REVISED

DEPARTMENT OF TAXATION
2010 Fiscal Impact Statement

1. Patron Charles J. Colgan

2. Bill Number SB 545

House of Origin:

X **Introduced**

_____ **Substitute**

_____ **Engrossed**

Second House:

_____ **In Committee**

_____ **Substitute**

_____ **Enrolled**

3. Committee Senate Finance

4. Title Income Tax: Conformity with Internal Revenue Code

5. Summary/Purpose:

This bill would advance Virginia's date of conformity to the Internal Revenue Code (IRC) from December 31, 2008 to December 31, 2009. Virginia would continue to disallow most bonus depreciation, and any five year carry-back of certain net operating losses (NOL) allowed for NOLs generated in taxable years 2001 or 2002.

This bill would disallow the income tax deductions related to applicable high yield discount obligations and the ratable deferral of cancellation of debt income allowed under the American Reinvestment and Recovery Act (ARRA) of 2009.

In addition, this bill would deconform from the deduction allowed for domestic production activities effective for taxable years beginning on and after January 1, 2010.

This bill contains an emergency clause and would be in force from its passage.

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

7. Budget amendment necessary: No.

8. Fiscal implications:

Administrative Costs

TAX considers implementation of this bill as routine, and does not require additional funding.

Revenue Impact

The Introduced Executive Budget assumes the passage of this bill and therefore incorporates the fiscal impact of federal tax laws passed during 2009, as well as the deconformity from additional federal provisions. As a result, this bill would have no revenue impact.

The following amounts attributable to conformity with the ARRA are incorporated into the Introduced Executive Budget for this bill:

Fiscal Year	***Dollars***	***Fund***
2009-10	($14.72 Million)	GF
2010-11	$23.63 Million	GF
2011-12	$32.07 Million	GF
2012-13	$1.65 Million	GF
2013-14	$0.06 Million	GF
2014-15	($1.44 Million)	GF
2015-16	($1.13 Million)	GF

This bill would avoid the impact of two provisions in the ARRA – the discount on applicable high yield discount obligations and the cancellation of debt provision. Deconforming from these provisions eliminates a loss of $99.39 million in FY 2010 and $38.47 million in FY 2011 in General Fund revenue.

This bill also includes a provision to disallow the deduction for domestic production activities under § 199 of the IRC effective for taxable years beginning on and after January 1, 2010. It is estimated that deconforming to this deduction will increase General Fund revenues by approximately $30 million a year.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Current Law

Virginia's conformity to the IRC is currently fixed to the IRC as it existed on December 31, 2008. Since that date, Congress has enacted one significant measure that would affect income taxation in Virginia:

- The American Recovery and Reinvestment Act of 2009, which provides a variety of monetary provisions for states and localities to help improve the economy and tax relief for individuals and families.

Unless the date of IRC conformity is advanced, none of the provisions of this Act will flow through to Virginia taxable income. Because federal adjusted gross income (individuals) and federal taxable income (corporations) are the starting point for Virginia tax returns, if this bill is not enacted, Virginia taxpayers would be required to make complex "Fixed-Date Conformity" adjustments to remove the changes made by this Act when they prepare their Virginia tax returns.

Federal Law

In 2009, the American Recovery and Reinvestment Act (ARRA) was enacted. This legislation provides a variety of monetary provisions for states and localities to help improve the economy and tax relief for individuals and families. Among the significant tax provisions was a temporary increase in the earned income tax credit for 2009 and 2010 and an extension of the temporary increase in the expensing of certain business assets.

ARRA also added IRC § 108(i). This section allows deferral of cancellation of debt income realized in connection with a reacquisition of business debt at a discount after December 31, 2008 and before January 1, 2011. Such income is then recognized ratably over the five-year tax period beginning in the fifth taxable year following a 2009 reacquisition and in the fourth taxable year following a 2010 reacquisition.

In addition, ARRA established a provision under IRC § 163(e)(5)(F) that suspends the application of the applicable high yield debt obligation (AHYDO) rules for certain debts issued after September 30, 2008 and before January 1, 2010. Under this provision corporate and certain partnership debt that would have otherwise created deferred or non-deductible interest will be provided immediate tax deductions under general interest deductibility principles.

In 2004, Congress created a provision under IRC § 199, which allows a tax deduction for domestic production by certain businesses. The intent of the change was to reduce the effective tax rate on domestic manufacturing. The deduction is equal to 3% of qualified production activities income of the taxpayer in tax years 2005 and 2006, 6% in 2007 through 2009, and 9% in 2010 and thereafter. If taxable income is less than this amount, then the deduction is equal to taxable income. Additionally, the deduction is limited to 50% of the W-2 wages paid by the taxpayer for that taxable year. Virginia conformed to this provision in 2005.

The activities eligible for the deduction include not only the manufacture of personal property but also software development; film and music production; the production of water, natural gas, and electricity; and construction, engineering, and architectural activities and services.

Proposed Legislation

This bill would advance Virginia's date of conformity to the Internal Revenue Code (IRC) from December 31, 2008 to December 31, 2009 and incorporate most changes contained in the ARRA. Virginia would continue to disallow most bonus depreciation, and any five year carry-back of certain net operating losses (NOL) allowed for NOLs generated in taxable years 2001 or 2002.

In addition, this bill would deconform from the following provisions:

- IRC § 108(i), relating to the ratable deferral of cancellation of debt income;
- IRC § 163(e)(5)(f), relating to the tax deductions related to applicable high yield discount obligations; and
- IRC § 199, enacted in 2004, relating to the deduction of a percentage of income attributable to domestic production activities, effective for taxable years beginning on and after January 1, 2010.

This bill contains an emergency clause and would be in force from its passage.

Other Legislation

House Bill 614 is identical to this bill.

Senate Bill 179 is similar to this bill, but includes a provision that amendments to the IRC would not apply for Virginia income tax purposes in taxable years beginning in the calendar year in which the amendments were enacted if the Tax Commissioner determined that (i) the amendment, or combination of related amendments, would reduce Virginia tax revenue by $5 million or more in any fiscal year, or (ii) any group of amendments would together reduce Virginia tax revenue by $25 million or more in any fiscal year.

cc : Secretary of Finance

Date: 1/17/2010 TG
SB545F161