DEPARTMENT OF TAXATION
2019 Fiscal Impact Statement

1. Patron Timothy D. Hugo

2. Bill Number HB 2529

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

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

3. Committee House Rules

4. Title Individual Income Tax; Virginia Tax Policy Changes

5. Summary/Purpose:

The Department of Taxation ("the Department") understands that the Patron intends to introduce a substitute for this bill. This fiscal impact statement is drafted based on the substitute version of this bill.

This bill would increase the Virginia standard deduction from $3,000 to $4,000 for individuals and married taxpayers filing separately, and from $6,000 to $8,000 for married taxpayers filing joint returns. This bill would provide that a taxpayer may elect either to claim the Virginia standard deduction or to itemize deductions on his or her Virginia income tax return, regardless of whether the taxpayer elected for the taxable year to itemize deductions on his or her federal income tax return. These provisions of the bill would be effective for taxable years beginning on and after January 1, 2019, but before January 1, 2026.

This bill would provide an individual income tax deduction for the amount of real property and personal property taxes not otherwise deducted on the state return solely on account of the application of the cap on the federal deduction for state and local taxes paid that was imposed by the Tax Cuts and Jobs Act ("TCJA"). This provision of the bill would be effective for taxable years beginning on and after January 1, 2019.

The bill would also expand Virginia's existing corporate income tax subtraction for subpart F income so that it also applies to global intangible low-tax income ("GILTI"). As a result, GILTI would be permitted to be subtracted for Virginia corporate income tax purposes to the extent it is included in a taxpayer's federal taxable income. This provision of the bill would be effective for taxable years beginning on and after January 1, 2018.

6. Budget amendment necessary: Yes.
Item(s): Page 1, Revenue Estimates

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

7a. Expenditure Impact:

Fiscal Year	***Dollars***	***Positions***	***Fund***
2019-20	$1,017,712	10	GF
2020-21	$893,582	10	GF
2021-22	$893,582	10	GF
2022-23	$893,582	10	GF
2023-24	$893,582	10	GF
2024-25	$893,582	10	GF

7b. Revenue Impact:

Fiscal Year	***Dollars***	***Fund***
2018-2019	($7.1 million)	GF
2019-20	($573.9 million)	GF
2020-21	($392.6 million)	GF
2021-22	($406.6 million)	GF
2022-23	($422.5 million)	GF
2023-24	($438.2 million)	GF
2024-25	($452.2 million)	GF

8. Fiscal implications:

<u>Administrative Costs</u>

This bill would result in administrative costs to the Department of Taxation ("the Department") of $1,017,712 in Fiscal Year 2020 and $893,582 in Fiscal Year 2021 and each fiscal year thereafter. Such funding would include costs for hiring five new full-time employees for customer service to respond to taxpayer calls arising from this bill and hiring five new full-time employees for compliance purposes. In its January 25, 2019 Fiscal Impact Review of this bill, the Joint Legislative Audit and Review Commission ("JLARC") indicated that these costs appear reasonable and are a relatively small proportion of the total fiscal impact.

<u>Revenue Impact</u>

This bill would result in a negative General Fund revenue impact of $7.1 million in Fiscal Year 2019; $573.9 million in Fiscal Year 2020; $392.6 million in Fiscal Year 2021; $406.6 million in Fiscal Year 2022; $422.5 million in Fiscal Year 2023; $438.2 million in Fiscal Year 2024, and $452.2 million in Fiscal Year 2025. If this bill is enacted, the budget would need to be adjusted to reduce the revenue estimate by $7.1 million in Fiscal Year 2019 and $573.9 million in Fiscal Year 2020. As the Introduced Executive Budget assumes advancement of the date of conformity, and because this bill proposes modifications to provisions within the TCJA or affected by the TCJA, these estimates assume that Virginia's date of conformity will be advanced to December 31, 2018 and that Virginia will otherwise conform to the TCJA. According to the January 25, 2019 Fiscal Impact Review, JLARC concurs with the revenue estimates within this fiscal impact statement.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

<u>Federal Law Regarding Standard and Itemized Deductions</u>

When completing their federal income tax return, taxpayers are generally allowed to elect to claim either the total amount of their itemized deductions or the flat amount of their standard deduction. Taxpayers will generally choose to deduct the greater of the two amounts.

Federal Standard Deduction

The standard deduction is a fixed dollar amount that reduces a taxpayer's taxable income and varies according to their filing status. The current amount of the federal standard deduction is $12,000 for single taxpayers; $18,000 for heads of household; and $24,000 for married taxpayers filing jointly.

The federal standard deduction amounts have increased significantly since 1988. The federal Tax Reform Act of 1986 increased the standard deduction amount for Taxable Year 1988 to $3,000 for individuals; $4,400 for heads of household; and $5,000 for married taxpayers filing jointly. The Act also required, beginning in Taxable Year 1989, the Internal Revenue Service to adjust the amount of such deduction annually for inflation based on the percentage change in the Consumer Price Index for Urban Consumers ("CPI-U") for the preceding calendar year. Because of these inflation adjustments, the federal standard deduction increased annually from Taxable Year 1988 through Taxable Year 2002. For Taxable Year 2002, the standard deduction amounts were $4,700 for individuals; $6,900 for heads of household; and $7,850 for married taxpayers filing jointly.

The federal Jobs and Growth Tax Relief Reconciliation Act of 2003 increased the standard deduction for married couples filing jointly to $9,500, which was equal to twice the standard deduction for single taxpayers. This was intended to eliminate the standard deduction marriage penalty. From 2003 until 2017, the federal standard deduction continued to increase annually due to inflation adjustments. For Taxable Year 2017, the standard deduction amounts were $6,350 for individuals; $9,350 for heads of household; and $12,700 for married taxpayers filing jointly.

On December 22, 2017, Congress enacted the TCJA, which substantially increased the federal standard deduction amounts beginning with Taxable Year 2018 as follows:

- From $6,350 to $12,000 for single taxpayers;
- From $9,350 to $18,000 for heads of household; and
- From $12,700 to $24,000 for married taxpayers filing jointly.

In addition, beginning with Taxable Year 2019, the Internal Revenue Service is required to adjust the standard deduction amount based upon a new inflation measure, chained CPI-U.

Like the majority of the individual provisions of the TCJA, the increase in the federal standard deduction is currently scheduled to sunset after December 31, 2025, and revert to its pre-2018 amounts. Future legislation would be required to make such increases effective beyond Taxable Year 2025. However, the 2025 sunset date does not apply to the TCJA's substitution of a new inflation measure for indexing the federal standard deduction and other provisions.

Federal Itemized Deductions Generally

In lieu of deducting the standard deduction amount, taxpayers may elect to claim up to approximately a dozen separate deductions, referred to as "itemized deductions," on their federal return to the extent that they qualify for such deductions. The rationale for each itemized deduction is generally to take account of large or unusual personal expenditures that affect a taxpayer's ability to pay. Certain itemized deductions are also provided as a way of encouraging certain desired behaviors and activities. The most common expenses that may be claimed as an itemized deduction include:

- Home mortgage interest;
- State and local income taxes or sales taxes (but not both);
- Real estate and personal property taxes;
- Gifts to charities;
- Casualty or theft losses;
- Unreimbursed medical expenses; and
- Unreimbursed employee business expenses.

The TCJA included a number of provisions that greatly limit or repeal certain federal itemized deductions.

Itemized Deduction for State and Local Taxes

Under federal law, a deduction may be claimed for state and local taxes, such as income or sales tax (but not both), real estate tax, and personal property tax. Prior to the TCJA, taxpayers' deductions for state and local taxes were generally unlimited. For taxable years beginning January 1, 2018, but before January 1, 2026, the TCJA limited the deduction for state and local taxes which are not paid or accrued in carrying on a trade or business or an activity to $10,000 per taxable year.

<u>Virginia Law Regarding Standard and Itemized Deductions</u>

When completing their Virginia income tax returns, taxpayers are bound by the election they made for federal purposes regarding whether to claim a standard deduction or to itemize their deductions. Therefore, if they claimed the standard deduction on their federal income tax return, they are not allowed to claim itemized deductions on their Virginia return. In contrast, if they claimed itemized deductions on their federal income tax return, they are not allowed to claim the standard deduction on their Virginia return.

Virginia's Standard Deduction

Taxpayers that do not itemize their deductions for federal purposes are permitted to claim a standard deduction on their Virginia income tax returns. The current amount of the Virginia standard deduction is $3,000 for single individuals and $6,000 for married persons filing jointly. Virginia's standard deduction amounts increased from Taxable Year 1988 to the present, as shown below:

Year	**Virginia Standard Deduction for Single Taxpayers**	**Virginia Standard Deduction for Married Persons Filing Jointly**
1987	$2,000	$2,000
1988	$2,700	$2,700
1989-2004	$3,000	$5,000
2005-present	$3,000	$6,000

During the 2005 Session, the General Assembly increased the standard deduction for married persons filing jointly from $5,000 to $6,000. This was intended to eliminate the standard deduction marriage penalty at the state level, similar to how this issue was addressed at the federal level. Since 2005, the Virginia standard deduction amounts have remained at $3,000 for single taxpayers and $6,000 for married taxpayers filing jointly.

Prior to 1987, the Virginia standard deduction was not a fixed amount. For example, in Taxable Year 1986, the Virginia standard deduction was 15 percent of a taxpayer's federal adjusted gross income with a $1,300 minimum and a $2,000 maximum.

Virginia Itemized Deductions

Taxpayers that elect to itemize their deductions for federal purposes are permitted to claim such deductions on their Virginia income tax return as well. The amount of itemized deductions that may be claimed on such return is equal to the:

- Federally allowable amount of itemized deductions, *minus*
- Amount claimed as a federal deduction for income taxes paid to Virginia or any other state, locality, foreign country, or other taxing jurisdiction, *plus*
- Amount needed to increase the amount deducted federally for charitable contribution transportation to 18¢ per mile.

Virginia and the Itemized Deduction for State and Local Taxes

Virginia permits taxpayers that elect to itemize their deductions for federal income purposes to claim the federal deduction for state and local taxes on their Virginia income tax return. However, Virginia does not permit a taxpayer to deduct income taxes paid to

Virginia or any other taxing jurisdiction. Therefore, for Virginia income tax purposes, the federal itemized deduction for state and local taxes is required to be reduced to the extent this limitation applies.

<u>Global Intangible Low-Taxed Income</u>

The TCJA made significant changes to the federal taxation of U.S. corporations and individuals that own stock in foreign corporations. Prior to the TCJA, domestic corporations as well as U.S. citizens and U.S. residents were required to report and pay tax on their worldwide income, which includes both their domestic and foreign income. Therefore, the U.S. tax system prior to the TCJA was referred to as a "worldwide system." Despite the apparent far-reaching nature of a worldwide system, some U.S. taxpayers were able to avoid U.S. tax on their foreign income by forming foreign corporations in the countries where they do business. Because foreign corporations are not considered U.S. corporations even if wholly owned by a U.S. parent, their foreign profits were not generally subject to U.S. taxation so long as they kept the profits abroad and did not distribute them to their domestic parent corporation.

The TCJA replaced the worldwide system for certain domestic corporations with what is referred to as a "territorial system." In this system, domestic corporations generally pay U.S. tax only on their domestic income and are exempt from U.S. tax on their foreign income. To prevent multinational firms from shifting their profits to low-tax countries, the TCJA included a provision that requires U.S. corporations and other U.S. shareholders that own stock in specified foreign corporations to pay federal income tax at reduced rates on certain abnormally high overseas profits, referred to as global intangible low-taxed income or "GILTI."

U.S. individuals and domestic corporations that are 10 percent-or-more owners that collectively own more than 50 percent of a foreign corporation, referred to as a "controlled foreign corporation" or "CFC," are required to pay tax on their GILTI. The GILTI inclusion is the taxpayer's aggregate net income from CFCs that exceeds a 10 percent return on the CFCs' tangible assets. Net income means the CFCs gross income less deductions, exclusive of income already taxed or exempted from U.S. tax in the current year. This may include, but is not limited to, Subpart F income, income effectively connected with a U.S. trade or business, and income subject to a high foreign effective tax rate. The 10 percent return on tangible assets is not counted for any CFC with a net loss.

Corporations are allowed a foreign tax credit on their federal income tax returns for foreign taxes allocable to their GILTI inclusion. Therefore, the GILTI inclusion is grossed up for the related foreign taxes. For corporations only, the GILTI inclusion plus the gross-up is reduced by 50 percent for Taxable Years 2018 through 2025 and by 37.5 percent for Taxable Years 2026 and after. The 50 percent or 37.5 percent reduction applies after net operating losses. Any unused excess reduction is lost and may not be carried forward.

Individuals are taxed on the full GILTI inclusion. However, such taxpayers may make an election to be taxed on the deemed income at corporate rates, including credits, which gives temporary relief until the earnings are actually repatriated.

Virginia Income Tax Incentives for Foreign Income

For corporate income tax purposes, Virginia generally exempts income from other countries. This is accomplished by allowing subtractions on the Virginia corporate income tax return for foreign source income and for subpart F income to the extent such income is included in and not otherwise subtracted from federal taxable income. However, GILTI does not currently qualify for either of these corporate income tax subtractions.

Proposed Legislation

This bill would increase the Virginia standard deduction from $3,000 to $4,000 for individuals and married taxpayers filing separately, and from $6,000 to $8,000 for married taxpayers filing joint returns. This bill would provide that a taxpayer may elect either to claim the Virginia standard deduction or to itemize deductions on his or her Virginia income tax return, regardless of whether the taxpayer elected for the taxable year to itemize deductions on his or her federal income tax return. These provisions of the bill would be effective for taxable years beginning on and after January 1, 2019, but before January 1, 2026.

This bill would provide an individual income tax deduction for the amount of real property and personal property taxes not otherwise deducted on the state return solely on account of the application of the cap on the federal deduction for state and local taxes paid that was imposed by the TCJA. This provision of the bill would be effective for taxable years beginning on and after January 1, 2019.

The bill would expand Virginia's existing corporate income tax subtraction for subpart F income so that it also applies to GILTI. As a result, GILTI would be permitted to be subtracted for Virginia corporate income tax purposes to the extent it is included in a taxpayer's federal taxable income. This provision of the bill would be effective for taxable years beginning on and after January 1, 2018.

Similar Bills

House Bill 1851, **House Bill 1980**, **House Bill 2086**, **House Bill 2110**, **House Bill 2529**, **House Bill 2673**, **House Bill 2765**, **Senate Bill 1225**, **Senate Bill 1443**, and **Senate Bill 1631** would make various, different tax policy changes.

Senate Bill 1531 would increase the standard deduction to $12,000 for single individuals and $24,000 for married taxpayers filing joint returns.

House Bill 1618 and **Senate Bill 1237** would allow a taxpayer to elect either to claim the Virginia standard deduction or to itemize his or her deductions, regardless of whether the taxpayer elected for the taxable year to itemize deductions on his or her federal return, for Taxable Year 2019 through Taxable Year 2025.

House Bill 2708 would allow a taxpayer to elect either to claim the Virginia standard deduction or to itemize his or her deductions, regardless of whether the taxpayer elected for the taxable year to itemize deductions on his or her federal return, for Taxable Year 2019 and after.

House Bill 2700 and **Senate Bill 1698** would expand Virginia's existing corporate income tax subtraction for subpart F income so that it also applies to GILTI.

House Bill 2704 would require, if the General Assembly does not enact legislation during the 2019 Session that provides at least $100 million in tax relief, that any additional revenues from the TCJA in Fiscal Year 2019-2020 be transferred to the Tax Policy Fund, and used to provide tax reform.

Senate Bill 1739 would advance Virginia's date of conformity to the IRC to December 31, 2018, and require additional revenues from the TCJA for fiscal years beginning on and after July 1, 2018, but before July 2, 2026, to be transferred to the Taxpayer Relief Fund and distributed on September 1 of each year from 2019 through 2027 as a refund to Virginia taxpayers who filed a return in the immediately preceding taxable year.

Senate Bill 1744 would increase the standard deduction to $4,000 for single individuals and $8,000 for married taxpayers filing jointly for Taxable Year 2018 only, and the standard deduction would revert to its current amounts for Taxable Year 2019 and after.

cc : Secretary of Finance

Date: 1/27/2019 JJS
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