an indeterminate number of health care providers providing dialysis treatment, such as hospitals, may benefit.

Source: JLARC staff analysis of the *Code of Virginia* and TAX data.

Table D-2: Tax Preferences Designed to Promote Activity (Chapter 4)

Tax Preference	Public Policy Purpose	# Beneficiaries TY 08	Reduced Tax Liability TY 08 ($)
Public Policy Purpose: Promote Preservation Activity			
§ 58.1-512 Land Preservation Tax Credit	Promote the preservation and sustainability of Virginia's unique natural resources, wildlife habitats, open spaces, and forested resources.	5,384	$119,580,083
§ 58.1-339.2 Historic Rehabilitation Tax Credit	Encourage individuals and businesses to restore certified historic structures in Virginia.	1,173	60,825,813
§ 58.1-322(C)(22); § 58.1-402(C)(16) Gain on the Sale of Land for Open Space Use Subtraction	Promote the preservation of open-space land for at least 30 years.	319	1,376,533
§ 58.1-339.3; § 58.1-439.5 Agricultural Best Management Practices Tax Credit	Encourage farmers and other agricultural businesses to implement agricultural best management practices to reduce the impact of nonpoint source pollutants on State streams, rivers, and the Chesapeake Bay.	663	665,517
§ 58.1-334; § 58.1-432 Conservation Tillage Equipment Tax Credit	Encourage farmers and other agricultural businesses to install conservation tillage equipment used in agricultural production, which is designed to minimize soil disruption and erosion in the planting process.	188	328,754
§ 58.1-609. 1(18) Sales Tax Holiday - EnergyStar & Watersense	Promote purchases of energy efficient goods, thereby furthering Virginia's competitiveness with other states.	n.d.	178,862
§ 58.1-439.10 Waste Motor Oil Burning Equipment Tax Credit	Encourage businesses that purchase waste motor oil burning equipment to use waste motor oil.	86	175,344
§ 58.1-322(D)(12) Energy Efficient Appliance Deduction	Promote the purchase of energy efficient appliances while maintaining Virginia's competitiveness with other states.	14,910	163,933
§ 58.1-339.10; § 58.1-439.12 Riparian Forest Buffer Protection for Waterways Tax Credit	Encourage people and businesses who profit from timber harvesting to leave areas adjacent to waterways forested.	60	161,460
§ 58.1-337; § 58.1-436 Fertilizer and Pesticide Application Equipment Tax Credit	Encourage farmers and other agricultural businesses to purchase equipment certified to apply pesticides and fertilizers which are designed to reduce the potential for adverse environmental impacts.	101	153,968
§ 58.1-438.1(ii) Vehicle Emissions Testing Equipment Tax Credit	Encourage service station owners to participate in the inspection program.	36	12,974
§ 58.1-438.1(i) Clean Fuel Vehicle and Certain Refueling Property Tax Credit	Encourage businesses to purchase clean fuel vehicles and install green refueling technologies.	11	5,929

Public Policy Purpose: Promote Charitable Activity			
§ 58.1-609.11 Nonprofit Organizations Exemption	Promote activity by nonprofits that provide charitable services such as relief to the poor and advancement of education or science, promote social welfare, and reduce the burdens of government.	5,773 nonprofits (2010)[a]	178,215,787
§ 58.1-609.10(16) Churches Exemption	Promote community, civic, and other charitable activity by churches.	n.d.	6,023,359
§ 58.1-609.10(15) Donations of Tangible Goods to Nonprofits Exemption	Promote donations by businesses to entities that are serving a charitable purpose or providing other public services.	n.d	5,454,043
§ 58.1-439.18 - 58.1-439.24 Neighborhood Assistance Act Tax Credit	Encourage business firms and individuals to make donations to approved neighborhood organizations for the benefit of impoverished people.	2,420	4,795,970
§ 58.1-609. 6(7) Donations of Educational Materials Exemption	Encourage book publishers to donate textbooks and other educational materials to professionals and others with an educational focus.	n.d.	143,167
§ 58.1-609.10(19) Fabrication of Food for Nonprofits or Home Use Exemption	Promote services or donations to nonprofits that provide services benefitting the common good.	n.d.	n.d.
Public Policy Purpose Promote Economic Activity			
§ 58.1-439.2 Coalfield Employment Enhancement Tax Credit	Encourage coal mine operators to produce Virginia coal and coal bed methane and employ miners to slow the decline in Virginia coal production and employment.	66	31,223,226
§ 58.1-609. 3(5) Research & Development Exemption	Promote private research and development activities by reducing the cost of operations and capital investment.	764 companies (2007)	28,913,734
§ 58.1-609. 3(3) Railroad Common Carriers Exemption	Promote maintenance and expansion of Virginia railroads.	11 railroads (2011)	20,119,456
§ 58.1-609. 3(6) Airline Common Carriers Exemption	Encourage commercial airline service to Virginia airports.	62 airlines (2010)	10,077,425
§ 58.1-609. 6(2) Media Provider Equipment Exemption	Promote broadcasting, cable television, and similar industries.	287 companies[b] (2010)	5,194,657
§ 58.1-609. 6(4)(i)(ii) Certain Printed Materials for Out-of-State Distribution Exemption	Encourage out-of-state businesses, especially direct marketers and advertising firms, to use Virginia printers.	396 commercial and publications printers (2007)	4,968,716
§ 58.1-609. 3(9) Pollution Control Equipment & Facilities Exemption	Encourage businesses’ regulatory compliance by reducing the cost, thereby relieving taxpayers of part of their cost burden.	77 companies[c]	3,757,945
§ 58.1-609. 3(4) Ships and Vessels Exemption	Promote maritime shipping industries, including commercial ship building, repair, supplying, and dredging.	12 companies[d]	2,796,352
§ 58.1-439 Major Business Facility Job Tax Credit	Encourage employers to relocate or expand their business facilities or operations in Virginia by rewarding job creation.	108	2,173,063
§ 58.1-609. 3(17) Data Centers Exemption*	Promote the construction of new, large-scale data centers in Virginia.	1 company	1,975,000
§ 58.1-339.4 Qualified Equity and Subordinated Debt Investment Tax Credit	Promote investment in small Virginia businesses engaged in emerging technologies.	220	1,937,068

§ 58.1-439.7 Recyclable Materials Processing Equipment Tax Credit	Encourage manufacturers and processors to purchase equipment for use in Virginia to produce tangible goods from recyclable materials.	59	1,035,523
§ 58.1-609.10(6) Out-of-state Nuclear Facility Repair Exemption	Promote purchases of nuclear power repair supplies for the purpose of providing services to out-of-state buyers.	n.d.	412,445
§ 58.1-609. 6(6) Film, Television, & Audio Production Exemption	Encourage the audiovisual industry to produce films or other audiovisual works in Virginia to encourage national programmers and producers to establish operations in Virginia.	n.d.	406,539
§ 58.1-609. 3(10) Taxi Parts & Radios Exemption	Encourage commercial taxi operations in order to prevent their decline.	n.d.	338,215
§ 58.1-609. 3(13) Virginia Spaceport Users Exemption	Promote spaceport operations at facilities owned, leased, or operated by the State.	n.d.	112,739
§ 58.1-609. 3(1) Contractor Temporary Storage Exemption	Promote inter-state competitiveness of Virginia-based construction material supply industry in order to gain economic benefit.	n.d.	110,325
§ 58.1-439.12:02 Biodiesel and Green Diesel Fuels Producers Tax Credit	Encourage the fuel industry to open new biodiesel and green diesel fuel production operations.	17	78,354
§ 58.1-439.6 Worker Retraining Tax Credit	Encourage businesses to provide worker retraining to keep workers employed.	7	26,075
§ 58.1-439.12:01 Cigarettes Manufactured and Exported Tax Credit	Encourage cigarette manufacturers to keep export production capacity in Virginia.	0	0
§ 58.1-439.1 Clean Fuel Vehicle Job Creation Tax Credit	Promote job creation in the clean vehicle manufacturing and conversion industries.	0	0
§ 58.1-439.9 Employers of Temporary Assistance to Needy Families (TANF) Recipients Tax Credit	Encourage businesses to employ TANF recipients.	0	0
§ 58.1-439.13 Investment in Technology Industries in Tobacco-Dependent Localities Tax Credit*	Encourage biotechnology companies to invest in technology-related activities in tobacco dependent localities.	0	0
§ 58.1-439.14 Research and Development Activity Occurring in Tobacco- Dependent Localities Tax Credit*	Promote biotechnology companies to conduct research and development activity in tobacco-dependent localities.	0	0
§ 58.1-433.1 Virginia Coal Production and Employment Incentive Tax Credit	Encourage electricity producers to purchase Virginia coal and in turn slow the decline in Virginia coal production and employment.	0	0
§ 58.1-609. 3(16) Railroad Rolling Stock Exemption	Promote investment by private rail yards and rail lines in rolling stock to gain economic benefit.	n.d.	n.d.[e]
§ 58.1-609. 3(11) Electrostatic Duplicators Exemption	Promote small-scale printing operations in Virginia.	n.d.	n.d.
§ 58.1-609. 3(14) Semiconductor Manufacturers Exemption	Promote semiconductor manufacturing in Virginia.	n.d.	n.d.

§ 58.1-609. 3(8) Uniform Rental & Laundry Businesses Exemption	Promote commercial uniform rental businesses and provide parity with businesses that do not complete their own laundry.	n.d.	n.d.
§ 58.1-439.12:09 Barge and Rail Usage Tax Credit	Encourage international trade facilities to ship cargo via rail and not trucks.	n.d.	n.d.
§ 58.1-339.12 Farm Wineries and Vineyards Tax Credit	Promote the production of Virginia wine.	n.d.	n.d.
§ 58.1-439.12:05 Green Job Creation Tax Credit	Encourage employers to create jobs in Virginia in industries relating to the field of renewable, alternative energies (green jobs).	n.d.	n.d.
§ 58.1-439.12:06 International Trade Facility Tax Credit	Promote employment and capital at international trade facilities in Virginia.	n.d.	n.d.
§ 58.1-422 Manufacturing SSF	Encourage manufacturers to invest capital and locate employees in Virginia.	n.d.	n.d.
§ 58.1-439.12:03 Motion Picture Production Tax Credit	Encourage motion picture companies to film motion pictures in Virginia.	n.d.	n.d.
§ 58.1-322(C)(35); 58.1-402(C)(24) Qualified Business Long-Term Capital Gain Subtraction	Promote investment in small, qualified Virginia businesses related to technology.	n.d.	n.d.
§ 58.1-439.12:08 Research and Development Expenses Tax Credit	Promote Virginia qualified research and development.	n.d.	n.d.
§ 58.1-439.12:07 Telework Expenses Tax Credit	Encourage employers to allow teleworking.	n.d.	n.d.
§ 58.1-439.12:10 Virginia Port Volume Increase Tax Credit	Promote increase in Virginia port volume.	n.d.	n.d.
§ 58.1-402(C)(22); 58.1-322(C)(33) Zero G Zero Tax Act (Part I) Subtraction	Encourage the space industry to develop and provide launch services in Virginia.	n.d.	n.d.
§ 58.1-402(C)(23) ; 58.1-322(C)(34) Zero G Zero Tax Act (Part II) Subtraction	Encourage the space industry to provide resupply services launched from Virginia air or spaceports.	n.d.	n.d.
§ 58.1-439.4 Day-Care Facility Investment Tax Credit	Encourage employers to create day-care facilities for the children of their employees.	0	0
§ 58.1-609. 2(7) Farmer's Markets Exemption	Promote sales by farmers at farmer's markets.	n.d.	n.d.
§ 58.1-609. 3(18) Data Centers (Broad) Exemption	Promote the construction of new, large-scale data centers in Virginia.	4 companies (FY12 or later)	n.d.
§ 58.1-609. 3(15) Semiconductor Wafers Exemption	Promote semiconductor manufacturing in Virginia.	n.d.	n.d.[f]
Public Policy Purpose: Promote Other Activity			
§ 58.1-322(D)(7) Virginia Education Savings Trust Deduction	Encourage families to save for their children's' higher education expenses by providing tax relief to individuals to participate in Virginia College Savings Plans.	72,024	17,856,127

§ 58.1-322(D)(10) Long-Term Health Care Deduction	Promote purchases of private long-term care insurance, thereby reducing the costs to individuals and the State.	77,751	8,024,136
§ 58.1-339.11 Long-Term Care Insurance Tax Credit	Promote purchases of private long-term care insurance, thereby reducing the costs to individuals and the State as care is needed.	4,192	1,140,692
§ 58.1-322(C)(20) Virginia College Savings Plan Subtraction	Encourage families to save for their children's' higher education expenses by providing tax relief to individuals to participate in Virginia College Savings Plans.	5,360	1,133,543
§ 58.1-339.6 Political Candidate Contribution Tax Credit	Promote donations to political candidates.	24,234	820,741
§ 58.1-322(C)(11) National Guard Salary Subtraction	Promote enlisting in the Virginia National Guard.	3401	482,098
§ 58.1-435 Low-Income Housing Credit*	Promote the construction of new and rehabilitation of existing rental housing for low-income households.	45	215,884
§ 58.1-322(C)(10) Lottery Prize Subtraction	Promote participation in the State lottery.	1,653	157,700
§ 58.1-322(D)(4) Foster Child Deduction	Encourage people to provide permanent foster care for children.	1,893	137,645
§ 58.1-339.7 Home Accessibility Features for the Disabled Tax Credit	Encourage taxpayers to provide relief for the disabled by installing accessibility features.	50	24,469
§ 58.1-339.9 Rent Reduction Tax Credit*	Provide incentive to landlords to provide reduced rent for elderly, disabled, or previously homeless individuals.	14	13,926
§ 58.1-322(D)(8); 58.1-402(C)(15) Contributions to Public School Construction Grants Program Deduction	Promote individuals and businesses to donate to the Virginia Public School Construction Grants Program and Fund to promote school construction, additions, and renovations.	126	11,864
§ 58.1-322(D)(6) Bone Marrow Screening Fee Deduction	Encourage people to have bone marrow screened so that they may become donors.	204	11,585
§ 58.1-322(D)(13) Organ Donation Expenses Deduction	Encourage people to donate organs.	60	4,185
§ 58.1-609. 1(15) Government Collaboration Nonprofits Exemption	Promote government collaboration with nonprofits.	n.d.	n.d.[g]
§ 58.1-322(C)(12) Crime Solver Reward Subtraction	Encourage people to report crimes.	n.d.	n.d.
§ 58.1-609. 1(12) Department of the Blind & Vision Impaired & Ancillary Nonprofits Exemption	Promote business ownership, operation, and employment opportunities for the blind.	n.d.	n.d.
§ 58.1-609.10(18) Multifuel Heating Stoves Exemption	Promote purchases of socially beneficial goods.	n.d.	n.d.
§ 58.1-439.12:04 Participating Landlords Tax Credit	Encourage landlords to accept housing vouchers from housing authorities for rental properties in the Richmond Metropolitan Statistical Area that are in census tracts with poverty rates less than ten percent.	n.d.	n.d.

Note: n.d., not determined due to lack of available data.
* Indicates that the tax preference was active in 2008 but has since expired.

[a.] Number of nonprofits that potentially benefited in 2010 as well as Virginia State and local governments and school districts.
[b.] Companies include: 232 radio stations, 44 television stations, eight cable companies, and an unknown number of other general video or internet access and content providers.
[c.] Companies that filed for exemption certificate had projects ending in 2008.
[d.] At least 14 companies, but possibly more from 2004-2011, including 4 shipyards, 7 ship chandlers, and dredging operations. The estimate of reduced liability does not include data from ship chandlers.
[e.] Partially redundant due to broader exemption on railroad purchases (§ 58.1-609.3(3)).
[f.] Redundant due to broader exemption on semiconductor manufacturing inputs (§ 58.1-609.3(14)).
[g.] Partially redundant due to broader exemption on nonprofit entities (§ 58.1-609.11).

Source: JLARC staff analysis of the *Code of Virginia* and TAX data.

Appendix E Tax Preferences With Sunset Dates

Table E-1: Tax Preferences With Sunset Dates

Statute	Tax Preference	Sunset Date
§ 58.1-439.12:09	Barge and Rail Usage Tax Credit	January 1, 2015
§ 58.1-609.6 (4)(i)(ii)	Certain Printed Materials for Out-of-State Distribution Exemption	July 1, 2012[a]
§ 58.1-439.12:01	Cigarettes Manufactured and Exported Tax Credit	January 1, 2016
§ 58.1-439.1	Clean Fuel Vehicle Job Creation Tax Credit	January 1, 2015
§ 58.1-439.2	Coalfield Employment Enhancement Tax Credit	January 1, 2015
§ 58.1-609. 3(18)	Data Centers (Broad) Exemption	June 30, 2020
§ 58.1-609. 6(7)	Donations of Educational Materials Exemption	July 1, 2012
§ 58.1-609. 6(6)	Film, Television, & Audio Production Inputs Exemption	July 1, 2019
§ 58.1-439.12:05	Green Job Creation Tax Credit	January 1, 2015
§ 58.1-611.3	Hurricane Preparedness Sales Tax Holiday	July 1, 2012
§ 58.1-439.12:06	International Trade Facility Tax Credit	January 1, 2015
§ 58.1-439	Major Business Facility Job Tax Credit	January 1, 2020
§ 58.1-609.10(18)	Multifuel Heating Stoves Exemption	July 1, 2012
§ 58.1-609. 3(12)	Natural Gas & Oil Materials & Equipment Exemption	July 1, 2016
§ 58.1-439.18-24	Neighborhood Assistance Act Tax Credit	July 1, 2014
§ 58.1-439.7	Recyclable Materials Processing Equipment Tax Credit	January 1, 2015
§ 58.1-439.12:08	Research and Development Expenses Tax Credit	January 1, 2016
§ 58.1-609. 1(18)	Sales Tax Holiday - EnergyStar & Watersense	July 1, 2012
§ 58.1-439.12:07	Telework Expenses Tax Credit	January 1, 2014
§ 58.1-439.12:10	Virginia Port Volume Increase Tax Credit	January 1, 2016

[a.] Only § 58.1-609.6(4)(ii) is scheduled to sunset.

Source: JLARC staff analysis of the *Code of Virginia*.

Appendix F Agency Response

As part of an extensive validation process, State agencies and other entities involved in a JLARC assessment are given the opportunity to comment on an exposure draft of the report. JLARC staff provided an exposure draft of this report to the Department of Taxation and the Secretary of Finance. Appropriate technical corrections resulting from the comments received have been made in this version of the report. This appendix includes the written response letter received from the Department of Taxation.

COMMONWEALTH of VIRGINIA

Department of Taxation

November 7, 2011

Mr. Glen S. Tittermary
Director
Joint Legislative Audit and Review Commission
Suite 1100, General Assembly Building
Richmond, Virginia 23219

Glen
Dear ~~Mr.~~ Tittermary:

I want to thank you for the opportunity to review and to comment on the exposure draft of Review of the Effectiveness of Virginia Tax Preferences, dated October 25, 2011. Department of Taxation staff believe the report is well done and will be very useful to the members of the General Assembly going forward.

We have enjoyed working with the Joint Legislative Audit and Review Commission (JLARC) staff during the last two years while this report and last year's review of the corporate income tax were conducted. This report on tax preferences provides an objective and thorough analysis as well as a potential mechanism for conducting a systematic review, should the General Assembly choose to do so, of tax preferences.

In addition to the technical comments that we have shared with your staff, we would also offer these comments. First, in terms of establishing a joint subcommittee to continue the study of tax preferences on an ongoing basis, your report recommends that the subcommittee utilize policy analysts and economists from the Department of Taxation. Your report correctly concludes that there will be a fiscal impact on the Department of staffing the formal review process discussed in the report. I would note that in 1989, when the Department undertook a study of the Retail Sales and Use Tax Exemptions, six professional staff were assigned primary responsibility for the study. However, until the parameters of the new tax preference study are known, the costs to the Department of the report's recommendation cannot be fully determined.

The JLARC report also recommends the use of an outside technical advisory group to work with the joint subcommittee. We believe that the recommendation for a technical advisory group would enhance the process, much as a technical advisory group benefits the state's annual prison and jail inmate forecasting process. In addition to the members the report identifies, we would suggest that consideration be given to including staff or designees from the Office of the Secretary of Finance in a technical advisory group. The Office of the Secretary of Finance oversees the development of the state's budget and the revenue forecasting process as well as oversees the Department of Taxation.

We want to thank you again for the opportunity to comment on the exposure draft. We also appreciate you taking the time to meet with us and discuss the report. The Department of Taxation stands ready to assist JLARC and members of the General Assembly as the study leads to further inquiries.

Sincerely,

Craig M. Burns
Tax Commissioner

c: The Honorable Richard D. Brown, Secretary of Finance

Joint Legislative Audit and Review Commission
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