

**WEST VIRGINIA
TAX EXPENDITURE
STUDY**

**Expenditures
for
Corporation Net Income Tax,
Business Franchise Tax
and Personal Income Tax**

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EXECUTIVE SUMMARY

This report covers West Virginia's Personal Income Tax and two major broad-based business taxes, the Corporation Net Income Tax and the Business Franchise Tax. The report analyzes all provisions involving exclusions, exemptions, deductions or credits for these three taxes. Some of these provisions constitute government expenditure programs while others are an integral part of the basic tax structure.

Corporation Net Income Tax

The section on Corporation Net Income Tax provides analysis of explicit and implicit provisions in the laws of West Virginia and the United States that may be considered tax expenditures for this tax. Domestic and foreign corporations doing business in West Virginia are subject to the Corporation Net Income Tax. Some businesses, such as insurance companies and subchapter S corporations, are exempt from this tax. The Corporation Net Income Tax is levied on federal taxable income adjusted and apportioned according to State law. Some of these adjustments, along with the various exemptions for businesses specifically excluded from taxation, represent tax expenditures for the Corporation Net Income Tax. In addition, West Virginia law provides a variety of tax credits that can be used against Corporation Net Income Tax liability. These credits are also considered tax expenditures.

Business Franchise Tax

The section on Business Franchise Tax provides analysis of tax expenditures for this tax. Partnerships and corporations are subject to the Business Franchise Tax, which is a tax on the privilege of doing business in West Virginia. Business Franchise Tax liability is based on the capital of the corporation or partnership with certain adjustments. The very definition of the tax exempts those businesses with no definable capital, such as sole proprietors and political subdivisions of the State, from the tax. Such exemptions represent tax expenditures for the Business Franchise Tax. Adjustments to the capital of a corporation or partnership are also tax expenditures. As with the Corporation Net Income Tax, a variety of credits are allowed against Business Franchise Tax liability.

Personal Income Tax

This section of the report provides analysis of the exemptions, exclusions, deductions and credits that can be used to reduce Personal Income Tax liability. The computation of West Virginia Personal Income Tax begins with federal adjusted gross income. The Internal Revenue Code provides for certain exclusions and adjustments in determining federal adjusted gross income. The Personal Income Tax section includes a list of these federal exclusions, but no revenue estimate or

analysis has been provided. West Virginia allows some decreasing modifications to federal adjusted gross income. A deduction is also allowed based on the number of personal exemptions claimed on the federal return. In addition, various credits may be applied to Personal Income Tax liability.

Also included in the Personal Income Tax section is an analysis of four expenditures relating to the taxation of estates and trusts under the Fiduciary Income Tax. Computation of West Virginia Fiduciary Income Tax begins with federal taxable income, as opposed to federal adjusted gross income under Personal Income Tax law. West Virginia taxable income of estates and trusts is derived after specific increasing or decreasing modifications are made to federal taxable income.

INTRODUCTION

West Virginia Code §11-10-5s(c) requires a tax expenditure report to be submitted to the Legislature by January 15th of each year. In three-year cycles, these reports are intended to analyze tax expenditures for most major State taxes. The law defines the term "tax expenditure" as a provision in the tax laws designed to encourage certain kinds of activities or to aid taxpayers in special circumstances. Such provisions generally include exclusions, exemptions, deductions, adjustments, credits and deferrals from tax.

The Tax Commissioner has promulgated rules setting forth a procedure and timetable for such reports. This report covers the **Corporation Net Income Tax, Business Franchise Tax and Personal Income Tax**. Other reports cover all other taxes administered by the State Tax Department.

OVERVIEW

The Corporation Net Income Tax, Business Franchise Tax and Personal Income Tax accounted for \$1.7 billion, or 45.9 percent, of the total General Revenue Fund collections in Fiscal Year 2007. Collections for these taxes as a percentage of the total General Revenue Fund increased from roughly 40.5 percent in FY2004. Growth in tax collections over the past several years was attributable to overall strength in the economy. Profit and income growth led to an increase in both corporate and personal income tax collections.

The revenue share attributable to the Corporation Net Income Tax and the Business Franchise Tax rose significantly from 5.9 percent in FY2004 to 9.6 percent in FY2007. The increase was attributable to continued strength in corporate profits and overall economic growth in the U.S.

WEST VIRGINIA GENERAL REVENUE FUND PERCENTAGE YIELD

| <u>Revenue Source</u> | <u>FY 2004</u> | <u>FY 2005</u> | <u>FY 2006</u> | <u>FY 2007</u> |
|---|----------------|----------------|----------------|----------------|
| Personal Income | 34.6% | 33.4% | 35.4% | 36.3% |
| Corporation Net Income/ Business Franchise | <u>5.9</u> | <u>8.0</u> | <u>9.5</u> | <u>9.6</u> |
| Total | 40.5% | 41.4% | 44.9% | 45.9% |

Most exclusions, exemptions, deductions and credits associated with these taxes may be viewed as tax expenditures. Such tax expenditures tend to escape the usual legislative scrutiny afforded other expenditures in the annual budget approval process because provisions in the tax law often remain intact indefinitely. Programs funded through tax expenditures in effect receive priority funding over all other programs. The goal of this report is to facilitate an examination of Corporation Net Income Tax, Business Franchise Tax and Personal Income Tax expenditures using available resources.

ESTIMATING COSTS OF TAX EXPENDITURES

This study provides estimates of the value of Corporation Net Income Tax, Business Franchise Tax and Personal Income Tax expenditures and certain provisions considered necessary to define a model tax structure. Except where otherwise noted, each expenditure within the study is examined independently from all other expenditures. Following the establishment of a value in isolation, the influence of outside factors (i.e., other expenditures and taxpayer behavior) is discussed, where applicable.

Several sources of information were used in the construction of expenditure valuations. These include, among others:

1. tax return data;
2. alternative tax data, and
3. fiscal note estimates.

Databases were constructed from samples of Personal Income Tax, Business Franchise Tax and Corporation Net Income Tax returns. These databases were used to estimate some expenditure values. In other cases, actual figures were available for the cost of the expenditure. Also, various books and publications were examined for ideas concerning the rationale for the tax expenditures.

In most cases, the revenue impact attributable to the repeal of a tax expenditure is less than the value of that expenditure. This occurs because tax expenditures tend to overlap one another and taxpayers tend to alter their behavior whenever items of income or equity become taxed for the first time.

CAUTION MUST BE EXERCISED WHEN USING VALUES FROM THIS REPORT AS ESTIMATES OF TAX REVENUE ATTRIBUTABLE TO POTENTIAL TAX LAW CHANGES, DUE TO THE IMPACT OF OVERLAPPING EXPENDITURES AND THE UNCERTAINTY ABOUT HOW TAXPAYERS WILL ALTER THEIR BEHAVIOR IN RESPONSE TO TAX LAW CHANGES. For example, the partial exclusion of a teacher's pension income may overlap the \$8,000 exclusion for senior citizens. Therefore, both exclusions would have to be repealed before the State would receive the full value of the senior citizen exclusion.

RATIONALE SUPPORTING TAX EXPENDITURES

This report also attempts to briefly articulate a rationale for each separate exclusion, exemption, deduction and credit evaluated. The rationales are not intended to be all inclusive. The reader may identify other rationales for the various exclusions, exemptions, deductions and credits in the law. **Due to the lack of formal legislative guidance or history available or preserved when a tax expenditure is adopted, the Department relied solely upon its judgment to formulate the rationales set forth herein.** The reader is left to judge the extent to which a particular rationale is appropriate and the extent to which a particular exemption furthers the preferred activity.

CORPORATION NET INCOME TAX

OVERVIEW

The West Virginia Corporation Net Income Tax is a direct income tax imposed on domestic and foreign corporations engaged in business in West Virginia or deriving income from property, activity or other sources in the State. As set forth in the Legislative regulations, the tax is described in 110 C.S.R. 24, §110-24-2 as follows:

"The West Virginia Corporation Net Income Tax became effective July 1, 1967, and is a conformity tax in that it utilizes federal taxable income as a starting point to determine West Virginia taxable income and in that it adopts federal definitions wherever possible. Although the West Virginia Corporation Net Income Tax is not a unitary tax, it does, in many aspects resemble a modified waters edge unitary tax, with a throwout rule rather than a throwback rule."

The unitary concept requires affiliated corporations to file combined, or consolidated, returns. Combined reporting treats the affiliated corporations as if they were divisions of one corporation rather than separate corporations. "Water's edge" computation includes only the affiliated corporations' activities in the United States as opposed to worldwide consolidation.

Corporations that file a consolidated return for federal tax purposes may, at the taxpayer's election, file a consolidated West Virginia return. This treatment, together with exclusions for foreign income, justifies the characterization of the West Virginia Corporation net Income Tax as a modified "water's edge" unitary tax. However, for tax years beginning on or after January 1, 2009, corporations engaged in an unitary business with one or more other corporations must file a combined return which includes the income of all corporations that are members of the unitary business.

Computation of the Corporation Net Income Tax begins with federal taxable income modified by specific additions and subtractions. A corporation's income is subject to tax without allocation or apportionment if the entire business is transacted within West Virginia. For multistate corporations, certain income items are allocated or apportioned to West Virginia according to State law. The allocated items are rents and royalties from real or tangible personal property, capital gains, interest and dividends, and patent or copyright royalties. This type of income is generally allocated to West Virginia if the situs of the income-producing property is in the State. Non-allocated income is apportioned by a three-factor formula of property, payroll and sales. A double weight is applied to the sales factor. West Virginia allocated income plus non-allocated income apportioned to the State becomes taxable income. An adjustment to taxable income is also made for West Virginia net

operating losses. Adjusted taxable income after net operating loss deductions is subject to an 8.75 percent¹ tax.

A large percentage of the Corporation Net Income Tax collections is remitted by a relatively few businesses. Since this tax is imposed on net income, collections of the Corporation Net Income Tax can vary significantly from one year to the next based upon the economic status of a few companies.

ORGANIZATION AND ANALYSIS

The Corporation Net Income Tax expenditures discussed in this report are divided into seven groups:

- Businesses Exempt from Taxation
- Federal Taxable Income Expenditures
- Modifications Decreasing Federal Taxable Income for State Tax Purposes
- Apportionment Factor Adjustments
- Modifications Decreasing West Virginia Taxable Income
- Credits
- Duplicate Tax Expenditure Benefits

The analysis provided for each tax expenditure includes the item's cost to the State, a rationale and where applicable, an analysis of the possible revenue scenarios if an expenditure was repealed.

¹ The tax rate was reduced from 9 percent to 8.75 percent effective for tax years beginning on or after January 1, 2007.

BUSINESSES EXEMPT FROM TAXATION

Selected businesses are exempt from Corporation Net Income Tax due to the structure of the business or the nature of the business activity. The following businesses are exempt:

Sole Proprietorships, Partnerships and Subchapter S Corporations
Various Miscellaneous Businesses

An analysis of these exemptions follows.

SOLE PROPRIETORSHIPS, PARTNERSHIPS AND SUBCHAPTER S CORPORATIONS

STATUTE: West Virginia Code §§11-24-3a(4) and 11-24-5(d)

EXEMPTION: The term "corporation" includes a joint-stock company and any association or other organization which is taxable as a corporation under the federal income tax law [which excludes sole proprietorships and partnerships] (W. Va. Code §11-24-3a(4))
Corporations electing to be taxed under subchapter S of the Internal Revenue Code of one thousand nine-hundred eighty-six, as amended (W. Va. Code §11-24-5(d))

| | | |
|---------------|----------------------------|---------------------------------|
| VALUE: | Sole Proprietorships: | \$ 2.7 million per year |
| | Partnerships: | \$82.4 million per year |
| | Subchapter S Corporations: | \$27.9 million per year |
| | TOTAL | \$113.0 million per year |

Rationale

Since the Corporation Net Income Tax is only levied on businesses organized as corporations, an implied exemption exists for businesses organized as sole proprietorships or partnerships. This exemption presumably exists for ease of administration and to avoid double taxation of the business income of the sole proprietor or partnership. Income of businesses organized as sole proprietorships or partnerships is generally included on the Personal Income Tax return of the proprietor or partnership. However, if the partner is itself a corporation, the income is reported on the Corporation Net Income Tax return. Therefore, subjecting these businesses to the Corporation Net Income Tax without removing the income from taxation under the Personal Income Tax statute would subject some business income to double taxation. Additionally, computation of the West Virginia Corporation Net Income Tax begins with taxable income as reported on the federal

corporation income tax return. The absence of similar federal net income tax returns for sole proprietors and partnerships would make administration of a tax on these businesses more difficult. West Virginia follows the federal practice of classifying limited liability companies as partnerships unless they are organized as corporations.

The income of subchapter S corporations is passed through to the stockholders of the corporation. Stockholders include income from the corporation on their individual income tax returns. The exemption for subchapter S corporations exists to avoid the double taxation of the income of these businesses (once under the Corporation Net Income Tax and once under the Personal Income Tax).

Revenue Analysis

The expenditure values above were made in isolation from any other factors that could affect taxable income. If the business income of these businesses was subject to the Corporation Net Income Tax and removed from taxation under the Personal Income Tax, the net gain in State revenue would be approximately \$1.3 million for sole proprietors, \$41.2 million for partnerships and \$13.9 million for subchapter S corporations.

VARIOUS MISCELLANEOUS BUSINESSES

| | | | | | | | | | | | | | | | | | | | | | |
|-------------------------------------|--|--------------------|----------------------|--------------------------------|--------------------------------|----------------------|----------------------|---------------------------------|----------------|---------------------|----------------|----------------------|--|------------------------------|----------------|-------------------------------------|----------------------|------------------------------|----------------------|------------------------------------|----------------------|
| STATUTE: | United States Code 15 U.S.C. §381 et seq. (United States Public Law 86-272) West Virginia Code §§11-24-5(a), 11-24-5(b), 11-24-5(c), 11-24-5(e), 19-23-12, 31-10-33, 33-22-16, 33-23-29(b) and 33-24-4 | | | | | | | | | | | | | | | | | | | | |
| EXEMPTION: | Corporations Whose Only Activity Is Solicitation of Sales (15 U.S.C. §381 et seq. (United States Public Law 86-272)) Corporations Exempt from Federal Income Tax (W. Va. Code §11-24-5(a)) Insurance companies which pay this State a tax upon premiums (W. Va. Code §11-24-5(b)) Production Credit Associations (Farm Credit Act of 1933) (W. Va. Code §11-24-5(c)) Section 186 Trusts (W. Va. Code §11-24-5(e)) Horse or Dog Tracks (W. Va. Code §19-23-12) Capital Stock Credit Unions (W. Va. Code §31-10-33) Farmer's Mutual Fire Insurance Companies (W. Va. Code §33-22-16) Fraternal Benefit Societies (W. Va. Code §33-23-29(b)) Nonprofit Hospital, Medical, Dental and Health Service Corporations (W. Va. Code §33-24-4) | | | | | | | | | | | | | | | | | | | | |
| VALUE: | <table><tr><td>Public Law 86-272:</td><td>Not Available</td></tr><tr><td>Federally Exempt Corporations:</td><td>\$13.4 million per year</td></tr><tr><td>Insurance Companies:</td><td>Not Available</td></tr><tr><td>Production Credit Associations:</td><td>Minimal</td></tr><tr><td>Section 186 Trusts:</td><td>Minimal</td></tr><tr><td>Horse or Dog Tracks:</td><td>Cannot be Disclosed¹</td></tr><tr><td>Capital Stock Credit Unions:</td><td>Minimal</td></tr><tr><td>Farmer's Mutual Fire Insurance Co.:</td><td>Not Available</td></tr><tr><td>Fraternal Benefit Societies:</td><td>Not Available</td></tr><tr><td>Nonprofit Healthcare Corporations:</td><td>Not Available</td></tr></table> | Public Law 86-272: | Not Available | Federally Exempt Corporations: | \$13.4 million per year | Insurance Companies: | Not Available | Production Credit Associations: | Minimal | Section 186 Trusts: | Minimal | Horse or Dog Tracks: | Cannot be Disclosed¹ | Capital Stock Credit Unions: | Minimal | Farmer's Mutual Fire Insurance Co.: | Not Available | Fraternal Benefit Societies: | Not Available | Nonprofit Healthcare Corporations: | Not Available |
| Public Law 86-272: | Not Available | | | | | | | | | | | | | | | | | | | | |
| Federally Exempt Corporations: | \$13.4 million per year | | | | | | | | | | | | | | | | | | | | |
| Insurance Companies: | Not Available | | | | | | | | | | | | | | | | | | | | |
| Production Credit Associations: | Minimal | | | | | | | | | | | | | | | | | | | | |
| Section 186 Trusts: | Minimal | | | | | | | | | | | | | | | | | | | | |
| Horse or Dog Tracks: | Cannot be Disclosed¹ | | | | | | | | | | | | | | | | | | | | |
| Capital Stock Credit Unions: | Minimal | | | | | | | | | | | | | | | | | | | | |
| Farmer's Mutual Fire Insurance Co.: | Not Available | | | | | | | | | | | | | | | | | | | | |
| Fraternal Benefit Societies: | Not Available | | | | | | | | | | | | | | | | | | | | |
| Nonprofit Healthcare Corporations: | Not Available | | | | | | | | | | | | | | | | | | | | |

Rationale

These businesses are exempt from the West Virginia Corporation Net Income Tax for a variety of reasons. In some cases (e.g., Corporations Whose Only Activity Is Solicitation of Sales), federal law precludes the State from levying a tax on the specified business. Ease of administration (i.e., Corporations Exempt from Federal Income Tax), double taxation concerns (i.e., Insurance

¹ Due to taxpayer confidentiality

companies which pay this State a tax upon premiums) and the encouragement of certain business activities are some of the other reasons for these exemptions.

FEDERAL TAXABLE INCOME EXPENDITURES

The use of federal taxable income as a starting point for the calculation of West Virginia Corporation Net Income Tax includes various allowances for federal tax expenditures. The following is considered a tax expenditure for the purposes of this study:

Federal Tax Expenditures Incorporated Within the State Tax Structure

An analysis of this expenditure follows.

FEDERAL TAX EXPENDITURES INCORPORATED WITHIN THE STATE TAX STRUCTURE

STATUTE: West Virginia Code §11-24-3a(25)

EXCLUSION: The term "West Virginia taxable income" means the taxable income of a corporation as defined by the laws of the United States for federal income tax purposes, adjusted, as provided in West Virginia Code §11-24-6

| | | |
|---------------|---|--------------------------|
| VALUE: | Cost of goods sold: | \$2,486.3 million |
| | Compensation of officers: | \$67.6 million |
| | Salaries and wages less employment credits: | \$443.1 million |
| | Repairs and Maintenance: | \$31.9 million |
| | Bad debts: | \$35.9 million |
| | Rents: | \$82.7 million |
| | Taxes and licenses: | \$91.0 million |
| | Interest: | \$241.8 million |
| | Charitable contributions: | \$3.1 million |
| | Depreciation: | \$167.1 million |
| | Depletion: | \$3.3 million |
| | Advertising: | \$54.2 million |
| | Pension, profit-sharing, etc., plans: | \$35.2 million |
| | Employee benefit programs: | \$65.8 million |
| | Other deductions: | \$538.6 million |
| | Special deductions: | \$43.3 million |

Rationale

Since West Virginia uses federal taxable income as the starting point for the calculation of the Corporation Net Income Tax, deductions granted in the calculation of federal taxable income become implied exclusions from West Virginia taxable income. These implied exclusions exist to ease administration of the Corporation Net Income Tax. As stated in West Virginia Code §11-24-1, "the adoption by this State for its corporation net income tax purposes of certain provisions of the laws of the United States relating to the determination of income for federal income tax purposes will (1) simplify preparation of state corporation net income tax returns by taxpayers, (2) improve enforcement of the state corporation net income tax through better use of information obtained from federal income tax audits, and (3) aid interpretation of the state corporation net income tax law through increased use of federal judicial and administrative determinations and precedents."

The Corporation Net Income Tax is often equated to a tax on profits. Some of the items mentioned above, such as cost of goods sold, are an integral part of the definition of net income or profit. Those items necessary for the definition of net income may **not** be tax expenditures. However, the inclusion of other items, such as employee benefit programs, may not necessarily be required to define net income and therefore may constitute tax expenditures.

Revenue Analysis

The expenditure values presented in this section were calculated in isolation from any other listed expenditure. Also, calculation of the expenditure value was made without consideration of any portion of the exclusion added back pursuant to West Virginia Code §11-24-6(b). Thus, caution should be used in adding the values presented above.

MODIFICATIONS DECREASING FEDERAL TAXABLE INCOME FOR STATE TAX PURPOSES

Several deductions are available to corporations in West Virginia as decreasing modifications to federal taxable income in determining taxable income for State purposes. These modifications exist for one of the following reasons:

1. to account for deviations between federal statutes and the West Virginia Code;
2. to account for income for which states are prohibited from taxing, or
3. to remove from taxable income amounts that were added to current federal taxable income and related to prior year deductions not permitted by West Virginia.

West Virginia has codified the following decreasing modifications:

Gain on Sale of Property Acquired Prior to July 1, 1967
Refund or Credit for Overpayment of Income-Based Taxes
Reserve Bad Debt Deduction
Disallowed Interest Expense
Section 78 Dividends Received from Foreign Corporations
Salary Expense Not Allowed as a Federal Deduction
Subpart F Income
Employer Contributions to Medical Savings Accounts
Foreign Source Income
West Virginia Water or Air Pollution Control Facilities
Federal Obligations
West Virginia Obligations
Investments Secured by Mortgages and Loans on Residential Property

An analysis of these modifications follows.

**GAIN ON SALE OF PROPERTY
ACQUIRED PRIOR TO JULY 1, 1967**

STATUTE: West Virginia Code §11-24-6(c)(1)

EXCLUSION: There shall be subtracted from federal taxable income to the extent included therein: Any gain from the sale or other disposition of property having a higher fair market value on the first day of July, one thousand nine-hundred sixty-seven, than the adjusted basis at said date for federal income tax purposes

VALUE: Not Available

Rationale

This modification exists to exclude income earned before the effective date of the Corporation Net Income Tax but realized after that date. The Corporation Net Income Tax was enacted in 1967 with application to income earned after June 30, 1967. When property purchased before July 1, 1967 is sold after that date, the difference between the sales price and the adjusted federal basis on July 1, 1967 represents a gain (or loss) on the property. Normally, any gain is reported as income on the federal income tax return. If the fair market value on July 1, 1967 was greater than the adjusted federal basis on July 1, 1967, the difference is deemed attributable to income earned before the enactment of the West Virginia Corporation Net Income Tax. The difference, representing income earned before July 1, 1967, is thus excluded from the State tax base.

This exclusion exists as a grandfather clause for those who owned or purchased property before the effective date of the Corporation Net Income Tax statute in 1967. Similar provisions for the Personal Income Tax were eliminated in 1987 and legislation enacted in 2007 provides for the elimination of the Corporation Net Income Tax modification for tax years beginning on or after January 1, 2009.

Revenue Analysis

Sales of qualified property could vary significantly from year to year. Additionally, the pending elimination of the modification may result in changes in taxpayer behavior to take advantage of the modification before January 1, 2009.

**REFUND OR CREDIT FOR
OVERPAYMENT OF INCOME-BASED TAXES**

STATUTE: West Virginia Code §11-24-6(c)(2)

EXCLUSION: There shall be subtracted from federal taxable income to the extent included therein: The amount of any refund or credit for overpayment of income taxes and other taxes, including franchise and excise taxes, which are based on, measured by, or computed with reference to net income, imposed by this state or any other taxing jurisdiction, to the extent properly included in gross income for federal income tax purposes

VALUE: **Minimal**

Rationale

For State purposes, West Virginia requires taxpayers to add back to federal taxable income the income tax deduction. State and local income taxes are deducted on the federal return for the tax year in which the payments are made. However, any refund is included in federal taxable income for the tax year in which it is received. Since West Virginia does not allow the federal deduction for income taxes paid, a refund included in federal taxable income may be deducted for State purposes. This exclusion eliminates double taxation of this refund amount and therefore is **not** a tax expenditure.

RESERVE BAD DEBT DEDUCTION

STATUTE: West Virginia Code §11-24-6(c)(3)

EXCLUSION: There shall be subtracted from federal taxable income to the extent included therein: The amount added to federal taxable income due to the elimination of the reserve method for computation of the bad debt deduction

VALUE: **Not Available**

Rationale

The federal Tax Reform Act of 1986 eliminated the reserve method for computing bad debts for all taxpayers, except savings and loans and small banks (assets of \$500 million or less). Whenever savings and loans or small banks are acquired by businesses that do not qualify for the reserve method, the reserve bad debt must be added to taxable income to comply with the 1986 legislation. The West Virginia expenditure presumably exists because the reserve bad debt would be a valid business deduction, except for the nature or size of the business that acquires other companies qualified to use the reserve bad debt method.

DISALLOWED INTEREST EXPENSE

STATUTE: West Virginia Code §11-24-6(c)(4)

EXCLUSION: There shall be subtracted from federal taxable income to the extent included therein: The full amount of interest expense actually disallowed in determining federal taxable income which was incurred or continued to purchase or carry obligations or securities of any state or of any political subdivision thereof

VALUE: **\$350,000 per year**

Rationale

This expenditure presumably exists in recognition that the identified interest expense is a normal business expense at the state and local government level. Interest income from state and municipal government securities is excluded from income for federal income tax purposes due to the intergovernmental immunity principle. Since it is not included in income for federal income tax purposes, the interest expense related to the exempt obligations is disallowed as a deduction at the federal level.

West Virginia requires taxpayers to make an increasing modification to federal taxable income for State income tax purposes for interest or dividends received from any state or local bonds or securities. While recognizing the interest received on state and local securities as income, this expenditure recognizes that expenses incurred in holding or carrying these securities are legitimate business expenses for State tax purposes.

West Virginia provides a modification to taxable income for its own obligations and those of its political subdivisions. This expenditure is analyzed later in this section.

SECTION 78 DIVIDENDS RECEIVED FROM FOREIGN CORPORATIONS

STATUTE: West Virginia Code §11-24-6(c)(5)

EXCLUSION: There shall be subtracted from federal taxable income to the extent included therein: The amount required to be added to federal taxable income as a dividend received from a foreign (non-United States) corporation under section 78 of the Internal Revenue Code of 1986, as amended, by a corporation electing to take the foreign tax credit for federal income tax purposes.

VALUE: **\$400,000 per year**

Rationale

This exclusion exists to avoid a conflict with federal legislation. According to State Taxation: Corporate Income and Franchise Taxes, "The [U.S. Supreme] court has rebuffed challenges to the inclusion in the apportionable base of State income taxes of dividends paid by a taxpayer's subsidiaries operating in foreign countries, on the ground that such taxation was in conflict with Federal policy."

Taxpayers with dividends from foreign corporations under Section 78 of the Internal Revenue Code may elect to include the dividends in the calculation of income or claim a credit against the calculated tax. If the income is included in federal taxable income, it must be deducted for State tax purposes.

SALARY EXPENSE NOT ALLOWED AS A FEDERAL DEDUCTION

STATUTE: West Virginia Code §11-24-6(c)(6)

EXCLUSION: There shall be subtracted from federal taxable income to the extent included therein: The amount of salary expenses disallowed as a deduction for federal income tax purposes due to claiming the federal jobs credit under section 51 of the Internal Revenue Code of 1986, as amended

VALUE: **\$200,000 per year**

Rationale

Taxpayers claiming a Federal Work Opportunity Tax Credit (formerly the Federal Jobs Credit) on the federal corporation net income tax return must reduce their salary expense deduction for federal tax purposes by the total of salaries upon which the credit is calculated. However, West Virginia does not offer a similar credit. Therefore, such salary expenses are a legitimate business deduction for State tax purposes. This modification is **not** an expenditure.

SUBPART F INCOME

STATUTE: West Virginia Code §11-24-6(c)(7)

EXCLUSION: There shall be subtracted from federal taxable income to the extent included therein: The amount included in federal adjusted gross income by the operation of section 951 of the Internal Revenue Code of 1986, as amended [Subpart F income]

VALUE: **\$800,000 per year**

Rationale

This expenditure exists to preclude double taxation, once by the State and once by a foreign country. Subpart F income is composed of earnings and profits of controlled foreign corporations exclusive of any income from sources within the United States.

The double taxation argument was set forth in Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 99 S. Ct. 1813 (1979). A summary of the ruling as presented in State Taxation: Corporate Income and Franchise Taxes states:

"[N]either this Court nor this Nation can ensure full apportionment when one of the taxing entities is a foreign sovereign. If an instrumentality of commerce is domiciled abroad, the country of domicile may have the right, consistently with the custom of nations, to impose a tax on its full value. If a State should seek to tax the same instrumentality on an apportioned basis, multiple taxation inevitably results. Hence, whereas the fact of apportionment in interstate commerce means that 'multiple burdens logically cannot occur', Washington Revenue Dept. [v. Ass'n of Wash. Stevedoring Cos., 435 US 734, 98 S. Ct. 1388 (1978)], 435 U.S. at 746-747, 98 S. Ct. at 1397-98, the same conclusion, as to foreign commerce, logically cannot be drawn. Due to the absence of an authoritative tribunal capable of ensuring that the aggregation of taxes is computed on no more than one full value, a state tax, even

though 'fairly apportioned' to reflect an instrumentality's presence within the State, may subject foreign commerce 'to the risk of a double tax burden to which [domestic] commerce is not exposed, and which the commerce clause forbids.' *Evco v. Jones*, 409 U.S., at 94, 93 S. Ct. at 351, quoting *J. D. Adams Mfg. Co.*, 304 U.S., at 311, 58 S. Ct. at 915."

If the taxpayer was required to include foreign source income, exclusive of intangibles, in federal taxable income under Internal Revenue Code, Section 951, it may claim an exclusion for this amount. The income of a domestic corporation is taxable by the federal government whether earned in this country or abroad.

EMPLOYER CONTRIBUTIONS TO MEDICAL SAVINGS ACCOUNTS

STATUTE: West Virginia Code §11-24-6(c)(8)

EXCLUSION: There shall be subtracted from federal taxable income to the extent included therein: Employer contributions to medical savings accounts established pursuant to section fifteen, article sixteen, chapter thirty-three of the West Virginia Code to the extent included in federal adjusted gross income for federal income tax purposes less any portion of employer contributions withdrawn for purposes other than payment of medical expenses.

VALUE: **Minimal**

Rationale

This expenditure presumably exists to encourage the formation and use of medical savings accounts.

FOREIGN SOURCE INCOME

STATUTE: West Virginia Code §11-24-6(c)(9)

EXCLUSION: There shall be subtracted from federal taxable income to the extent included therein: Any amount included in federal adjusted gross income which is foreign source income

VALUE: **\$94.2 million per year**

Rationale

This exclusion presumably exists to preclude double taxation, once by the State and once by a foreign country. An explanation of the double taxation argument was presented in an earlier expenditure relating to Subpart F income. A decreasing modification is allowed for foreign source income, as defined, if it was included in federal taxable income, less attributable expenses.

WEST VIRGINIA WATER OR AIR POLLUTION CONTROL FACILITIES

STATUTE: West Virginia Code §11-24-6(e)

EXCLUSION: If the taxpayer so elects under West Virginia Code §11-24-6(e)(2), there shall be: (A) Subtracted from federal taxable income the total of the amounts paid or incurred during the taxable year for the acquisition, construction or development within this state of water pollution control facilities or air pollution control facilities as defined in Section 169 of the Internal Revenue Code; and (B) Added to federal taxable income the total of the amounts of any allowances for depreciation and amortization of the water pollution control facilities or air pollution control facilities, as so defined, to the extent deductible in determining federal taxable income

VALUE: **Cannot be disclosed¹**

Rationale

This expenditure exists to encourage investment in water and air pollution control devices in West Virginia. Deducting the full cost of pollution control devices in a single year provides a greater benefit to the taxpayer than a normal depreciation allowance.

Revenue Analysis

Facility modifications necessary to comply with the Clean Air Act of 1990 may cause the value of this expenditure to fluctuate significantly from year to year.

¹ Due to taxpayer confidentiality

FEDERAL OBLIGATIONS

| | |
|--------------------|---|
| STATUTE: | West Virginia Code §11-24-6(f)(1)(A) |
| ADJUSTMENT: | The West Virginia taxable income of a taxpayer subject to West Virginia Code §11-24 et seq. as adjusted in accordance with subsections (b), (c) and (e) of West Virginia Code §11-24-6 shall be further adjusted by multiplying the taxable income after the adjustment by said subsections by a fraction equal to one minus a fraction: (1) The numerator of which is the sum of the average of the monthly beginning and ending account balances during the taxable year (account balances to be determined at cost in the same manner that obligations, investments and loans are reported on Schedule L of the Federal Form 1120) of the following: (A) Obligations or securities of the United States, or of any agency, authority, commission or instrumentality of the United States and any other corporation or entity created under the authority of the United States Congress for the purpose of implementing or furthering an objective of national policy; . . . (2) The denominator of which is the average of the monthly beginning and ending account balances of the total assets of the taxpayer which are shown on Schedule L of Federal Form 1120, which are filed by the taxpayer with the Internal Revenue Service |
| VALUE: | \$2.7 million per year |

Rationale

This modification exists for compliance with the immunity of the federal government and its instrumentalities from State taxation. Codified in the federal statutes, the prohibition reads in part as follows:

"Except as otherwise provided by law, all stocks, bonds, Treasury notes and other obligations of the United States, shall be exempt from taxation by . . . other State or municipal or local authority."

The statute was revised in 1959 to provide an exception for nondiscriminatory franchise taxes imposed on corporations. The West Virginia Corporation Net Income Tax is a direct tax on net income. Thus, the State cannot subject federal obligations to the tax. If legislative action repealing the above cited adjustment would be enacted, the prohibition against taxation would still exist. Therefore, this modification is **not** a tax expenditure.

WEST VIRGINIA OBLIGATIONS

- STATUTE:** West Virginia Code §11-24-6(f)(1)(B)
- ADJUSTMENT:** The West Virginia taxable income of a taxpayer subject to West Virginia Code §11-24 et seq. as adjusted in accordance with subsections (b), (c) and (e) of West Virginia Code §11-24-6 shall be further adjusted by multiplying the taxable income after the adjustment by said subsections by a fraction equal to one minus a fraction: (1) The numerator of which is the sum of the average of the monthly beginning and ending account balances during the taxable year (account balances to be determined at cost in the same manner that obligations, investments and loans are reported on Schedule L of the Federal Form 1120) of the following: . . . (B) Obligations or securities of this state and any political subdivision or authority thereof; . . . (2) The denominator of which is the average of the monthly beginning and ending account balances of the total assets of the taxpayer which are shown on Schedule L of Federal Form 1120, which are filed by the taxpayer with the Internal Revenue Service
- VALUE:** **\$200,000 per year**

Rationale

The purpose of this expenditure is presumably to reduce the cost of borrowed money for West Virginia and local governments. An adjustment to taxable income for government securities reduces the cost of holding government obligations. The reduced cost makes the securities more attractive to investors and thus makes the marketing of State and local bonds easier. If the security instruments are easier to sell, the governmental unit selling the securities can obtain financing at lower interest rates.

**INVESTMENTS SECURED BY MORTGAGES AND LOANS
ON RESIDENTIAL PROPERTY**

STATUTE: West Virginia Code §§11-24-6(f)(1)(C) and 11-24-6(f)(1)(D)

ADJUSTMENT: The West Virginia taxable income of a taxpayer subject to West Virginia Code §11-24 et seq. as adjusted in accordance with subsections (b), (c) and (e) of West Virginia Code §11-24-6 shall be further adjusted by multiplying the taxable income after the adjustment by said subsections by a fraction equal to one minus a fraction: (1) The numerator of which is the sum of the average of the monthly beginning and ending account balances during the taxable year (account balances to be determined at cost in the same manner that obligations, investments and loans are reported on Schedule L of the Federal Form 1120) of the following: . . . (C) Investments or loans primarily secured by mortgages, or deeds of trust, on residential property located in West Virginia and occupied by nontransients; and (D) Loans primarily secured by a lien or security agreement on residential property in the form of a mobile home, modular home, or double-wide, located in this state and occupied by nontransients. (2) The denominator of which is the average of the monthly beginning and ending account balances of the total assets of the taxpayer which are shown on Schedule L of Federal Form 1120, which are filed by the taxpayer with the Internal Revenue Service

VALUE: **\$15.6 million per year**

Rationale

This expenditure exists to encourage investments or loans on West Virginia residential property occupied by nontransients. The preferential treatment for these obligations presumably lowers the cost of the investment instruments by reducing the tax imposed on the income from the loans. The intention is for part of the reduced cost in holding the identified securities to be passed on to the loan recipients. Thus, housing may be more affordable.

APPORTIONMENT FACTOR ADJUSTMENTS

Taxpayers with business activity in more than one state must apportion such activity among the various jurisdictions. Apportionment is typically based upon three factors (property, payroll and sales). In some cases, deviations from the simple three-factor formula may be considered expenditures. The following apportionment factor adjustments are discussed in this section:

Double-Weighted Sales Apportionment Factor
Alternate Apportionment Formulas

An analysis of these apportionment factor adjustments follows.

DOUBLE-WEIGHTED SALES APPORTIONMENT FACTOR

STATUTE: West Virginia Code §11-24-7(e)
ADJUSTMENT: Double-weighted sales apportionment factor
VALUE: **\$10.3 million per year**

Rationale

This provision presumably exists to shift a greater portion of the tax burden to taxpayers with a significant sales factor in relation to their property and payroll factors. Businesses with larger property and payroll factors in relation to their sales factor benefit from a lower apportioned taxable income compared to taxpayers with a large sales factor in relation to the other factors. An underlying assumption of the double-weighted sales factor is that the companies with relatively larger property and payroll factors make a greater contribution to the State economy. Financial outlays for maintaining property and for paying workers located in the State are assumed to provide a larger direct and indirect impact on the State's economy than the mere sale of goods and services. In rural states, such as West Virginia, the net result of a double-weighted sales apportionment formula is a loss of tax revenue. However, as West Virginia's economy becomes more service-based, the negative effect of the double-weighted sales factor will decrease.

ALTERNATE APPORTIONMENT FORMULAS

| | |
|--------------------|--|
| STATUTE: | West Virginia Code §§11-24-7(h)(1), 11-24-7(h)(2), 11-24-7a(b) and 11-24-7b(f) |
| ADJUSTMENT: | Alternate apportionment formulas |
| VALUE: | Not available |

Rationale

Alternate apportionment formulas exist to fairly apportion taxable income whenever the normal apportionment methodology may not accurately represent the taxpayer's business activities in the State. In addition to an alternate methodology available to all taxpayers (West Virginia Code §11-24-7(h)(1)), alternate formulas are available to public utilities (West Virginia Code §§11-24-7(h)(2)) and are mandated for motor carriers (West Virginia Code §11-24-7a(b)) and financial institutions without a commercial domicile in West Virginia (West Virginia Code §11-24-7b(b)(4)). The taxpayer may petition the State Tax Commissioner, or the State Tax Commissioner may require the taxpayer, to use the general alternate method or public utility alternate method, if applicable. If the alternate formula is used for purposes other than the attainment of a more accurate apportionment figure, then the formula would represent a tax expenditure.

In the case of motor carriers, if the taxpayer has significant property and/or payroll factors in West Virginia, the use of the alternate formula based on vehicle miles may result in lower tax liability. The alternate methodology for financial institutions applies only to those organizations not having their commercial domicile in West Virginia. Without a commercial domicile in the State, it is likely that the organization's property and payroll factors would be small in comparison to the receipts factor. Since apportionment for the identified businesses is accomplished through a single factor closely related to sales, use of the alternate apportionment method will generally result in a higher apportionment factor than that based on the property, payroll and sales methodology. In some cases for motor carriers and in most instances for financial institutions, the alternate methodology may not meet the definition of a tax expenditure.

MODIFICATIONS DECREASING WEST VIRGINIA TAXABLE INCOME

A modification to West Virginia taxable income is available to corporations. The decreasing modification to West Virginia taxable income is as follows:

West Virginia Net Operating Loss Deduction

An analysis of this expenditure follows.

WEST VIRGINIA NET OPERATING LOSS DEDUCTION

STATUTE: West Virginia Code §11-24-6(d)

DEDUCTION: There is allowed as a deduction for the taxable year an amount equal to the aggregate of: (1) The West Virginia net operating loss carryovers to that year; plus (2) the net operating loss carrybacks to that year: Provided, That no more than three hundred thousand dollars of net operating loss from any taxable year beginning after the thirty-first day of December, one thousand nine-hundred ninety-two may be carried back to any previous taxable year

VALUE: **\$82.2 million per year**

Rationale

This expenditure exists to extend the concept of "net income" across multiple years and thus reduce the tax liability of corporations that experience "net losses." In some years, the normal business expenses of a corporation may be greater than income, thus resulting in a "net loss." The carryback and/or carryforward provisions of the net operating loss statute permit the corporation to apply the loss (deductions in excess of income) to other tax years where income exceeded deductions. Thus, instead of the activities of a single year determining taxable income, calculation of taxable income may be based, in part, on activities from other years. However, the West Virginia net operating loss deduction is only available to corporations that did business in West Virginia and filed Corporation Net Income Tax returns in previous tax years. A net operating loss deduction of a multi-state corporation is subject to West Virginia allocation and apportionment rules. Except for

the provision limiting the amount of carryback, West Virginia generally follows Section 172 of the Internal Revenue Code of 1986, as amended¹.

¹ West Virginia Code §11-24-3 provides that terms used in West Virginia Code §11-24 “shall have the same meaning as when used in a comparable context in the laws of the United States relating to federal income taxes, unless a different meaning is clearly required by context or definition ...” The statute defines the term “Internal Revenue Code of 1986” as the Internal Revenue Code of the United States enacted by the “Federal Tax Reform Act of 1986”. The 1986 act provided that net operating losses could be carried back for three years and carried forward for fifteen. However, the “Taxpayer Relief Act of 1997” provides for carry back of two years and carry forward of twenty years.

CREDITS

The West Virginia Code provides for the application of various tax credits against the Corporation Net Income Tax. Some credits provide qualifying businesses with an investment incentive or employment incentive. Others provide relief from double taxation or provide relief to utilities providing aid to low-income households. The following tax credits are grouped by broad-category.

Economic Development Tax Credits

- Economic Opportunity Tax Credit
- Economic Opportunity Tax Credit - High Technology Manufacturers
- Strategic Research and Development Tax Credit
- Manufacturing Investment Tax Credit
- High-Growth Business Investment Tax Credit
- Film Industry Investment Credit

Employment Tax Credits

- Military Employment Incentive Credit
- Apprenticeship Training Credit

Credits That Aid Low-Income Families

- Credit for Reducing Utility Charges to Low-Income Families
- Credit for Reducing Telephone Charges to Low-Income Families

Credit to Prevent Double Taxation

- Commercially Domiciled Financial Organization Tax Credit

Miscellaneous Tax Credits

- Environmental Agricultural Equipment Credit
- Historic Rehabilitated Buildings Investment Credit
- Neighborhood Investment Program Credit
- Credit for Utility Taxpayers with Net Operating Loss Carryovers

Expired and Terminated Tax Credits

Many of the credits listed above may also be applied against other business and personal taxes. Expenditure values presented in this section represent the amounts applied against only Corporation Net Income Tax. Often, the credit claimed against the Corporation Net Income Tax has been reduced by the application of the credit against other taxes according to the priority order specified by statute or regulations. Thus, the credit amounts claimed against Corporation Net Income Tax may be negligible compared to the total cost of the credit taken against all taxes. An analysis of these expenditures follows.

ECONOMIC DEVELOPMENT TAX CREDITS

STATUTES: West Virginia Code §§11-13Q, 11-13R, 11-13S, 11-13U, and 11-13X

CREDITS: Economic Opportunity Tax Credit (W. Va. Code §11-13Q)
Economic Opportunity Tax Credit - High Technology Manufacturers (W. Va. Code §11-13Q-10a)
Strategic Research and Development Tax Credit (W. Va. Code §11-13R)
Manufacturing Investment Tax Credit (W. Va. Code §11-13S)
High-Growth Business Investment Tax Credit (W. Va. Code §11-13U)
Film Industry Investment Tax Credit (W. Va. Code §11-13X)

VALUE: **\$200,000**

Rationale

The Economic Development Tax Credits are generally designed to promote job creation and/or investment within the State. Benefits attributable to the Economic Opportunity Tax Credit, Strategic Research and Manufacturing Investment Tax Credit are generally available over a ten-year period of time while the benefits attributable to the High-Growth Business Investment Tax Credit are available for a five-year period and the Economic Opportunity Tax Credit - High Technology Manufacturers is available for a twenty-year period. However, any unused Film Industry Investment Credit remaining after the second tax year following the tax year in which the qualifying investment was made is forfeited.

The Economic Opportunity Tax Credit exists to encourage greater capital investment in businesses in the State and thus increase economic opportunity. While the base credit program requires the creation of at least twenty new jobs, lower minimum new jobs levels are provided for the Corporate Headquarters Relocation portion of the credit program (minimum of fifteen new jobs) and for the Small Business provision (minimum of ten new jobs). The basis of the program is largely attributable to capital investment, not direct employment growth.

In 2007, legislation was enacted to create a special tax credit for certain manufacturers. The Economic Opportunity Tax Credit - High Technology Manufacturers, effective January 1, 2008, exists to promote job creation in the following industries:

| North American Industry Classification System Code (NAICS) | <u>Manufacturing Activity</u> |
|--|---------------------------------|
| 334111 | Electronic Computers |
| 334112 | Computer Storage Devices |
| 334411 | Electron Tubes |
| 334414 | Electronic Capacitors |
| 334413 | Semiconductor & Related Devices |
| 333295 | Semiconductor Machinery |

In addition to the specified manufacturing activity, potential credit claimants must also create at least twenty new jobs with a median compensation of \$45,000¹ per year.

The Strategic Research and Development Tax Credit exists to encourage research and development activity within West Virginia.

The Manufacturing Investment Tax Credit exists to encourage the location of new industry in West Virginia and to encourage the expansion, growth and revitalization of existing industrial facilities in the State.

The High-Growth Business Investment Tax Credit exists to encourage investment in start-up, growth-oriented, qualified research and development businesses in West Virginia.

To encourage economic growth through the production of motion pictures and other commercial film or audiovisual projects in West Virginia, the Film Industry Investment Credit was enacted in 2007.

Revenue Analysis

The Economic Opportunity Tax Credit, Strategic Research and Development Tax Credit and Manufacturing Investment Tax Credit were enacted into law in 2002 and apply to qualified investment made on or after January 1, 2003 while the High-Growth Business Investment Tax Credit was enacted into law in 2004 and applies to qualified investment made on or after July 1, 2005. The Economic Opportunity Tax Credit - High Technology Manufacturers and Film Industry Investment Credit were enacted in 2007. In many cases, a one-year investment made for these credits entitles the Taxpayer to multiple-year credit availability. Since these credits are still relatively new,

¹ The median compensation level for determining attributable new jobs will be adjusted for inflation annually.

additional utilization of the credits is expected and will result in a greater reduction in revenue. Also, claims of these credits are first used to offset Business Franchise Tax liability.

EMPLOYMENT TAX CREDITS

STATUTE: West Virginia Code §§11-13W and 11-24-12

CREDITS: Apprenticeship Training Tax Credit (W.Va. Code §11-13W)
Military Employment Incentive Credit (W.Va. Code §11-24-12)

VALUE: **Minimal**

Rationale

The above listed Employment Tax Credits exist to promote employment of explicit individuals. Specifically, the Apprenticeship Training Tax Credit is available to Taxpayers employing construction trade workers in a qualifying apprenticeship program while the Military Employment Incentive Credit seeks to encourage the hiring of the following:

Disabled veterans,
Economically disadvantaged Vietnam era or Korean conflict veterans,
or
Unemployed members of the West Virginia National Guard or
reserve forces of the United States

CREDITS THAT AID LOW-INCOME FAMILIES

STATUTE: West Virginia Code §§11-13F, 11-24-11, 11-13G and 11-24-11a

CREDITS: Credit for Reducing Utility Charges to Low-Income Families (W.Va. Code §§11-13F and 11-24-11)
Credit for Reducing Telephone Charges to Low-Income Families (W.Va. Code §§11-13G and 11-24-11a)

VALUE: **Cannot be Disclosed¹**

¹ Due to taxpayer confidentiality

Rationale

These credits are a form of government assistance to qualified low-income households. Public utilities and local telephone companies are compensated for the value of rate reductions to low-income customers through these tax credit programs.

Revenue Analysis

These credits are applied first against Business and Occupation Tax or Telecommunications Tax, and any unused portion can be taken as a credit against Corporation Net Income Tax.

CREDIT TO PREVENT DOUBLE TAXATION

STATUTE: West Virginia Code §11-24-24

CREDIT: Commercially Domiciled Financial Organization Tax Credit (W.Va. Code §11-24-24)

VALUE: **Minimal**

Rationale

For commercially domiciled financial organizations, double taxation could occur because of differences between the business activity allocation formula for domiciled financial institutions and the formula for non-domiciled financial institutions. Such differences could lead to taxation of the same business activity by two separate states. These credits are **not** tax expenditures because they simply provide a mechanism for the return of funds never due to the State. Due in part to the move to combined reporting, this expenditure becomes null and void for tax years beginning on or after January 1, 2009.

MISCELLANEOUS TAX CREDITS

STATUTES: West Virginia Code §§11-13J, 11-13K, 11-24-11b, and 11-24-23a

CREDITS: Neighborhood Investment Credit (W.Va. Code §11-13J)
Environmental Agricultural Equipment Credit (W.Va. Code §11-13K)
Credit for Utility Taxpayers with Net Operating Loss Carryovers (W.Va. Code §11-24-11b)
Historic Rehabilitated Buildings Investment Credit (W.Va. Code §11-24-23a)

VALUE: **\$400,000 per year**

Rationale

The Miscellaneous Tax Credits have many purposes ranging from the promotion of historic building rehabilitation to the promotion of capital contributions to community-based organizations.

EXPIRED AND TERMINATED CREDITS

STATUTE: West Virginia Code §§5E-1-8, 5E-2-4, 11-6D, 11-13C-16, 11-13D-10 and 11-24-22a(a)

CREDIT: West Virginia Capital Company Credit (W.Va. Code §5E-1-8)
West Virginia Venture Capital Credit (W.Va. Code §5E-2-4)
Alternative-Fuel Motor Vehicles Credit (W.Va. Code §11-6D)
Business Investment and Jobs Expansion Credit (W.Va. Code §11-13C-16)
Research and Development Projects Credit (W.Va. Code §11-13D-10)
Management Information Services Facilities Credit (W.Va. Code §11-13D-10)
Industrial Facilities Coal-Based Synthetic Fuels Credit (W.Va. Code §11-13D-10)
Aerospace Industrial Facility Investment Credit (W.Va. Code §11-13D-10)
Value-Added Agricultural Products Credit (W.Va. Code §11-24-22a(a))

VALUE: **\$11.4 million per year**

Rationale

The Alternative-Fuel Motor Vehicles Credit expired on June 5, 2006 per provisions in the original credit enactment law. The other above listed credits were replaced or repealed and new qualifying applications were terminated through tax credit reform legislation enacted in 2002 or through tax modernization legislation enacted in 2007 (i.e., West Virginia Capital Company Credit and West Virginia Venture Capital Credit).

Revenue Analysis

The above listed credits generally provided for multi-year application (e.g., three years for the Alternative-Fuel Motor Vehicles Credit, five years for the Value-Added Agricultural Products Credit and up to thirteen years for the Business Investment and Jobs Expansion Credit). While the legislation expiring or terminating these credits precludes any new qualifying credit after the expiration or termination date, taxpayers that gained entitlement to any of the above listed credits prior to the expiration or termination date retained that entitlement and may apply the credit until the original multi-year entitlement has been exhausted. Thus, these credits will remain a tax expenditure for several years.

DUPLICATE TAX EXPENDITURE BENEFITS

Duplicate tax expenditure benefits are those items not included in West Virginia's tax base. These items are excluded by default because addbacks for these expenses were not included in the West Virginia Code when tax credits were enacted. The items listed below are treated as duplicate tax expenditures:

Depreciation and Amortization Expenses Tied to Various Investment Tax Credits
Salary Expenses Tied to Employment Incentive Credits

An analysis of these expenditures follows.

DEPRECIATION AND AMORTIZATION EXPENSES TIED TO VARIOUS INVESTMENT TAX CREDITS

STATUTE: West Virginia Code §11-24-6(b) et seq.

DEDUCTION: Depreciation and amortization expenses tied to investments subject to the Economic Opportunity Tax Credit, Economic Opportunity Tax Credit - High Technology Manufacturers, Strategic Research and Development Tax Credit, Manufacturing Investment Tax Credit, High-Growth Business Investment Credit, Film Industry Investment Credit, the Historic Rehabilitated Buildings Investment Credit, the Environmental Agricultural Equipment Credit, and certain expired and terminated credits (the Alternative-Fuel Motor Vehicles Credit, the Business Investment and Jobs Expansion Credit, the Management Information Services Facilities Credit, the Industrial Facilities Coal-Based Synthetic Fuels Credit, the Aerospace Industrial Facility Investment Credit)

VALUE: Not available

Rationale

Taxpayers are usually required to increase their federal taxable income by the amount of the otherwise allowable expenses attributable to tax credits. This eliminates the possibility of double tax benefits through both a deduction and a credit for the same item or activity. Currently, taxpayers are not required to add back amortization and depreciation expenses attributable to the following credits:

Economic Opportunity Tax Credit
Economic Opportunity Tax Credit - High Technology Manufacturers

Strategic Research and Development Tax Credit
Manufacturing Investment Tax Credit
High-Growth Business Investment Credit
Film Industry Investment Credit
Historic Rehabilitated Buildings Investment Credit
Alternative-Fuel Motor Vehicles Credit
Business Investment and Jobs Expansion Credit
Management Information Services Facilities Credit
Industrial Facilities Coal-Based Synthetic Fuels Credit
Environmental Agricultural Equipment Credit
Aerospace Industrial Facility Investment Credit

However, a portion of the amortization and depreciation expenses attributable to the Research and Development Projects Credit must be added back in calculating West Virginia tax liability.

**SALARY EXPENSES TIED TO
EMPLOYMENT INCENTIVE CREDITS**

STATUTE: West Virginia Code §§11-13W and 11-24-12

DEDUCTION: Salary expenses tied to employment incentive credits

VALUE: **Minimal**

Rationale

The federal government usually requires taxpayers to increase their federal taxable income by the amount of the otherwise allowable expenses attributable to tax credits. This eliminates the possibility of double tax benefits through both a deduction and a credit for the same item or activity. However, West Virginia taxpayers are not required to add back salary expenses attributable to the Apprenticeship Training Tax Credit or the Military Employment Incentive Credit.

BUSINESS FRANCHISE TAX

OVERVIEW

The Business Franchise Tax was enacted in 1985 as part of the restructuring of West Virginia's business tax system and became effective on July 1, 1987. The statutory article that established the tax classified the Business Franchise Tax as a tax on the "privilege of doing business" in West Virginia, as opposed to an ad valorem tax on the property of corporations and partnerships. The Business Franchise Tax is levied on the wealth of a business as measured by net worth.

For corporations and partnerships, the measure of the tax is their capital. Capital for corporations is defined by the Statute as the average of the beginning and ending balances of the value of common and preferred stock, appropriated and unappropriated retained earnings, and paid-in capital or capital surplus, less treasury stock. These accounts are commonly considered to comprise the owners' equity portion of the balance sheet. Partnership capital is defined as the average of the beginning and ending balances of the partners' capital accounts. The Tax Commissioner may adjust these definitions as required to ". . . fairly represent the net equity of the taxpayer as defined in accordance with generally accepted accounting principles . . ." (West Virginia Code §11-23-3b(2)(D)).

After the application of financial obligations adjustments, the taxpayer's net worth is apportioned to West Virginia based on a three-factor apportionment formula. The formula consists of a property factor, a payroll factor, and a double-weighted sales factor. The tax is then computed at a rate of 0.55 percent of the apportioned adjusted net capital. The rate will gradually decrease over a five-year span beginning on January 1, 2009 from 0.55 percent to 0.20 percent. The rate adjustments are as follows:

| <u>Effective Date</u> | <u>Rate</u> |
|-----------------------------|--------------|
| On or after January 1, 2009 | 0.48 percent |
| On or after January 1, 2010 | 0.41 percent |
| On or after January 1, 2011 | 0.34 percent |
| On or after January 1, 2012 | 0.27 percent |
| On or after January 1, 2013 | 0.20 percent |

ORGANIZATION AND ANALYSIS

This study separates the Business Franchise Tax expenditures into five groups:

Businesses Excluded from Taxation

Balance Sheet Liabilities Excluded from the Tax Base

Special Adjustments Available to Taxpayers

Apportionment Factor Adjustments

Credits

As noted in the following pages, some of the provisions listed are not classified as tax expenditures because they are an integral part of the tax structure.

BUSINESSES EXCLUDED FROM TAXATION

Several classes or types of businesses are excluded from the Business Franchise Tax based on the structure of the business or based upon the activity in which the business is involved. The following businesses are excluded from taxation under Business Franchise Tax statutes:

- Sole Proprietorships
- Corporations Exempt from Federal Income Tax
- Insurance Companies Paying a Tax upon Premiums
- Production Credit Associations (Farm Credit Act of 1933)
- Trusts
- Capital Stock Credit Unions
- Political Subdivisions of the State
- Agriculture or Farming Activities
- Horse or Dog Tracks
- Hunting Clubs Not Distributing Income or Dividends
- Venture Capital Companies

An analysis of these exclusions follows.

SOLE PROPRIETORSHIPS

STATUTE: West Virginia Code §11-23-7(a)

EXEMPTION: Natural persons doing business in West Virginia that are not doing business as a partnership or as a corporation

VALUE: **Not available**

Rationale

Sole proprietors are excluded from the Business Franchise Tax due to the lack of a definable tax base.

CORPORATIONS EXEMPT FROM FEDERAL INCOME TAX

STATUTE: West Virginia Code §11-23-7(b)

EXEMPTION: Corporations and organizations that because of their purposes or activities are exempt from federal income tax, provided that the exclusion does not apply to that portion of their capital used, directly or indirectly, in the generation of unrelated business income, if the unrelated business income is subject to federal income tax

VALUE: Not available

Rationale

Included in this exemption from the Business Franchise Tax are the groups of businesses identified in Section 501(c) of the Internal Revenue Code. Some of these excluded businesses include the following:

1. corporations organized and operated exclusively for religious, charitable, scientific or educational purposes;
2. civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare;
3. labor, agricultural or horticultural organizations;
4. business leagues, chambers of commerce, boards of trade not organized for profit;
5. clubs organized for pleasure, recreation and other nonprofit purposes;
6. fraternal beneficiary societies, order or associations, and
7. posts or organizations of past or present members of the Armed Forces of the United States.

This exemption exists to promote the public service activities of these organizations.

INSURANCE COMPANIES PAYING A TAX UPON PREMIUMS

| | |
|-------------------|---|
| STATUTE: | West Virginia Code §11-23-7(c) |
| EXEMPTION: | Insurance companies which pay the State a tax on premiums |
| VALUE: | \$34.8 million per year |

Rationale

Although other businesses, such as natural resource producers, are subject to other taxes in addition to the Business Franchise Tax, this exemption exists to preclude the double taxation of businesses paying the Insurance Premium Tax. A full exemption from the Business Franchise Tax is available to all insurance companies who pay the Insurance Premium Tax, regardless of how much Insurance Premium Tax is paid.

PRODUCTION CREDIT ASSOCIATIONS (FARM CREDIT ACT OF 1933)

| | |
|-------------------|---|
| STATUTE: | West Virginia Code §11-23-7(d) |
| EXEMPTION: | Production credit associations organized under the provisions of the federal "Farm Credit Act of 1933": Provided, That this exemption shall not apply to corporations or associations organized under the provisions of article four, chapter nineteen of this code |
| VALUE: | Minimal |

Rationale

This exemption exists to promote the formation of these associations. Production credit associations are also exempt from Business Franchise Tax under West Virginia Code §11-23-7(b), which provides an exemption for corporations that are exempt from federal income tax. Section 501(c)(16) of the Internal Revenue Code provides an exemption from federal income tax for corporations organized by farmers' cooperatives to finance ordinary crop operations.

TRUSTS

| | |
|-------------------|--|
| STATUTE: | West Virginia Code §11-23-7(e) |
| EXEMPTION: | Any trust established pursuant to section one hundred eighty-six, chapter seven, title twenty-nine of the United States Code |
| VALUE: | Not available |

Rationale

Similar to production credit associations, these organizations are exempt from the Business Franchise Tax to encourage their formation. Also, certain trusts benefit from an exemption from federal income tax. Thus, the repeal of this exemption would not necessarily result in any additional revenue due to the exemption provided to corporations exempt from federal income tax.

CAPITAL STOCK CREDIT UNIONS

| | |
|-------------------|---|
| STATUTE: | West Virginia Code §11-23-7(f) |
| EXEMPTION: | Any credit union organized under the provisions of West Virginia Code §31-1-1 et seq. or any other chapter of the West Virginia Code, provided that this exemption shall not apply to corporations or cooperative associations organized under article four, chapter nineteen of the West Virginia Code |
| VALUE: | Minimal |

Rationale

West Virginia Code §31-10-1 allows the formation of credit unions with capital stock by West Virginia residents having a common bond of occupation or association. By definition, these credit unions are cooperative nonprofit associations. Credit unions without capital stock are exempt from federal income tax under section 501(c) of the Internal Revenue Code. Therefore, they are also exempt from the Business Franchise Tax. This exemption exists to provide the nonprofit West Virginia capital stock credit unions with an exemption similar to the credit unions without capital stock.

POLITICAL SUBDIVISIONS OF THE STATE

| | |
|-------------------|--|
| STATUTE: | West Virginia Code §11-23-7(g) |
| EXEMPTION: | Any corporation that is a political subdivision of the State of West Virginia, or is an instrumentality of a political subdivision of this State |
| VALUE: | Not available |

Rationale

County commissions are declared to be corporations by West Virginia Code §7-1-1 and municipalities are allowed to incorporate under West Virginia Code §8-2-1. Although county commissions and municipalities may be called corporations in the West Virginia Code, they are dissimilar in nature and purpose from business and nonprofit corporations formed according to Chapter 31 of the West Virginia Code. This exemption exists to preclude the taxation of governmental services.

AGRICULTURE OR FARMING ACTIVITIES

| | |
|-------------------|---|
| STATUTE: | West Virginia Code §11-23-7(h) |
| EXEMPTION: | Any corporation or partnership engaged in the activity of agriculture and farming, as defined by West Virginia Code §11-23-3(b)(8), provided that if a corporation or partnership is not exclusively engaged in such activity, its tax base shall be apportioned between the agricultural and non-agricultural activities and only that portion attributable to agricultural activities shall be exempt |
| VALUE: | \$350,000 per year |

Rationale

This exemption exists to promote agriculture and farming within West Virginia.

HORSE OR DOG TRACKS

STATUTE: West Virginia Code §11-23-7(i)

EXEMPTION: Any corporation or partnership licensed under West Virginia Code §19-23-1 et seq. to conduct horse or dog racing meetings or a pari-mutuel system of wagering, provided that if a corporation or partnership is not exclusively engaged in such activity, its tax base shall be apportioned between the pari-mutuel wagering and other activities, and only that portion attributable to pari-mutuel wagering shall be exempt

VALUE: **Minimal**

Rationale

Although other businesses, such as natural resource producers, are subject to other taxes in addition to the Business Franchise Tax, this exemption exists to preclude the double taxation of businesses engaged in horse or dog racing. These businesses pay a tax based on pari-mutuel wagering. In general, the pari-mutuel wagering tax produces significantly more revenue than the application of the Business Franchise Tax to these businesses.

HUNTING CLUBS NOT DISTRIBUTING INCOME OR DIVIDENDS

STATUTE: West Virginia Code §11-23-7(j)

EXEMPTION: Any corporation or partnership operating as a hunting club, provided, that the corporation or partnership distributes no income or dividends to its owners or stockholders. A hunting club is a group of persons owning land which is used principally for hunting purposes by the members of the club and guests.

VALUE: **Minimal**

Rationale

These organizations are not established to generate income. The fees paid by members are principally used to defray costs of operation and maintenance of the club and club properties or for the establishment of a reasonable reserve to defray costs of operation or maintenance.

VENTURE CAPITAL COMPANIES

STATUTE: West Virginia Code §11-23-7(k)

EXEMPTION: Any person or organization engaged in the activity of providing venture capital to West Virginia businesses, provided, that if the person or organization is not exclusively engaged in that activity, only that portion of its tax base that is attributable to the providing of venture capital to West Virginia businesses shall be exempt.

VALUE: **Not Available**

Rationale

This exemption exists to promote venture or risk capital investment to West Virginia businesses and to alleviate disadvantages imposed by a business franchise tax on such capital.

BALANCE SHEET LIABILITIES EXCLUDED FROM THE TAX BASE

The Business Franchise Tax is a privilege tax upon the business capital of partnerships and corporations. Liabilities to stockholders (i.e., those balance sheet components which constitute owners' equity) are subject to tax, with the exception of loans from stockholders, but liabilities to financial lenders are not. The following liabilities are not included within the definition of the tax base:

- Accounts Payable
- Mortgages, Notes, Bonds Payable Within One Year
- Other Current Liabilities
- Mortgages, Notes, Bonds Payable Over a Period of More Than One Year
- Loans from Stockholders
- Other Liabilities

These categories correspond with those found on Schedule L of the Federal Tax Form 1120. Expenditure values for these excluded items follow.

STATUTE: West Virginia Code §§11-23-3(b)(2)(A) and (B)

EXCLUSION: Balance sheet liabilities (Short and long term debt)

| | | |
|---|----------------------------|-----------------------|
| VALUE: | Short-Term Debt: | |
| | Accounts Payable: | \$39.9 million |
| Mortgages, Notes, Bonds Payable within One Year: | | \$31.1 million |
| | Other Current Liabilities: | \$95.6 million |
| | Long-Term Debt: | |
| | Loans to Stockholders: | \$3.6 million |
| Mortgages, Notes, Bonds Payable More Than One Year: | | \$57.6 million |
| | Other Liabilities: | \$49.9 million |

Rationale

Business capital is typically raised from both obligations to stockholders and obligations to lenders. Owners' equity represents obligations to stockholders while debt represents obligations to lenders. A current liability requires payment out of a current asset or the incurrence of another short-term liability. The exclusion of short-term debt recognizes the need for businesses to incur this type of debt as a necessary aspect of on-going business operations. Short-term debt represents money that

will soon be circulating back into the economy. The exclusion of long-term debt encourages businesses to rely more heavily on debt for long-term capitalization than on equity.

SPECIAL ADJUSTMENTS AVAILABLE TO TAXPAYERS

The value of certain investments is factored into an adjustment formula to reduce the tax base, therefore encouraging certain types of investment, whether intentional or not. The following items enter into the adjustment calculation:

Federal Obligations and Securities
West Virginia Obligations
Investments Secured by Mortgages and Loans on Residential Property

An analysis of these expenditures follows.

FEDERAL OBLIGATIONS AND SECURITIES

STATUTE: West Virginia Code §11-23-3(b)(2)(E)(i)(I)

ADJUSTMENT: Adjustment to the tax base due to federal obligations and securities

VALUE: **\$4.3 million per year**

Rationale

Ad valorem (property) taxation of United States property, including United States government obligations, is prohibited by federal law. The West Virginia Business Franchise Tax has a statutory characterization as a tax on the "privilege of doing business", and a tax base composed of equity as opposed to asset components of the balance sheet. However, the Business Franchise Tax might be considered a tax on corporate property and thus subject to the prohibition of ad valorem taxation on United States government obligations. This adjustment may also exist to allow obligations of West Virginia and its political subdivisions to be eliminated from the franchise tax base.

WEST VIRGINIA OBLIGATIONS

| | |
|--------------------|--|
| STATUTE: | West Virginia Code §11-23-3(b)(2)(E)(i)(II) |
| ADJUSTMENT: | Adjustment to the tax base for obligations of West Virginia and its political subdivisions |
| VALUE: | \$300,000 per year |

Rationale

This adjustment is intended to lower the cost of borrowing for the State and local governments in West Virginia.

INVESTMENTS SECURED BY MORTGAGES AND LOANS ON RESIDENTIAL PROPERTY

| | |
|--------------------|--|
| STATUTE: | West Virginia Code §§11-23-3(b)(2)(E)(i)(III) and (IV) |
| ADJUSTMENT: | Adjustment to the tax base for investments or loans primarily secured by mortgages or deeds of trust on residential property located in West Virginia and occupied by non-transients and adjustment to the tax base for loans primarily secured by a lien or security agreement on residential property in the form of a mobile home, modular home or double-wide, located in West Virginia and occupied by non-transients |
| VALUE: | \$24.7 million per year |

Rationale

This expenditure exists to encourage investments or loans on West Virginia residential property occupied by non-transients. The preferential treatment for these obligations presumably lowers the cost of the investment instruments by reducing the tax imposed on these investments. The intention is for part of the reduced cost in holding the identified securities to be passed on to the loan recipients. Thus, housing may be more affordable.

APPORTIONMENT FACTOR ADJUSTMENTS

Taxpayers with business activity in multiple states must apportion such activity between those jurisdictions. Apportionment is typically based upon three factors (property, payroll and sales). Sometimes, deviations from the simple three-factor formula may be expenditures. The following apportionment factor adjustments may be tax expenditures.

Double-Weighted Sales Apportionment Factor
Alternate Apportionment Formulas

An analysis of these apportionment factor adjustments follows.

DOUBLE-WEIGHTED SALES APPORTIONMENT FACTOR

STATUTE: West Virginia Code §11-23-5(a)

ADJUSTMENT: Double-weighted sales apportionment factor

VALUE: **\$3.8 million per year**

Rationale

This provision presumably exists to shift a greater portion of the tax burden to taxpayers with a significant sales factor in relation to their property and payroll factors. Businesses with larger property and payroll factors in relation to their sales factor benefit from a lower apportioned tax base compared to taxpayers with a large sales factor in relation to the other factors. An underlying assumption of the double-weighted sales factor is that the companies with relatively larger property and payroll factors make a greater contribution to the State economy. Financial outlays for maintaining property and for paying workers located in the State are assumed to provide a larger direct and indirect impact on the State's economy than the mere sale of goods and services. In rural states, such as West Virginia, the net result of a double-weighted sales apportionment formula is a loss of tax revenue. However, as West Virginia becomes more of a service-based economy, the negative effect of the double-weighted sales factor will decrease.

ALTERNATE APPORTIONMENT FORMULAS

| | |
|--------------------|--|
| STATUTE: | West Virginia Code §§11-23-5(p) and 11-23-5a |
| ADJUSTMENT: | Alternate apportionment formulas and filing methods granted to taxpayers |
| VALUE: | Not available |

Rationale

Occasionally, the general formula for apportionment of the tax base may be inappropriate because it does not accurately reflect the taxpayers' business activity. West Virginia Code §11-23-5(p) allows the taxpayer to petition the Tax Commissioner to use a different apportionment method. The Tax Commissioner may also require the taxpayer to use an alternate method. If the alternate formula is used for purposes other than the attainment of a more accurate apportionment figure, then the formula would represent a tax expenditure.

In 1991, the State Legislature determined that the general apportionment formula was inappropriate for financial institutions due to the particular characteristics of these businesses. A single-factor receipts formula was enacted to address the apportionment of capital for these businesses.

CREDITS

The West Virginia Code provides for the application of various tax credits against the Business Franchise Tax. Some credits provide qualifying businesses with an investment incentive or employment incentive. Other credits eliminate either double taxation or the possibility of taxation under more than one privilege tax. The following tax credits are grouped by major category:

Economic Development Tax Credits

- Industrial Expansion and Revitalization Credit for Electric Power Producers
- Coal Loading Facilities Tax Credit
- Economic Opportunity Tax Credit
- Economic Opportunity Tax Credit - High Technology Manufacturers
- Strategic Research and Development Tax Credit
- Manufacturing Investment Tax Credit
- High-Growth Business Investment Tax Credit
- Film Industry Investment Credit

Credits to Prevent Double Taxation

- Business and Occupation Tax Credit
- Subsidiary Tax Credit
- Commercially Domiciled Financial Organization Tax Credit

Miscellaneous Tax Credits

- Neighborhood Investment Program Credit
- Apprenticeship Training Tax Credit

Terminated Credits

Many of the credits listed above may also be applied against other business and personal taxes. Expenditure values presented in this section represent the amounts applied only against the Business Franchise Tax. Often, the credit claimed against the Business Franchise Tax has been reduced by the application of the credit against other taxes according to the priority order specified by statute or regulations. Thus, the credit amounts claimed against Business Franchise Tax may be negligible compared to the total cost of the credit. An analysis of these expenditures follows.

ECONOMIC DEVELOPMENT TAX CREDITS

| | |
|------------------|--|
| STATUTES: | West Virginia Code §§11-13D-4, 11-13E, 11-13Q, 11-13R, 11-13S, 11-13U, and 11-13X |
| CREDITS: | Industrial Expansion and Revitalization Credit for Electric Power Producers (W.Va. Code §11-13D-4) Coal Loading Facilities Tax Credit (W.Va. Code §11-13E) Economic Opportunity Tax Credit (W.Va. Code §11-13Q) Economic Opportunity Tax Credit - High Technology Manufacturers (W. Va. Code §11-13Q-10a) Strategic Research and Development Tax Credit (W.Va. Code §11-13R) Manufacturing Investment Tax Credit (W.Va. Code §11-13S) High-Growth Business Investment Tax Credit (W.Va. Code §11-13U) Film Industry Investment Tax Credit (W. Va. Code §11-13X) |
| VALUE: | \$1.9 million |

Rationale

The Economic Development Tax Credits are generally designed to promote job creation and/or investment within the State. Benefits attributable to the Industrial Expansion and Revitalization Credit for Electric Power Producers and the Coal Loading Facilities Tax Credit, Economic Opportunity Tax Credit, Strategic Research and Development Tax Credit and Manufacturing Investment Tax Credit are generally available over a ten-year period while the benefits attributable to the High-Growth Business Investment Tax Credit are available for a five-year period and the Economic Opportunity Tax Credit - High Technology Manufacturers is available for a twenty-year period. However, any unused Film Industry Investment Credit remaining after the second tax year following the tax year in which the qualifying investment was made is forfeited.

The Industrial Expansion and Revitalization Credit exists as a capital investment incentive for electric power producers. The Coal Loading Facilities Credit exists as a capital investment incentive for taxpayers with coal loading facilities.

The Economic Opportunity Tax Credit exists to encourage greater capital investment in businesses in the State and thus increase economic opportunity. While the base credit program requires the creation of at least twenty new jobs, lower minimum new jobs levels are provided for the Corporate Headquarters Relocation portion of the credit program (minimum of fifteen new jobs) and for the Small Business provision (minimum of ten new jobs). The basis of the program is largely attributable to capital investment, not direct employment growth.

Legislation enacting the Economic Opportunity Tax Credit - High Technology Manufacturers was passed in 2007 to promote job creation in the following industries:

| North American Industry Classification System Code (NAICS) | <u>Manufacturing Activity</u> |
|--|---------------------------------|
| 334111 | Electronic Computers |
| 334112 | Computer Storage Devices |
| 334411 | Electron Tubes |
| 334414 | Electronic Capacitors |
| 334413 | Semiconductor & Related Devices |
| 333295 | Semiconductor Machinery |

In addition to the specified manufacturing activity, potential credit claimants must also create at least twenty new jobs with a median compensation of \$45,000¹ per year.

The Strategic Research and Development Tax Credit exists to encourage research and development activity within West Virginia.

The Manufacturing Investment Tax Credit exists to encourage the location of new industry in West Virginia and to encourage the expansion, growth and revitalization of existing industrial facilities in the State.

The High-Growth Business Investment Tax Credit exists to encourage investment in start-up, growth-oriented, research and development businesses in West Virginia.

To encourage economic growth through the production of motion pictures and other commercial film or audiovisual projects in West Virginia, the Film Industry Investment Credit was enacted in 2007.

Revenue Analysis

The Economic Opportunity Tax Credit, Strategic Research and Development Tax Credit and Manufacturing Investment Tax Credit were enacted into law in 2002 and apply to qualified investment made on or after January 1, 2003 while the High-Growth Business Investment Tax Credit was enacted into law in 2004 and applies to qualified investment made on or after July 1, 2005. The Economic Opportunity Tax Credit - High Technology Manufacturers and Film Industry Investment

¹ The median compensation level for determining attributable new jobs will be adjusted for inflation annually.

Credits were enacted in 2007. In many cases, a one-year investment made for these credits generally entitles the Taxpayer to multiple-year credit availability. Since these credits are still relatively new, additional utilization of the credits is expected and will result in a greater reduction in revenue. Generally, the Industrial Expansion and Revitalization Credit for Electric Power Producers and the Coal-Loading Facilities Tax Credit are applied against taxes other than Business Franchise Tax. Thus, a minimal amount, if any, is applied against Business Franchise Tax.

CREDITS TO PREVENT DOUBLE TAXATION

STATUTE: West Virginia Code §§11-23-17(b), 11-23-17(c), and 11-23-17(d)

CREDITS: Business and Occupation Tax Credit (W.Va. Code §11-23-17(b))
Subsidiary Tax Credit (W.Va. Code §11-23-17(c))
Commercially Domiciled Financial Organization Tax Credit (W.Va. Code §11-23-17(d))

VALUE: **\$13.3 million per year**

Rationale

These credits exist to eliminate the possibility of double taxation. The Business and Occupation Tax Credit provides an offset to account for a special alternative tax. The Subsidiary Credit prevents double taxation of capital for both subsidiaries and the parent corporation in cases where the taxpayer elects to file separate tax returns. For commercially domiciled financial organizations, double taxation could occur because of differences between the business activity allocation formula for domiciled financial institutions and the formula for non-domiciled financial institutions. Such differences could lead to taxation of the same business activity by two separate states. These credits are **not** tax expenditures because they simply provide a mechanism for the return of funds never due to the State.

MISCELLANEOUS TAX CREDITS

| | |
|-----------------|--|
| STATUTE: | West Virginia Code §§5E-1-8, 5E-2-4, 11-13J and 11-23-24a |
| CREDITS: | Neighborhood Investment Program Credit (W.Va. Code §11-13J) Apprenticeship Training Tax Credit (W.Va. Code §11-13W) |
| VALUE: | \$200,000 per year |

Rationale

The Miscellaneous Tax Credits have purposes ranging from the promotion of capital contributions to community-based organizations to the promotion of employment of construction trade workers in a qualifying apprenticeship program.

Revenue Analysis

Since the Apprenticeship Training Tax Credit applies to tax years beginning on or after January 1, 2008, the total cost of these credits may increase.

TERMINATED CREDITS

| | |
|-----------------|--|
| STATUTE: | West Virginia Code §§5E-1-8, 5E-2-4, 11-13C-16, 11-13D-10, 11-13M, 11-13N, 11-13O, 11-23-17(d) and 11-23-24(a) |
| CREDITS: | West Virginia Capital Company Credit (W.Va. Code §5E-1-8) West Virginia Venture Capital Credit (W.Va. Code §5E-2-4) Business Investment and Jobs Expansion Credit (W.Va. Code §11-13C-16) Industrial Expansion and Revitalization Credit for Non-Electric Power Producers (W.Va. Code §11-13D-10) Research and Development Projects Credit (W.Va. Code §11-13D-10) Residential Housing Development Credit (W.Va. Code §11-13D-10) Management Information Services Facilities Credit (W.Va. Code §11-13D-10) Industrial Facilities Coal-Based Synthetic Fuels Credit (W.Va. Code §11-13D-10) Aerospace Industrial Facility Investment Credit (W.Va. Code §11-13D-10) Consumer-Ready Wood Products Manufacturing Employment Credit (W.Va. Code §11-13M) Credit for New Steel Manufacturing Operations (W.Va. Code §11-13N) Credit for New Aluminum or Polymer Manufacturing Operations (W.Va. Code §11-13O) Financial Organization Property Tax Credit (W.Va. Code §11-23-17(d)) Value Added Agricultural Products Credit (W.Va. Code §11-23-24(a)) |
| VALUE: | \$16.6 million per year |

Rationale

Many of the above listed credits were replaced or repealed and new qualifying applications were terminated through tax credit reform legislation enacted in 2002 or through tax modernization legislation enacted in 2007 (i.e., West Virginia Capital Company Credit and West Virginia Venture Capital Credit).

Revenue Analysis

While the legislation expiring or terminating these credits precludes any new qualifying credit after the expiration or termination date, taxpayers that gained entitlement to any of the above listed credits prior to the expiration or termination date retained that entitlement and may apply the

credit until the original multi-year entitlement has been exhausted. Thus, these credits will remain a tax expenditure for several years.

PERSONAL INCOME TAX

OVERVIEW

The Personal Income Tax is the largest source of revenue for West Virginia. It is imposed on the West Virginia taxable income of resident individuals, estates and trusts wherever their income is earned. Nonresident individuals, estates and trusts are also subject to the tax on the income they receive from West Virginia sources. Corporations, partnerships (but not partners), and certain trusts and associations are exempt from West Virginia Personal Income Tax. While estates and trusts are taxed under the Personal Income Tax statute, their tax liability is calculated on the Fiduciary Income Tax return, not the Personal Income Tax return. For the purposes of this study, the Personal Income Tax sections deal with income tax on individuals while the Fiduciary Income Tax sections deal with income tax on estates and trusts.

For individuals, computation of West Virginia taxable income begins with federal adjusted gross income to which specific increases or decreases are made. West Virginia adjusted gross income results when the applicable West Virginia increasing or decreasing modifications have been applied to federal adjusted gross income. To determine West Virginia taxable income, the taxpayer then takes a deduction based on the number of personal exemptions claimed on the federal return.

Unlike the tax on individuals, federal taxable income is the starting point for the calculation of the West Virginia Fiduciary Income Tax for estates and trusts. West Virginia taxable income is derived after specific increasing or decreasing modifications are made to federal taxable income. The rate schedule for both resident and nonresident estates and trusts is the same as Personal Income Tax rates for all taxpayers, except for married taxpayers filing separate returns.

Personal Income Tax and Fiduciary Income Tax rates differ with each taxable income category. Although the rates increase as taxable income increases, each marginal rate is independent of every other rate. The following charts provide the tax rates.

WEST VIRGINIA TAX RATE SCHEDULE

**All Taxpayers
Except Married Filing Separate Returns**

| Taxable Income | | Tax Liability | | |
|----------------|-----------|---------------|------|--------|
| Over | Not Over | | Plus | Over |
| \$ 0 | \$ 10,000 | \$ 0.00 | 3.0% | \$ 0 |
| 10,000 | 25,000 | 300.00 | 4.0% | 10,000 |
| 25,000 | 40,000 | 900.00 | 4.5% | 25,000 |
| 40,000 | 60,000 | 1,575.00 | 6.0% | 40,000 |
| 60,000 | | 2,775.00 | 6.5% | 60,000 |

WEST VIRGINIA TAX RATE SCHEDULE

Married Filing Separate Returns

| Taxable Income | | Tax Liability | | |
|----------------|----------|---------------|------|--------|
| Over | Not Over | | Plus | Over |
| \$ 0 | \$ 5,000 | \$ 0.00 | 3.0% | \$ 0 |
| 5,000 | 12,500 | 150.00 | 4.0% | 5,000 |
| 12,500 | 20,000 | 450.00 | 4.5% | 12,500 |
| 20,000 | 30,000 | 787.50 | 6.0% | 20,000 |
| 30,000 | | 1,387.50 | 6.5% | 30,000 |

ORGANIZATION AND ANALYSIS

The Personal Income Tax expenditures discussed in this report are divided into six groups:

- Exclusions
- Exemptions
- Decreasing Modifications
- Federally Mandated Exclusions
- Credits
- Duplicate Tax Expenditure Benefits

The analysis provided for each tax expenditure includes a rationale for each item and the cost of each item to the State.

EXCLUSIONS

Computation of West Virginia taxable income begins with federal adjusted gross income. For that reason, items excluded from the definition of federal adjusted gross income are also excluded for West Virginia Personal Income Tax purposes, unless specific additions are included in the West Virginia Code. Some of these exclusions are as follows:

- Deductible Contributions to Individual Retirement Accounts (IRAs) and Keogh Accounts
- The Fifty Percent Self-employment Tax Exclusion
- The Self-employed Health Insurance Deduction
- The Self-employed SEP Deduction
- Early Withdrawal of Savings
- Alimony Paid
- Nontaxable Social Security Benefits¹
- Nontaxable Tier I Railroad Retirement Benefits¹
- Workers' Compensation Benefits
- Veterans' Benefits
- Life Insurance Annuity Payments
- Contributions to 401K Plans
- Interest on West Virginia or Municipal Tax Exempt Bonds
- Income Earned Abroad
- Capital Gains on Homes Sales
- Deferral for Reinvesting Scholarship and Fellowship Income
- Employee Meals and Lodging
- Employer Contributions for Medical Insurance and Care and Pensions
- Employer-Provided Child Care
- Benefits and Allowances to Armed Forces Personnel
- Employer Paid Premiums on Life, Disability and Health Insurance
- Oil and Gas Exploration Costs
- Depreciation and Expense Deductions
- Amortization of Business Start-up Costs
- Capital Gains at Death

¹ A portion of a taxpayer's Social Security benefits or equivalent Tier I Railroad Retirement benefits may be taxable for federal income tax purposes and therefore included in federal adjusted gross income. The amount of benefits that are taxable is based on the taxpayer's combined income over a specified base amount. The base amount is one of the following:

1. \$32,000 for married taxpayers filing jointly,
2. \$0 for married taxpayers filing separately, or
3. \$25,000 for all other taxpayers.

All Tier II Railroad Retirement benefits are taxable for federal income tax purposes.

Expenses of Capital Outlays for Farm Income Stabilization
Capital Asset Treatment of Timber Income and Iron, Ore and Coal Royalties
Research and Development Costs
Amortization of Pollution Control Facilities and Reforestation Expenditures
Student Loan Interest Deduction
Educator Expense Deduction

This list is not all-inclusive. No expenditure values have been calculated for these exclusions due to the lack of federal tax return data. In addition to the exclusions listed above, West Virginia law allows the following exclusion to aid low-income families.

LOW INCOME EXCLUSION

STATUTE: West Virginia Code §11-21-10

EXCLUSION: A deduction from federal adjusted gross income of the amount of earned income included, not to exceed \$10,000, except for a husband and wife filing separate returns whose exclusion cannot exceed \$5,000 each

VALUE: **\$8.6 million per year**

Rationale

The low income exclusion exists to provide some tax relief to low income taxpayers. However, the deduction is only available to taxpayers with total earned income below the statutory threshold.

EXEMPTIONS

Any individual taxpayer, whether resident or nonresident, is allowed a \$2,000 exemption for each personal exemption claimed on the federal return. A surviving spouse is allowed one additional \$2,000 exemption for the two taxable years beginning after the death of his or her spouse. Individuals claimed as dependents on another's return can only take one \$500 exemption. Estates and trusts are allowed only one \$600 exemption. The following exemptions are discussed in this section:

- Personal Exemption
- Surviving Spouse Exemption
- Exemption for Dependents Claimed on Another's Return
- Fiduciary Income Tax Exemption

An analysis of these exemptions follows.

PERSONAL EXEMPTION

STATUTE: West Virginia Code §11-21-16(a)

EXEMPTION: \$2,000 per personal exemption allowed

VALUE: **\$133.4 million per year**

Rationale

The personal exemption provides a tax deduction based on the number of people supported by the reported income. Additional exemptions are allowed for special circumstances (e.g., surviving spouse exemption). The personal exemption could possibly be seen as an allowance to reduce gross income. Such allowances increase the income threshold for income tax filing and provide some level of tax relief to low-income households and to families. However, in terms of a tax reduction, the value is greater per return at higher income levels.

SURVIVING SPOUSE EXEMPTION

| | |
|-------------------|---|
| STATUTE: | West Virginia Code §11-21-16(c) |
| EXEMPTION: | One additional \$2,000 exemption allowed for a surviving spouse for two taxable years beginning after the death of a spouse |
| VALUE: | \$200,000 per year |

Rationale

This modification presumably exists to help in the transition for the surviving spouse.

EXEMPTION FOR DEPENDENTS CLAIMED ON ANOTHER'S RETURN

| | |
|-------------------|---|
| STATUTE: | West Virginia Code §11-21-16(d) |
| EXEMPTION: | \$500 for individuals claimed as dependents on another's return |
| VALUE: | \$300,000 per year |

Rationale

Dependents claimed on another's return are not allowed a personal exemption for federal income tax purposes. West Virginia allows a lower exemption for these individuals. The amount for this exemption is equal to the basic federal standard deduction for dependents claimed on another's return in 1987. This partial exemption benefits dependents claimed on another's return, many of whom are students working part-time.

FIDUCIARY INCOME TAX EXEMPTION

| | |
|-------------------|---|
| STATUTE: | West Virginia Code §11-21-18(1) |
| EXEMPTION: | Exemption of \$600 for estates and trusts |
| VALUE: | \$170,000 per year |

Rationale

For simplicity, estates have the same exemption allowance as on the federal return. Since West Virginia's treatment of estates and trusts are similar, the same \$600 exemption is allowed for trusts. The exemption is in lieu of the federal deduction for estates and trusts.

DECREASING MODIFICATIONS

In determining West Virginia taxable income, specific increases or decreases are made to federal adjusted gross income. Most income reduction modifications are tax expenditures. These modifications are available to some but not all taxpayers. The following decreasing modifications are discussed in this section:

- Interest and Dividend Income from State or Local Obligations
- State Income Tax Refunds
- Itemized Deductions for Fiduciaries
- Decreasing Modification for Senior Citizens
- Decreasing Modification for Disabled Persons
- Decreasing Modification for Surviving Spouses
- Decreasing Modification for Resident Full-Time Military Personnel Stationed Outside West Virginia
- Decreasing Modification for National Guard and Reserve Forces Called to Active Duty
- Decreasing Modification for Contributions to Medical Savings Accounts
- Decreasing Modification for Contributions to the West Virginia Prepaid Tuition Trust Fund
- Decreasing Modification for Premiums for Long-Term Care Insurance Policies
- Pension Exclusions
 - Military Retirement Benefits
 - Federal Retirement Systems Benefits
 - West Virginia Public Employees' Retirement System Benefits
 - West Virginia Teachers' Retirement System Benefits
 - State or Local Police or Firefighters' or Deputy Sheriffs' Retirement Systems Benefits
 - Railroad Retirement Benefits
 - Military Retirement Modification
 - Pension Benefit Guarantee Modification

An analysis of these decreasing modifications follows.

**INTEREST AND DIVIDEND INCOME FROM
STATE OR LOCAL OBLIGATIONS**

| | |
|-------------------|---|
| STATUTE: | West Virginia Code §11-21-12(c)(2) |
| EXCLUSION: | Interest income on West Virginia obligations subject to federal tax but not State tax |
| VALUE: | Minimal |

Rationale

Interest income from West Virginia obligations is excluded because these obligations represent funding for State and local projects. A tax on interest income increases the cost of borrowing.

Interest from most state and local obligations is excluded for federal income tax purposes. Therefore, such income is usually not included in federal adjusted gross income, which is the starting point in calculating West Virginia Personal Income Tax liability. The amount of interest from West Virginia obligations not already excluded in calculating federal adjusted gross income is small. Therefore, the revenue loss from excluding any other interest from State or local obligations is minimal.

STATE INCOME TAX REFUNDS

| | |
|-------------------|--|
| STATUTE: | West Virginia Code §11-21-12(c)(4) |
| DEDUCTION: | Any refund or credit for overpayment of West Virginia income taxes or income taxes of any other taxing jurisdiction to the extent included in gross income for federal income tax purposes |
| VALUE: | \$2.6 million per year |

Rationale

This decreasing modification is only for taxpayers who itemized on their federal return for the previous year. For those taxpayers who itemize on their federal return, state and local income taxes withheld can be deducted on the federal return for the tax year in which the payments are made.

The modification is based on the amount of income tax paid, not the tax liability. Therefore, any refund must be included in federal adjusted gross income for the tax year in which it is received. Since West Virginia does not allow a deduction for State and local income taxes paid, a refund included in federal adjusted gross income may be deducted for State purposes. This modification eliminates double taxation of the same income and therefore is **not** a tax expenditure.

ITEMIZED DEDUCTIONS FOR FIDUCIARIES

STATUTE: West Virginia Code §11-21-18

DEDUCTION: Itemized deductions claimed prior to attainment of taxable income for the fiduciary

VALUE: **Not Available**

Rationale

Although the State does not permit federal itemized deductions for Personal Income Tax, West Virginia allows these deductions for the Fiduciary Income Tax. Current calculations of State tax liability for fiduciaries begin with federal taxable income, not federal adjusted gross income. Therefore, fiduciaries are essentially allowed to claim itemized deductions. This simplifies the filing requirements for these taxpayers.

DECREASING MODIFICATION FOR SENIOR CITIZENS

STATUTE: West Virginia Code §11-21-12(c)(8)

EXCLUSION: Senior citizen exclusion of up to \$8,000 per individual or \$16,000 per two-income married couple

VALUE: **\$39.6 million per year**

Rationale

This modification provides a significant tax reduction to those age sixty-five or older. It was designed as a minimum income exclusion for low-income senior citizens although all taxpayers over age sixty-five, whether they are low-income or high-income, are allowed this modification.

Revenue Analysis

The repeal of this modification would not necessarily yield the amount shown. The revenue impact for this exemption was calculated in isolation from other exemptions. Therefore, the actual revenue to be gained by the repeal of the decreasing modification for senior citizens would be less than stated above. Other exclusions, such as the decreasing modification for the first \$2,000 of military retirement pay, may overlap this modification. Due to these overlapping modifications, legislation to repeal the senior citizen modification would result in a revenue gain of approximately \$34.2 million.

DECREASING MODIFICATION FOR DISABLED PERSONS

| | |
|-------------------|---|
| STATUTE: | West Virginia Code §11-21-12(c)(8) |
| EXCLUSION: | Permanent disability exclusion of up to \$8,000 per individual or \$16,000 per married couple |
| VALUE: | \$2.8 million per year |

Rationale

This decreasing modification provides a measure of income tax relief to disabled individuals.

Revenue Analysis

The repeal of this modification would not necessarily yield the amount shown. The revenue impact for this exemption was calculated in isolation from other exemptions. Therefore, the actual revenue to be gained by the repeal of the decreasing modification for disabled persons would be less than stated above. Other exclusions, such as the decreasing modification for the first \$2,000 of military retirement pay, may overlap this modification. Due to these overlapping modifications, legislation to repeal the modification for disabled persons would result in a revenue gain of approximately \$2.5 million.

DECREASING MODIFICATION FOR SURVIVING SPOUSES

| | |
|-------------------|--|
| STATUTE: | West Virginia Code §11-21-12(c)(9) |
| EXCLUSION: | Surviving spouse exclusion of up to \$8,000 for the spouse of a person who had attained age sixty-five or who was certified as totally and permanently disabled prior to death |
| VALUE: | Minimal |

Rationale

This modification presumably exists to help in the transition for surviving spouses.

DECREASING MODIFICATION FOR RESIDENT FULL-TIME MILITARY PERSONNEL STATIONED OUTSIDE WEST VIRGINIA

| | |
|-------------------|--|
| STATUTE: | West Virginia Code §11-21-7 |
| EXCLUSION: | Exclusion for military income earned by military personnel who claim West Virginia as their state of residence but are stationed outside the State |
| VALUE: | Cannot be determined |

Rationale

If a taxpayer is a member of the United States military forces and the taxpayer's domicile was in West Virginia at the time the person entered military service, then assignment to duty outside the State does not change the taxpayer's West Virginia domicile. The member of the armed forces will be liable for West Virginia Personal Income Tax unless the following conditions are met:

1. the taxpayer had no permanent place of abode in West Virginia during the taxable year, and
2. the taxpayer did not spend more than thirty not necessarily consecutive days in West Virginia during the taxable year.

These taxpayers, although they claim West Virginia as their state of residence, were stationed elsewhere and did not live in West Virginia during the tax year. This is an implied modification

based on an administrative interpretation of the definition of residency for Personal Income Tax purposes.

Revenue Analysis

The revenue loss associated with this decreasing modification could not be determined. Most full-time military personnel are not required to file West Virginia Personal Income Tax returns because all of their income is exempt from State taxation.

DECREASING MODIFICATION FOR NATIONAL GUARD AND RESERVE FORCES CALLED TO ACTIVE DUTY

STATUTE: West Virginia Code §11-21-12e

EXCLUSION: Exclusion for income of members of the West Virginia National Guard or reserve forces who are called to active duty for Operation Enduring Freedom or for security duty

VALUE: **Cannot be determined**

Rationale

This expenditure presumably exists to recognize the services of reserve military personnel who are called to active duty for Operation Enduring Freedom or for domestic security duty as a result of a call out pursuant to an Executive Order of the President of the United States.

Revenue Analysis

The revenue loss associated with this decreasing modification cannot be determined. The loss of revenue in any given year depends on the number of military personnel called to active duty and the length of time they are on active duty.

**DECREASING MODIFICATION FOR
CONTRIBUTIONS TO MEDICAL SAVINGS ACCOUNTS**

STATUTE: West Virginia Code §11-21-12(c)(10)

EXCLUSION: Contributions to medical savings accounts established pursuant to section fifteen, article sixteen, chapter thirty-three of the West Virginia Code to the extent included in federal adjusted gross income for federal income tax purposes less any portion of employer contributions withdrawn for purposes other than payment of medical expenses.

VALUE: **\$0 per year**

Rationale

This expenditure presumably exists to encourage the formation and use of medical savings accounts.

**DECREASING MODIFICATION FOR CONTRIBUTIONS
TO WEST VIRGINIA PREPAID TUITION TRUST FUND**

STATUTE: West Virginia Code §11-21-12a

EXCLUSION: Payments made to the West Virginia Prepaid Tuition Trust Fund administered through the West Virginia State Treasurer's Office

VALUE: **\$1.5 million per year**

Rationale

This expenditure presumably exists to encourage savings for future educational expenses.

**DECREASING MODIFICATION FOR PREMIUMS FOR
LONG-TERM CARE INSURANCE POLICIES**

STATUTE: West Virginia Code §11-21-12c

EXCLUSION: Payments for premiums for a long-term care policy that offers coverage to either the taxpayer or the taxpayer's spouse, parent or dependent

VALUE: **\$690,000 per year**

Rationale

This expenditure presumably exists to encourage the purchase of long-term care.

PENSION EXCLUSIONS

Due to the similarities in West Virginia's tax treatment of retirement benefits for government retirees, these exclusions have been grouped together for purposes of this study. Currently, most pension plan contributions are tax-deferred under both federal and West Virginia tax laws. A pension income exclusion changes tax-deferred income into tax-exempt income.

MILITARY RETIREMENT BENEFITS

STATUTE: West Virginia Code §11-21-12(c)(5)

EXCLUSION: The first \$2,000 of benefits received from military retirement

VALUE: **\$680,000 per year**

Rationale

Because of the United States Supreme Court ruling in Davis v. Michigan, this partial exclusion is necessary because a similar exclusion is allowed for State government retirement benefits.

Revenue Analysis

Taxpayers who are sixty-five years old or totally and permanently disabled may currently take a \$2,000 decreasing modification for military retirement benefits and a \$6,000 modification for senior citizens. Without the decreasing modification for military retirement pay, these taxpayers would be eligible for the full \$8,000 senior citizen exclusion.

FEDERAL RETIREMENT SYSTEMS BENEFITS

STATUTE: West Virginia Code §11-21-12(c)(5)

EXCLUSION: The first \$2,000 of benefits received from any federal retirement system

VALUE: **\$830,000 per year**

Rationale

As a result of the United States Supreme Court's ruling in Davis v. Michigan, this partial exclusion is necessary because of a similar exclusion is allowed for State government retirement benefits.

Revenue Analysis

Taxpayers who are sixty-five years old or totally and permanently disabled may currently take a \$2,000 decreasing modification for any federal retirement benefits and a \$6,000 modification for senior citizens. Without the decreasing modification for federal retirement benefits, these taxpayers would be eligible for the full \$8,000 senior citizen exclusion.

**WEST VIRGINIA PUBLIC EMPLOYEES'
RETIREMENT SYSTEM BENEFITS**

STATUTE: West Virginia Code §11-21-12(c)(5)

EXCLUSION: The first \$2,000 of benefits received from the West Virginia Public Employees' Retirement System

VALUE: **\$700,000 per year**

Rationale

This exclusion is a benefit for West Virginia Public Employees' Retirement System participants.

Revenue Analysis

Taxpayers who are sixty-five years old or totally and permanently disabled may currently take a \$2,000 decreasing modification for Public Employees' Retirement System benefits and a \$6,000 modification for senior citizens. Without the decreasing modification for benefits from the West Virginia Public Employees' Retirement System, these taxpayers would be eligible for the full \$8,000 senior citizen exclusion.

**WEST VIRGINIA TEACHERS'
RETIREMENT SYSTEM BENEFITS**

STATUTE: West Virginia Code §11-21-12(c)(5)

EXCLUSION: The first \$2,000 of benefits received from the West Virginia Teachers' Retirement System

VALUE: **\$1.3 million per year**

Rationale

This modification exists as a benefit for West Virginia Teachers' Retirement System participants.

Revenue Analysis

Taxpayers who are sixty-five years old or totally and permanently disabled may currently take a \$2,000 decreasing modification for Teachers' Retirement System benefits and a \$6,000 modification for senior citizens. Without the decreasing modification for benefits from the West Virginia Teachers' Retirement System, these taxpayers would be eligible for the full \$8,000 senior citizen exclusion.

STATE OR LOCAL POLICE OR FIREFIGHTERS' OR DEPUTY SHERIFFS' RETIREMENT SYSTEMS BENEFITS

STATUTE: West Virginia Code §11-21-12(c)(6)

EXCLUSION: All benefits received under the West Virginia Department of Public Safety Death, Disability and Retirement Fund or retirement income received in the form of pensions or annuities from any West Virginia police or firemen's retirement system after December 31, 1979

VALUE: **\$4.3 million per year**

Rationale

All benefits received from any West Virginia state or local police or firefighters' retirement system are excluded from Personal Income Tax. These retirees usually are not eligible for Social Security benefits relating to their service as firefighters or police officers. Most other public sector retirees (State, federal and military) are eligible for Social Security retirement benefits.

Revenue Analysis

As a portion of total value, 85 percent of this exclusion is attributable to retirees from State or local police departments. The remaining 15 percent is attributable to retirees from municipal fire departments.

Some of these taxpayers are senior citizens. If no decreasing modification existed for benefits from State or local police or firefighters' retirement plans, these taxpayers would be eligible for the \$8,000 decreasing modification for taxpayers over age sixty-five or totally and permanently disabled.

RAILROAD RETIREMENT BENEFITS

| | |
|-------------------|--|
| STATUTE: | West Virginia Code §11-21-12(c)(11) |
| EXCLUSION: | Railroad Retirement benefits paid by the United States Railroad Retirement Board |
| VALUE: | \$2.0 million per year |

Rationale

Tier I and Tier II Railroad Retirement benefits included in federal adjusted gross income are excluded from State Personal Income Tax.¹ Taxation of Tier I benefits by states is prohibited under federal law. All or part of Tier I Railroad Retirement benefits may be excluded in computing federal adjusted gross income, the starting point for West Virginia Personal Income Tax computation. The amount excluded on the federal income tax return is based on the taxpayer's combined income over a specified base amount. The value of the State exclusion includes only those benefits that are taxable under federal income tax statutes.

Revenue Analysis

The full exclusion for Railroad Retirement benefits is not subject to the same restrictions as benefits from federal, State and local government retirement systems. Benefits claimed for government retirement systems (e.g., \$2,000 exclusion for military retirement) reduce the maximum amount allowed for the senior citizens exclusion. For example, if a taxpayer takes a \$2,000 exclusion for federal retirement benefits, the maximum amount of other income which can be excluded is \$6,000. The same is not true for Railroad Retirement benefits. These retirees may take a full exclusion for their Railroad Retirement benefits and then take an exclusion of up to \$8,000 of other income, if the taxpayer is at least sixty-five years old or is totally and permanently disabled.

¹ A portion of a taxpayer's Tier I Railroad Retirement benefits may be taxable for federal income tax purposes and therefore included in federal adjusted gross income. The amount of benefits that are taxable is based on the taxpayer's combined income over a specified base amount. The base amount is one of the following:

1. \$32,000 for married taxpayers filing jointly,
2. \$0 for married taxpayers filing separately, or
3. \$25,000 for all other taxpayers.

MILITARY RETIREMENT EXCLUSION

STATUTE: West Virginia Code §11-21-12(c)(7)
EXCLUSION: Additional military pension exclusion of up to \$20,000
VALUE: **\$3.8 million per year**

Rationale

This modification exists as a benefit for military retirees.

PENSION BENEFIT GUARANTEE MODIFICATION

STATUTE: West Virginia Code §11-21-12d
EXCLUSION: Reducing modification of the difference between the amount the taxpayer would have received had his pension plan not been terminated and the amount actually received from the guarantor for taxpayers who retire under an employer-provided defined benefits pension plan that terminates prior to or after the retirement and that pension plan is covered by a guarantor whose maximum benefit guarantee is less than the maximum benefit to which the taxpayer is entitled
VALUE: **\$390,000 per year**

Rationale

This modification exists as a benefit for retirees who are receiving less benefits than they were entitled to under a defined benefits plan because the pension plan has been terminated and payments are being made by a guarantor.

FEDERALLY MANDATED EXCLUSIONS

The following two exclusions are **not** tax expenditures because they are excluded from state taxation by federal law:

Interest Income from United States Obligations for Personal Income Tax Purposes
Interest Income from United States Obligations for Fiduciary Income Tax Purposes

For this report, these exclusions are considered a basic part of the Personal Income Tax structure because State lawmakers have no authority to tax such income. Values for these exclusions are given although additional revenue would not be realized through Legislative action due to federal prohibitions for taxing these obligations.

INTEREST INCOME FROM UNITED STATES OBLIGATIONS FOR PERSONAL INCOME TAX PURPOSES

STATUTE: West Virginia Code §11-21-12(c)(1)
EXCLUSION: Interest income on obligations of the United States
VALUE: **\$3.2 million per year**

INTEREST INCOME FROM UNITED STATES OBLIGATIONS FOR FIDUCIARY INCOME TAX PURPOSES

STATUTE: West Virginia Code §11-21-19
EXCLUSION: Interest income on obligations of the United States
VALUE: **\$3.0 million per year**

CREDITS

The West Virginia Code provides for the application of various tax credits against the Personal Income Tax. Some credits provide qualifying businesses or business shareholders with an investment incentive while others provide relief from double taxation. These credits include the following types:

Economic Development Tax Credits

- Economic Opportunity Tax Credit
- Economic Opportunity Tax Credit - High Technology Manufacturers
- Strategic Research and Development Tax Credit
- High-Growth Business Investment Tax Credit
- Film Industry Investment Credit

Credits to Prevent Double Taxation

- Business and Occupation Tax Credit
- Credit for Personal Income Taxes Paid to Other States
- Credit for Fiduciary Income Taxes Paid to Other States

Miscellaneous Tax Credits

- Environmental Agricultural Equipment Credit
- Neighborhood Investment Program Credit
- Apprenticeship Training Credit
- Historic Rehabilitated Buildings Investment Credit
- Qualified Rehabilitated Residential Building Investment Credit
- Nonfamily Adoption Credit
- Senior Citizens Credit for Property Tax Paid
- Low-Income Family Tax Credit
- Excess Property Tax Credit
- Military Employment Incentive Credit

Expired and Terminated Tax Credits

Many of the credits listed above may also be applied against other business and personal taxes. Expenditure values presented in this section represent the amounts applied against only Personal Income Tax. Often, the credit claimed against the Personal Income Tax has been reduced by the application of the credit against other taxes according to the priority order specified by statute or regulations. Thus, the credit amounts claimed against Personal Income Tax may be negligible compared to the total cost of the credit taken against all taxes. An analysis of these expenditures follows.

ECONOMIC DEVELOPMENT TAX CREDITS

| | |
|------------------|--|
| STATUTES: | West Virginia Code §§11-13Q, 11-13R, 11-13U, and 11-13X |
| CREDITS: | Economic Opportunity Tax Credit (W. Va. Code §11-13Q) Economic Opportunity Tax Credit - High Technology Manufacturers (W. Va. Code §11-13Q-10a) Strategic Research and Development Tax Credit (W. Va. Code §11-13R) High-Growth Business Investment Tax Credit (W. Va. Code §11-13U) Film Industry Investment Tax Credit (W. Va. Code §11-13X) |
| VALUE: | \$500,000 |

Rationale

The Economic Development Tax Credits are generally designed to promote job creation and/or investment within the State. Benefits attributable to the Economic Opportunity Tax Credit, Strategic Research and Manufacturing Investment Tax Credit are generally available over a ten-year period of time while the benefits attributable to the High-Growth Business Investment Tax Credit are available for a five-year period and the Economic Opportunity Tax Credit - High Technology Manufacturers is available for a twenty-year period. However, any unused Film Industry Investment Credit remaining after the second tax year following the tax year in which the qualifying investment was made is forfeited.

The Economic Opportunity Tax Credit exists to encourage greater capital investment in businesses in the State and thus increase economic opportunity. While the base credit program requires the creation of at least twenty new jobs, lower minimum new jobs levels are provided for the Corporate Headquarters Relocation portion of the credit program (minimum of fifteen new jobs) and for the Small Business provision (minimum of ten new jobs). The basis of the program is largely attributable to capital investment, not direct employment growth.

In 2007, legislation was enacted to create a special tax credit for certain manufacturers. The Economic Opportunity Tax Credit - High Technology Manufacturers, effective January 1, 2008, exists to promote job creation in the following industries:

| North American Industry Classification System Code (NAICS) | <u>Manufacturing Activity</u> |
|--|---------------------------------|
| 334111 | Electronic Computers |
| 334112 | Computer Storage Devices |
| 334411 | Electron Tubes |
| 334414 | Electronic Capacitors |
| 334413 | Semiconductor & Related Devices |
| 333295 | Semiconductor Machinery |

In addition to the specified manufacturing activity, potential credit claimants must also create at least twenty new jobs with a median compensation of \$45,000¹ per year.

The Strategic Research and Development Tax Credit exists to encourage research and development activity within West Virginia.

The High-Growth Business Investment Tax Credit exists to encourage investment in start-up, growth-oriented, research and development businesses in West Virginia.

To encourage economic growth through the production of motion pictures and other commercial film or audiovisual projects in West Virginia, the Film Industry Investment Credit was enacted in 2007.

Revenue Analysis

The Economic Opportunity Tax Credit and Strategic Research and Development Tax Credit were enacted into law in 2002 and apply to qualified investment made on or after January 1, 2003 while the High-Growth Business Investment Tax Credit was enacted into law in 2004 and applies to qualified investment made on or after July 1, 2005. The Economic Opportunity Tax Credit - High Technology Manufacturers and Film Industry Investment Credit were enacted in 2007. In many cases, a one-year investment made for these credits generally entitles the Taxpayer to multiple-year credit availability. Since these credits are still relatively new, additional utilization of the credits is expected and will result in a greater reduction in revenue. Also, claims of these credits are first used to offset Business Franchise Tax liability.

¹ The median compensation level for determining attributable new jobs will be adjusted for inflation annually.

CREDITS TO PREVENT DOUBLE TAXATION

| | |
|------------------|--|
| STATUTES: | West Virginia Code §§11-21-8(a), 11-21-20 and 11-21-40 |
| CREDITS: | Business and Occupation Tax Credit (W.Va. Code §11-21-8(a)) Credit for Personal Income Taxes Paid to Other States (W.Va. Code §§11-21-20 and 11-21-40) Credit for Fiduciary Income Taxes Paid to Other States (W.Va. Code §§11-21-20 and 11-21-40) |
| VALUE: | \$18.4 million per year |

Rationale

These credits generally exist to eliminate the possibility of double taxation. These credits are **not** tax expenditures because they simply provide a mechanism for the return of funds never due to the State.

MISCELLANEOUS TAX CREDITS

| | |
|------------------|---|
| STATUTES: | West Virginia Code §§11-13J, 11-13K, 11-13W, 11-21-8a, 11-21-8g, 11-21-10a, 11-21-21, 11-21-22, 11-21-23, and 11-21-42 |
| CREDITS: | Neighborhood Investment Credit (W.Va. Code §11-13J) Environmental Agricultural Equipment Credit (W.Va. Code §11-13K) Apprenticeship Training Credit (W.Va. Code §11-13W) Historic Rehabilitated Buildings Investment Credit (W.Va. Code §11-21-8a) Qualified Rehabilitated Residential Building Investment Credit (W.Va. Code §11-21-8g) Nonfamily Adoption Credit (W.Va. Code §11-21-10a) Senior Citizens Credit for Property Tax Paid (W.Va. Code §11-21-21) Low-Income Family Tax Credit (W.Va. Code §11-21-22) Excess Property Tax Credit (W.Va. Code §11-21-23) Military Employment Incentive Credit (W.Va. Code §11-21-42) |
| VALUE: | \$24.2 million per year |

Rationale

The Miscellaneous Tax Credits have numerous purposes ranging from promotion of capital contributions to community-based organization to providing tax relief to low-income families.

Revenue Analysis

The above value includes an estimate of the cost of the Low-Income Family Tax Credit. The credit was authorized for tax years beginning on or after January 1, 2007, However, for the 2007 tax year, qualifying taxpayers may only claim fifty percent of the credit otherwise available.

EXPIRED AND TERMINATED TAX CREDITS

| | |
|-----------------|---|
| STATUTE: | West Virginia Code §§5E-1-8, 5E-2-4, 11-6D, and 11-13C-16 |
| CREDITS: | West Virginia Capital Company Credit (W.Va. Code §5E-1-8) West Virginia Venture Capital Credit (W.Va. Code §5E-2-4) Alternative-Fuel Motor Vehicles Credit (W.Va. Code §11-6D) Business Investment and Jobs Expansion Credit (W.Va. Code §11-13C-16) |
| VALUE: | \$1.4 million per year |

Rationale

The Alternative-Fuel Motor Vehicles Credit expired on June 5, 2006 per provisions in the original credit enactment law. The other above listed credits were replaced or repealed and new qualifying applications were terminated through tax credit reform legislation enacted in 2002 (Business Investment and Jobs Expansion Credit) or tax modernization legislation enacted in 2007.

Revenue Analysis

The above listed credits generally provided for multi-year application (e.g., three years for the Alternative-Fuel Motor Vehicles Credit and up to thirteen years for the Business Investment and Jobs Expansion Credit). While the legislation expiring or terminating these credits precludes any new qualifying credit after the expiration or termination date, taxpayers that gained entitlement to any of the above listed credits prior to the expiration or termination date retained that entitlement and may apply the credit until the original multi-year entitlement has been exhausted. Thus, these credits will remain a tax expenditure for several years.

DUPLICATE TAX EXPENDITURE BENEFITS

Duplicate tax expenditure benefits are those items not included in West Virginia's tax base. These items are excluded by default because addbacks for these expenses were not included in the West Virginia Code when tax credits were enacted. The items listed below are treated as duplicate tax expenditures:

Depreciation and Amortization Expenses Tied to Various Investment Tax Credits
Salary Expenses Tied to Military Employment Incentive Credit

An analysis of these expenditures follows.

DEPRECIATION AND AMORTIZATION EXPENSES TIED TO VARIOUS INVESTMENT TAX CREDITS

STATUTE: West Virginia Code §11-21-12(b) et seq.

DEDUCTION: Depreciation and amortization expenses tied to investments subject to the Economic Opportunity Tax Credit, Economic Opportunity Tax Credit - High Technology Manufacturers, Strategic Research and Development Tax Credit, Film Industry Investment Credit, the Historic Rehabilitated Buildings Investment Credit, the Environmental Agricultural Equipment Credit, the Alternative-Fuel Motor Vehicles Credit, Business Investment and Jobs Expansion Credit, the Management Information Services Facilities Credit and the Industrial Facilities Coal-Based Synthetic Fuels Credit

VALUE: Not available

Rationale

Taxpayers are usually required to increase their federal adjusted gross income by the amount of the otherwise allowable expenses attributable to tax credits. This eliminates the possibility of double tax benefits through both a deduction and a credit for the same item or activity. Currently, taxpayers are not required to add back amortization and depreciation expenses attributable to the following credits:

Economic Opportunity Tax Credit
Economic Opportunity Tax Credit - High Technology Manufacturers
Strategic Research and Development Tax Credit
Film Industry Investment Credit
Historic Rehabilitated Buildings Investment Credit
Environmental Agricultural Equipment Credit
Alternative-Fuel Motor Vehicles Credit
Business Investment and Jobs Expansion Credit
Management Information Services Facilities Credit
Industrial Facilities Coal-Based Synthetic Fuels Credit

However, a portion of the amortization and depreciation expenses attributable to the Research and Development Projects Credit must be added back in calculating West Virginia tax liability.

**SALARY EXPENSES TIED TO
MILITARY EMPLOYMENT INCENTIVE CREDIT**

STATUTE: West Virginia Code §11-21-42

DEDUCTION: Salary expenses tied to Military Employment Incentive Credit

VALUE: **Minimal**

Rationale

The federal government usually requires taxpayers to increase their federal adjusted gross income by the amount of the otherwise allowable expenses attributable to tax credits. This eliminates the possibility of double tax benefits through both a deduction and a credit for the same item or activity. However, West Virginia taxpayers are not required to add back salary expenses attributable to the Military Employment Incentive Credit.