DEPARTMENT OF TAXATION
2010 Fiscal Impact Statement

1. Patron Charles J. Colgan

2. Bill Number SB 545

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

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

3. Committee House Appropriations

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.

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. However, partial deferral of some of the deductions would be permitted.

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

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

6b Revenue Impact

Fiscal Year	***GF Impact***
2009-10	($49.0 Million)
2010-11	($5.5 Million)
2011-12	($5.5 Million)
2012-13	($30 Million)
2013-14	($30 Million)
2014-15	($30 Million)
2015-16	($30 Million)

7. Budget amendment necessary: Yes.
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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 assumed the passage of the introduced version of this bill and therefore incorporated the fiscal impact of federal tax laws passed during 2009, as well as the deconformity from additional federal provisions. The following amounts, attributable to conformity with the ARRA, were incorporated into the Introduced Executive Budget for this bill:

Fiscal Year	***Dollars***	***Fund***
2009-10	($14.72 Million)	GF
2010-11	($6.37 Million)	GF
2011-12	$2.07 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

As introduced, 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. As amended, however, this bill would permit a partial deferral of the impact of deconforming from the cancellation of debt provision. This change decreases General Fund revenue by $49 million in FY 2010 and increases it by $24.5 million in FY 2011 and FY 2012.

As amended, this bill would also conform to the deduction for domestic production activities under § 199 of the IRC effective for taxable years beginning on and after January 1, 2010. Because the Introduced Executive Budget assumed deconformity to this provision, conforming to this deduction will decrease General Fund revenue by approximately $30 million per year beginning in FY 2011.

The following chart illustrates the impact of amendments to this bill.

Revenue Impact of Senate Amendments

Fiscal Year	§ 199 Deduction	§ 108(i) Deferral	*Total GF Impact*
2009-10	0	($49.0 Million)	($49.0 Million)
2010-11	($30.0 Million)	$24.5 Million	($5.5 Million)
2011-12	($30.0 Million)	$24.5 Million	($5.5 Million)
2012-13	($30.0 Million)	0	($30 Million)
2013-14	($30.0 Million)	0	($30 Million)
2014-15	($30.0 Million)	0	($30 Million)
2015-16	($30.0 Million)	0	($30 Million)

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. Under IRC § 108(i), the income realized upon the reacquisition of certain business debt during 2009 and 2010 may be deferred, and reported in taxable years 2014 through 2018. Thus, for example, if a corporation realized $15 million cancellation of debt income arising from reacquisitions in 2009, and another $15 million in 2010, the corporation could elect not to report any of the income on its federal income tax returns for 2009 and 2010, and instead report $6 million in each of the five taxable years 2014 through 2018.

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

This bill would conform to the IRC § 199 deduction effective for taxable years beginning on and after January 1, 2010.

This bill would also permit a partial deferral of the impact of deconforming from the cancellation of debt provision to taxable years 2010 and 2011. Under IRC § 108(i), the income realized upon the reacquisition of certain business debt during 2009 and 2010 may be deferred, and reported in taxable years 2014 through 2018. Thus, for example, if a corporation realized $15 million cancellation of debt income arising from reacquisitions in 2009, and another $15 million in 2010, the corporation could elect not to report any of the income on its federal income tax returns for 2009 and 2010, and instead report $6 million in each of the five taxable years 2014 through 2018.

Under the provision of this bill deconforming from IRC § 108(i), the corporation would be required to add $15 million to its Virginia Taxable Income in 2009 and 2010, and then would be allowed to subtract $6 million from its Virginia Taxable Income in 2014 through 2018.

Under the provisions of this bill, instead of adding $15 million in 2009, the corporation could elect to add one-third of its 2009 cancellation of debt income ($5 million) to its Virginia Taxable Income in 2009, 2010 and 2011. The amendment would not apply to cancellation of debt income arising from reacquisitions in 2010, so the corporation would have to add $20 million to its 2010 Virginia Taxable Income ($5 million from its 2009 reacquisitions plus $15 million attributable to its 2010 reacquisitions) and $5 million in 2011, for a total of $30 million. The corporation would subtract $6 million in taxable years 2014 through 2018, for a total of $30 million.

The conformity proposals contained in both the House and Senate budget amendments would allow conformity to federal legislation that accelerates the income tax benefits for charitable cash contributions for the relief of victims of the earthquake in Haiti. Under that provision, taxpayers who make such charitable contributions before March 1, 2010, will be allowed to deduct such contributions on their 2009 federal income tax returns.

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

cc : Secretary of Finance
Date: 2/23/2010 TG
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