City of Alexandria, Virginia

MEMORANDUM

DATE: MARCH 14, 2012

TO: THE HONORABLE MAYOR AND MEMBERS OF COUNCIL

FROM: RASHAD M. YOUNG, CITY MANAGER RMY

SUBJECT: BUDGET MEMO #10: USING VIRGINIA TAXABLE INCOME AS THE BASIS FOR THE BUSINESS LICENSE TAX

This budget memo responds to Councilman Rob Krupicka's request that staff analyze the City's ability to base the Business/Professional/Occupational License Tax (BPOL) on Virginia taxable income in lieu of gross receipts.

BACKGROUND: The General Assembly amended the Code of Virginia §58.1-3702 in 2011 to allow localities to levy BPOL on Virginia taxable income in lieu of gross receipts. With the exception of certain businesses that pay flat license taxes and public service corporations, all City businesses would be affected by this change if the City opted to change the basis for levying BPOL. The City would not have the option of using gross receipts for some businesses and Virginia taxable income for others. This would be an "all or nothing" proposition. In the FY 2013 Proposed Budget, BPOL revenues are estimated to be $33 million, or 4.6 percent of the budget.

In the first year of operation, the license tax for new businesses is calculated as follows:

Estimated Gross Receipts	License Tax Calculation
$0 - $99,999	$0
$100,000 - $1,999,999	$50 Flat Fee
$2,000,000 and above	Gross Receipts X Tax Rate

After the first year of operation, the license tax is calculated as follows:

Estimated Gross Receipts	License Tax Calculation
$0 - $9,999	$0
$10,000 - $99,999	$50 Flat Fee
$100,000 and above	Gross Receipts X Tax Rate

The above structure would remain the same if the City chooses to change to the taxable income basis for levying BPOL. Virginia taxable income would simply be substituted for the gross receipts.

DISCUSSION: The Fiscal Impact Statement provided by the Department of Taxation to the Senate Finance Committee provided no fiscal impact information. Since City businesses report only their gross receipts, staff has no means to provide a reliable fiscal impact estimate. However, in analyzing this option, the following issues should be considered when determining how this potential change would affect the City's BPOL revenues in general. These include:

1. Virginia taxable income will always be lower than gross receipts for all business types.
2. The differences in taxable income calculations related to organizational structure would create a significant disparity in tax obligations between otherwise similar businesses.
3. Taxable income includes deductions and exemptions that are unrelated to business operations but would create a further disparity in tax obligations by organization structure.
4. This change would increase revenue volatility due to the effects of state and federal tax laws on the calculation of Virginia taxable income and the greater variability of profits as compared to receipts.
5. The change could make BPOL administration more complex and more costly for both the City and City businesses.

Taxable Income

Gross receipts are defined as the whole, entire, total receipts attributable to the licensed privilege, without deductions. Virginia taxable income includes various federal and state tax deductions and exemptions and will, therefore, always be lower than gross receipts. This basic difference between gross receipts and Virginia taxable income would lead directly to a reduction in City BPOL revenues. The amount of the total reduction cannot be calculated at this time.

Organizational Structure

However, staff can determine that the tax reduction for specific businesses would depend on how each individual business is organized. In Virginia, only C Corporations file and pay corporate income taxes, which are calculated using federal taxable income as a starting point. Sole proprietors file and pay individual income taxes, which are calculated using federal adjusted gross income as a starting point. The owners and/or shareholders of pass-through entities (PTEs), such as partnerships, limited liability companies, and S corporations, report these businesses' taxable income on their own individual income tax returns. If any of the owners or shareholders are non-residents, the PTE may file a unified income tax return for those non-resident owners and shareholders. Since the individual income tax system permits a host of deductions and exemptions not available in the corporate income tax system and PTE taxable income may be spread across multiple individual income tax returns (and thus subject to the deductions and exemptions available to each owner or shareholder), this difference would act to the detriment of C corporations and, to some extent, sole proprietorships. While all businesses would receive a tax reduction, this disparity, which would result in differing tax obligations for otherwise similarly situated businesses, may become a point of contention. Ultimately, the disparity could discourage C corporations and sole proprietorships from locating in the City or encourage them to further lower their BPOL liabilities by reorganizing as PTEs.

Unrelated Deductions

Whether they file and pay corporate income tax or individual income tax, City businesses' taxable income would reflect a variety of federal and state deductions and exemptions completely unrelated to the operations of the business. For corporate income tax filers (C corporations), these would include deductions for income received from federal instruments and income received from foreign sources, deductions for dividends from stock in domestic international corporations, and deductions for contributions to the Virginia Public School Construction Grants Program and Fund. For individual income tax filers (sole proprietorships and PTEs), this would include but not be limited to standard personal exemptions as well as deductions for:

- Health savings accounts;
- Contributions to certain retirement accounts;
- Alimony payments;
- Student loan interest payments; and
- Child care costs.

Since the taxable income of PTEs may be distributed across multiple individual income tax returns, these deductions may apply multiple times. As above, this would create a tax disparity between businesses that have similar City operations, such as business size and profitability, and would generally disfavor C corporations and, to some extent, sole proprietorships. It would also represent a reduction in City revenues beyond what can reasonably be justified by the desire to make business license taxes more reflective of business realities.

Volatility of Tax Revenues

In addition to the factors described above, which would reduce revenues generally and cause disparities in BPOL assessments, the change would lead to greater volatility in BPOL revenues, because taxable income shows greater variation year-to-year than gross receipts. First, Virginia taxable income levels are sensitive to changes in federal and state tax policy. Policy fluctuations from one year to the next could create significant increases or decreases in City BPOL revenues that would be difficult to forecast in the medium and long term. Second, as discussed in JLARC's *Review of Virginia's Corporate Income Tax System* (dated November 2010), "Corporate net income tends to fluctuate substantially because businesses must often bear fixed costs that cannot be reduced to fully compensate for a decline in sales. As a result, the proportional change in profitability and net income can be greater than the corresponding change in sales, whether positive or negative." While JLARC was specifically addressing corporate income taxes, this same increased volatility would also affect sole proprietorships and PTEs.

Administration Complexity and Costs

Finally, switching from gross receipts to Virginia taxable income could make BPOL filing and administration more complex and, by extension, more costly for both the City and City businesses. This increase in complexity and cost would be related to the following factors:

1. Gross receipts for a business will generally be reflected in the businesses' books and, since no deductions are permitted, are relatively easy to calculate. Virginia taxable income for PTEs may be spread out over multiple owners or shareholders and, therefore, over multiple income tax returns.
2. The income tax returns for sole proprietors and PTE owners or shareholders may include reported income not related to the operation of the business.
3. While businesses will often keep separate sets of books for individual locations, a single income tax return may reflect income from multiple locations, making it more difficult to calculate, report, or audit the amount of business income that should be reported to each locality.
4. The City taxes different types of business activity at different rates. Businesses that conduct multiple activities at a single location are required to have multiple business licenses. It would be difficult to determine from income tax returns how much of a business' taxable income is attributable to each business activity.

Under the new standard, City auditors and/or City businesses filing business tax returns would have to review either one or multiple income tax returns for a single business, determine how much of the taxable income is attributable to the business enterprise, determine how much of the taxable income is related to each business activity (if there is more than one), and determine how any deductions and exemptions can be legally applied to the business-related income or apportioned amongst multiple business activities or locations. Determining how to apportion taxable income amongst multiple business activities or locations could require a review of both the businesses' books and all related tax returns. Allowing each owner or shareholder of a PTE to file a separate business license tax return could solve some of these problems; however, it would also increase processing time and administration costs. For many small businesses, which rarely have tax professionals on staff, the increased complexity involved in calculating their BPOL liability could force them to seek and pay for outside tax preparation services.

FISCAL IMPACT: As stated above, the fiscal impact cannot be estimated at this time. However, using Virginia taxable income as the basis of assessment would reduce BPOL revenues, would increase revenue volatility, would increase administration costs, and could create disparities in tax obligations for similarly situated businesses.

JLARC has initiated a fiscal analysis of restructuring BPOL in this manner; however, that study is not expected to be completed until 2013.