Economic Impact Analysis
Virginia Department of Planning and Budget

23 VAC 10-110 – Individual Income Tax
Department of Taxation
January 10, 2001

The Department of Planning and Budget (DPB) has analyzed the economic impact of this proposed regulation in accordance with Section 9-6.14:7.1.G of the Administrative Process Act and Executive Order Number 25 (98). Section 9-6.14:7.1.G requires that such economic impact analyses include, but need not be limited to, the projected number of businesses or other entities to whom the regulation would apply, the identity of any localities and types of businesses or other entities particularly affected, the projected number of persons and employment positions to be affected, the projected costs to affected businesses or entities to implement or comply with the regulation, and the impact on the use and value of private property. The analysis presented below represents DPB's best estimate of these economic impacts.

Summary of the Proposed Regulation

The Department of Taxation (department) proposes to add four sections to the Individual Income Tax regulations in order to govern the Qualified Equity and Subordinated Debt Investments Tax Credit program. The proposed new sections have been in effect as emergency regulations, which expired in February 2000.

Estimated Economic Impact

The 1998 session of the General Assembly enacted Chapter 491 that established a new program in the Commonwealth to stimulate capital investment in selected small businesses. The Qualified Equity and Subordinated Debt Investments Tax Credit program provides for a maximum tax credit equal to 50% of the amount of the investment. The amount of the credit that may be taken in any taxable year is limited to the lesser of the state income tax imposed on the taxpayer for the taxable year, or $50,000. In order for an investment to qualify under this program, the investment must be in a qualified business. According to Section 58.1-339.4 of the

Code of Virginia, "qualified" businesses are required to have gross revenues of no more than $5 million, be domiciled in Virginia, and conduct most of their business in the Commonwealth. Several types of businesses do not qualify as "qualified" businesses, including but not limited to financial institutions, professional service corporations, governmental and charitable institutions, real estate firms, and business consulting firms. An investment shall not be qualified if the taxpayer who has made the investment, or any of such taxpayer's family members, or any entity affiliated with such taxpayer, receives or has received compensation from the qualified business in exchange for services provided to such businesses as an employee, officer, director, manager, or independent contractor.

The proposed new sections of the regulations set forth the operating procedures of the program, including the process for applying for a credit, what types of businesses are eligible and ineligible, and the procedures to be used to ensure that the dollar volume of tax credits awarded for a given taxable year does not exceed the statutory limit of $5,000,000. If the value of tax credits correctly claimed in a given taxable year exceed $5,000,000, then each taxpayer will be awarded prorated credits. Specifically, the new sections of the regulations state that "the amount of such prorated credit shall be determined by multiplying a fraction, the numerator of which shall be the credit requested by the eligible taxpayer for such year, and the denominator of which shall be the total credits requested by all eligible taxpayers for such taxable year, by the Commonwealth's annual fiscal limitation of $5 million." For example, if $10 million in tax credits are correctly requested in a given taxable year, each qualified taxpayer will be awarded 50%[1] of the credit correctly requested for that year. Individual taxpayers may use only $50,000 of the awarded prorated credit in any given year. If the awarded prorated credit exceeds $50,000 for an individual taxpayer, the credit may be taken in annual increments of $50,000 for up to 15 years.

For taxable year 1999, requested credits totaled $8.24 million, exceeding the $5 million statutory cap. Qualified investors were awarded a 60.67% proration of their requested credit.[2] According to the department, applications received for taxable year 2000 indicate that the cap will again be exceeded; approved applicants will receive a yet to be determined prorated credit.

[1] Calculation: $5 million divided by $10 million equals 0.5 or 50%.
[2] Source: Department of Taxation

Under the proration system, taxpayers are uncertain as to how much in tax credits they will receive for their qualified investments at the time the investment decision is made. The uncertainty may discourage some potential investments. But the uncertainty of the proration system seems necessary with the presence of the cap on tax credits under this program.

A limited number of investors (164 in taxable year 1999)[3] will clearly benefit from the Qualified Equity and Subordinated Debt Investments Tax Credit program, in the form of lower state taxes due. Also, some small businesses (62 in 1999, 54 in 2000)[4] will benefit by receiving additional investment. Some of the investments that are declared qualified for this program would likely have been made even without this program. Other investments, or increases in the quantity of investments made, will likely be due to the tax credit incentives of the program. The additional investments made in small businesses due to the incentives of this program may allow some businesses to expand and others to avoid bankruptcy who otherwise would have been unable to do so. This may lead to the creation or preservation of jobs, and increasing or preservation of demand for supplies and services from other businesses, etc, that otherwise would not have occurred. No data is available indicating the number of jobs that will be created or maintained due to investments prompted by this program; nor is there data indicating by how much demand for supplies and services from other businesses will increase due to investments prompted by this program.

On the other hand, the Commonwealth will award $5 million a year in tax credits.[5] The amount of tax credits actually used from those earned under this program may be more or less than $5 million in any given year. The credits will create lost revenue for the Commonwealth. These dollars, if not issued as tax credits under this program, could be used for expenditures on programs that benefit citizens of the Commonwealth, funding for the Revenue Stabilization Fund, or tax cuts for a broader or different portion of Virginia taxpayers. Governing the Qualified Equity and Subordinated Debt Investments Tax Credit program will also create administrative costs. For Fiscal Year 2001, the department has $203,574 budgeted to run three programs that include tax credit caps. The preponderance of that cost is attributable to the

[3] Source: Department of Taxation
[4] Ibid
[5] Less than $5 million in tax credits may be requested and approved in some future years. Thus far though, the amount requested and approved has been well above $5 million.

Qualified Equity and Subordinated Debt Investments Tax Credit program.[6] Since there are some initial costs associated with setting up systems to run the program that will not exist or will be smaller in future years, the administrative cost of running the program is expected to be somewhat smaller in future years.

Whether the benefits of the program outweigh the costs depend on how the benefits and costs are valued. In order for a fair comparison to be made, reasonable estimates of the following benefit components are necessary: the portion of qualified investments that would have not been made without the existence of this program, the number and value of jobs that are created or preserved due to the qualified investments that would have not been made without the existence of this program, and the value of increased or preserved demand for goods and services from suppliers of the qualified businesses that otherwise would not have occurred, etc. Since none of this data is available, an accurate comparison of the benefits with the costs of the program cannot be made.

Businesses and Entities Affected

The proposed new sections to the regulations will affect taxpayers who wish to apply for the tax credit, and the small businesses that those taxpayers invest in. For taxable year 1999, there were 164 taxpayers who applied for and were approved for the tax credit. For taxable year 1999, there were 62 businesses that had applications for the "qualified business" designation approved. For taxable year 2000, there were 54 businesses that had their applications approved.[7] According to the department, "the largest number of applications were made by manufacturers and technology businesses (ISPs, computer and information services, biotech and dotcoms). In addition, there is a wide diversity of companies that were approved, including commercial fishing, chemical manufacturing, electronic voting, scrape metal recycling, farming, and a manufacturer of three dimensional holograms."

Localities Particularly Affected

The proposed regulations potentially affect investors and small businesses throughout the Commonwealth.

[6] Source: Department of Taxation
[7] The Department of Taxation provided all of the data in this paragraph.

Projected Impact on Employment

The Qualified Equity and Subordinated Debt Investments Tax Credit program will likely encourage some investments in small businesses that otherwise would not have occurred. These investments may allow some businesses to expand and others to avoid bankruptcy. Thus, the program will likely have a positive impact on employment.

Effects on the Use and Value of Private Property

Since the program will likely encourage private investment, the value of small businesses that receive such investments will increase.