DEPARTMENT OF TAXATION
2009 Fiscal Impact Statement

1. Patron Richard H. Stuart

2. Bill Number SB 0978

House of Origin:
_____ **Introduced**
_____ **Substitute**
_____ **Engrossed**

Second House:
_____ **In Committee**
_____ **Substitute**
__X__ **Enrolled**

3. Committee Passed House and Senate

4. Title Income Tax: Qualifying Dispositions of Real Property

5. Summary/Purpose:

This bill would allow individual and corporate taxpayers to recognize income from certain dispositions of real property under the installment method for Virginia tax purposes, even though they were required to report the entire gain as income in the year of the disposition for federal income tax purposes. The qualifying dispositions of real property would be those in which the real property is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.

This bill would require the election for the installment method to be made on or before the due date of the taxpayer's tax return for the taxable year in which the disposition occurred. This bill would also require TAX to establish guidelines, exempt from the Administrative Process Act, that outline the restrictions or conditions associated with qualifying dispositions. The disposition would be required to be in accordance with such restrictions or conditions in order for the taxpayer to elect the installment method.

This bill would be effective for qualifying dispositions of real property made on or after January 1, 2009.

6. Fiscal Impact Estimates are: Preliminary. (See Line 8.)

7. Budget amendment necessary: Yes.
Page 1, Revenue Estimates

8. Fiscal implications:

Administrative Costs

TAX has not assigned any administrative costs to this bill because the changes required by a single bill such as this can be implemented as part of the annual changes to our systems and forms. TAX considers implementation of this bill as "routine," and does not require additional funding.

Revenue Impact

This bill would have an unknown, but potentially significant, revenue impact. Available data do not provide the information necessary to accurately identify the current number or value of dispositions for which dealers would be eligible to receive installment treatment on the Virginia income tax return. In addition, there is no data on which to base an estimate of the number or value of additional dispositions that would be made in response to this bill. Under the provisions of this bill, however, in the year of the qualifying disposition, there would be a revenue loss associated with the deduction allowed by this bill. In subsequent years, there would be a revenue gain.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Installment Sale Method

Under federal law, income from an installment sale must be accounted for using the installment method unless the seller elects not to use this method. An “installment sale” is the disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. Under the installment sale method, the recognized reportable gain is calculated when each installment is received, and each payment represents two components. The first part is the nontaxable recovery amount of a portion of the seller's tax basis or net investment in the property, and the second part is the taxable realization of a portion of the seller's gain. Accordingly, the taxpayer is taxed only on the part of the payment that represents the gain on the sale. This amount is calculated by multiplying the total amount of payments received during the year by the ratio of the gross profit to the total contract price, which is the gross profit percentage.

The following example illustrates the basic mechanics of the installment sale method. Taxpayer A, a non-dealer, sells real estate with an adjusted tax basis of $350 to Taxpayer B for $500, which is payable to A in five annual installments of $100. A's gross profit on the sale is $150 ($500 sales price less $350 basis). The gross profit percentage is 30% ($150 gross profit divided by $500 total contract price). Accordingly, the amount of each payment received by A that will be reported as gain is $30 (30% multiplied by $100 payment). The remaining $70 of each payment is a nontaxable recovery of basis.

For federal income tax purposes, the installment method may not be used for dealer dispositions or inventories of personal property. A “dealer disposition” includes any disposition of personal property by a person who regularly sells or otherwise disposes of such property on an installment plan and any disposition of real property which is held for sale to customers in the ordinary course of the taxpayer's trade or business. A dealer disposition does not include the disposition of certain farm property or the disposition of certain timeshares and residential lots. Therefore, in the example above, Taxpayer A would be required to report the entire $150 gross profit in the year of the sale.

Although dealers may not use the installment method currently, the historical purpose of this method was to alleviate the hardship of paying an immediate tax on a transaction which produces no cash at the time of sale and may never produce cash if the buyer defaults. In 1987, however, Congress repealed the installment method for dealers because it is inconsistent with an accrual method of accounting, which generally requires a taxpayer to pay tax on realized gain, regardless of whether or not the taxpayer has received the related cash. Today, the principal beneficiaries of the installment method are casual sellers.

Conformity to the Internal Revenue Code

Virginia law provides that federal adjusted gross income is the starting point for computation of Virginia taxable income for individuals, while federal taxable income is the starting point for corporate taxpayers. Therefore, any income included in federal adjusted gross income (or federal taxable income) is also subject to Virginia taxation. The federal income reported by a Virginia taxpayer is then modified by the additions, subtractions, deductions, and exemptions specifically indicated in Virginia law.

Proposal

This bill would allow individual and corporate taxpayers to recognize income from certain dispositions of real property under the installment method for Virginia tax purposes, even though they were required to report the entire gain as income in the year of the disposition for federal income tax purposes. The qualifying dispositions of real property would be those in which the real property is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business. This bill would not allow the use of the installment method for dispositions of personal property by a person who regularly sells or otherwise disposes of such property on an installment plan.

This bill would require the election for the installment method to be made on or before the due date of the taxpayer's tax return for the taxable year in which the disposition occurred. This bill would also require TAX to establish guidelines, exempt from the Administrative Process Act, that outline the restrictions or conditions associated with qualifying dispositions. The disposition would be required to be in accordance with such restrictions or conditions in order for the taxpayer to elect the installment method.

After making the election, the Virginia taxpayer would be allowed to deduct the portion of the gain reported for federal purposes related to a qualifying disposition that is equal to the difference between what was subject to tax for federal purposes and what would have been subject to tax on the installment method. In the following years, the taxpayer would be required to add back the amount that would have been reported under the installment method.

For instance, as in the example listed above, Taxpayer A sells real estate with an adjusted tax basis of $350 to Taxpayer B for $500, which is payable to A in five annual installments of $100. In this case, however, Taxpayer A is a dealer. For federal purposes, Taxpayer A will not be required to report the entire $150 gain in the year of the sale. For Virginia income tax purposes, however, Taxpayer A would treat the transaction as an installment sale. Therefore, Taxpayer A would be required to make the following adjustments in his Virginia income tax return:

Return	Year 1	Year 2	Year 3	Year 4	Year 5
Federal	$150 gain	$0	$0	$0	$0
Virginia	$120 subtraction	$30 addition	$30 addition	$30 addition	$30 addition

This bill would be effective for qualifying dispositions of real property made on or after January 1, 2009.

cc : Secretary of Finance

Date: 2/20/2009 TLG
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