DEPARTMENT OF TAXATION
2020 Fiscal Impact Statement

1. Patron Joseph P. McNamara

2. Bill Number HB 48

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

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

3. Committee House Finance

4. Title Commonwealth's Tax System; Rolling Conformity with the Internal Revenue Code

5. Summary/Purpose:

This bill would conform Virginia to the Internal Revenue Code ("IRC") on a rolling basis. This would allow Virginia to conform to federal tax changes to the IRC as soon as they are enacted by Congress. This would also allow Virginia to conform to the Further Consolidated Appropriations Act, 2020 ("the federal extenders bill") and the Virginia Beach Strong Act.

If enacted during the 2020 Regular Session of the General Assembly, this bill would become effective July 1, 2020.

6. Budget amendment necessary: Yes.

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

8. Fiscal implications:

Administrative Costs

The Department of Taxation ("the Department") considers implementation of this bill as routine, and does not require additional funding.

Revenue Impact

This bill would have an unknown General Fund revenue impact beginning in Fiscal Year 2021. It is unknown to what extent Congress will enact changes to the IRC that would impact Virginia income tax returns in the future. Such changes may result in a positive or negative revenue impact on their own, or when aggregated with other changes that may occur during a particular year. In addition, Congress often enacts changes to the IRC that apply retroactively to taxable years that have already occurred. The continuation of this practice would increase any positive or revenue impact from future changes to the IRC.

The Department estimated that the revenue impact of advancing the date of conformity to the IRC from December 31, 2018 to December 31, 2019 would have a negative General

Fund revenue impact of $57.2 million in Fiscal Year 2020 and $18.7 million in Fiscal Year 2021. This revenue impact would primarily be the result of conforming to three provisions within the federal extenders bill:

- Extension of the reduced 7.5 percent floor for the medical expense deduction;
- Disaster relief provisions;
- Repeal of the unrelated business tax ("UBTI") on certain fringe benefits.

The other provisions of this federal legislation that affect Virginia tax returns either have a minimal impact on Virginia revenues or have no impact because their extension is already assumed in the official General Fund revenue forecast. Conformity to the Virginia Beach Strong Act would have no impact on General Fund revenue.

Because this bill would conform to these provisions, this bill would result in a similar General Fund revenue impact. However, because, as drafted, this bill would not be effective until July 1, 2020, a significant portion of taxpayers would be required to file amended returns or file on extension to account for such changes on their Taxable Year 2019 returns. It is unknown to what extent taxpayers would comply. Therefore, this could result in an uncertain portion of the revenue loss for Fiscal Year 2020 being deferred until Fiscal Year 2021.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: Yes.

As currently drafted, this bill does not specify an effective date. The Department recommends an enactment clause to specify which taxable years would be impacted. Without such an amendment, this bill would inadvertently reverse the General Assembly's deconformity from the enhanced medical expenses deduction for Taxable Year 2017. As a result, taxpayers could file amended returns to claim the enhanced federal medical expense deduction for Taxable Year 2017, thereby increasing the negative revenue impact of this bill. To address this issue, the Department suggests the following technical amendment:

Page 1, after Line 42
Insert: **3. That the provisions of this act shall apply to taxable years beginning on and after January 1, 2018.**

In addition, if the bill becomes effective on July 1, 2020, this would be after the original filing deadlines for most taxpayers. In the absence of other legislation advancing the date of conformity, taxpayers who filed their returns prior to July 1 would be required to file amended returns to account for such changes. To address this issue, the Department recommends the following technical amendment:

Page 1, after Line 42
Insert: **2. That an emergency exists and this act is in force from its passage.**

If additional legislation is adopted to address federal changes enacted during 2019, this amendment would not be necessary.

11. Other comments:

Virginia's Conformity to the IRC

Beginning in 1972, Virginia automatically conformed to federal income tax laws. Whenever a federal income tax law change affected the definition of taxable income, it automatically affected Virginia income tax revenue, unless the General Assembly enacted a specific exception. In 2003, Virginia began conforming to the IRC as of a fixed date, usually December 31 of the preceding year, in order to protect Virginia revenues from automatically being impacted by major federal tax law changes. Since 2003, the General Assembly has generally advanced the date in order to conform to any federal changes made during the prior year.

Virginia's date of conformity to the IRC is currently fixed to the IRC as it existed on December 31, 2018. Virginia law currently deconforms from the following IRC provisions:

- **Bonus depreciation allowed for certain assets under federal income taxation.** Taxpayers who claim bonus depreciation on their federal returns upon purchasing an asset are required to make adjustments on their Virginia returns for the taxable year in which they purchased such asset and in each subsequent year until the asset has been fully depreciated for federal and Virginia purposes.

- **The five-year carry-back of net operating losses ("NOLs") generated in certain taxable years.** Although no longer available, taxpayers who benefited from the use of a five-year carry-back on their federal returns for losses generated during 2008 and 2009 are required to make adjustments on their Virginia returns for the taxable year in which such losses were generated and in each subsequent year until all such losses have been fully utilized for both federal and Virginia purposes.

- **Tax exclusions related to cancellation of debt income.** Although no longer available, taxpayers who benefited from a deferral of income realized upon the reacquisition of certain business debt during 2009 and 2010 on their federal returns are required to make adjustments on their Virginia returns for the taxable year in which they deferred such income and in each subsequent year until such income is fully reported for both federal and Virginia purposes. However, for transactions completed on or before April 21, 2010, taxpayers were permitted to partially defer such income by reporting the income over three taxable years.

- **Tax deductions related to the application of the applicable high yield debt obligation rules.** Although no longer available, taxpayers who benefited from the suspension of the application of the applicable high yield debt obligation rules for certain debts issued between September 30, 2008 and December 31, 2009 on their federal returns, are required to make adjustments on their Virginia returns for the taxable year in which they claimed a deduction and in each subsequent year until such deductions are fully claimed for both federal and Virginia purposes.

- **Suspension of the federal overall limitation on itemized deductions.** During the 2019 Session, Virginia deconformed from the federal suspension of the overall limitation on itemized deductions (the “Pease Limitation”). This has the effect of reinstating the Pease Limitation for Virginia income tax purposes only beginning with Taxable Year 2019.

<u>Further Consolidated Appropriations Act</u>

On December 20, 2019, the Further Consolidated Appropriations Act, 2020 (H.R.1865) (“the federal extenders bill”) was signed into law. The federal legislation extends for three years over 30 tax provisions, commonly known as "extenders," which generally expired at the end of 2017. The legislation also provides tax relief to victims of certain 2018 and 2019 disasters, makes significant changes to several retirement tax provisions, and makes other miscellaneous changes. To conform to these federal tax provisions, Virginia would be required to enact legislation advancing its date of conformity.

Federal Extenders

A number of the federal tax provisions that were extended would have an impact on taxpayers preparing and filing their Virginia income tax returns during the 2020 tax filing season. These extender provisions include, but are not limited to, the following:

- The 7.5 percent of adjusted gross income limitation on the medical expense deduction;
- The above-the-line deduction for qualified tuition and related expenses for higher education;
- Exclusion from gross income of a discharge of qualified principal residence indebtedness; and
- Treatment of qualified mortgage insurance premiums as interest for purposes of the mortgage interest deduction.

Federal Disaster Relief

A number of disaster tax relief provisions relating to persons affected by certain disasters in 2018 and 2019 would have an impact on taxpayers preparing and filing their Virginia income tax returns during the 2020 tax filing season. These provisions include:

- Suspension of the annual limitations imposed on charitable contribution deductions for disaster relief;
- Waiver of the 10 percent additional tax on early distributions from retirement plans for up to $100,000 in distributions made by certain individuals in qualified disaster areas;
- Modification of the method by which earned income is determined for purposes of computing the earned income tax credit for taxpayers in disaster areas; and
- Modification of the deduction for personal casualty losses in qualified disaster areas to eliminate the requirement that casualty losses exceed 10 percent of adjusted gross income to qualify for the deduction.

Retirement Tax Provisions

H.R.1865 makes significant changes to the way that retirement plans work. The four retirement tax provisions with a greater than minimal Virginia revenue impact are:

- Reducing the minimum age for allowable in-service distributions from age 62 to age 59 ½;
- Modifying multiple employer plans and pooled employer plans;
- Raising the minimum age for required minimum distributions from 70 1/2 years of age to 72 years of age; and
- Eliminating so-called stretch IRA by requiring non-spouse beneficiaries of inherited IRAs to withdraw and pay taxes on all distributions from inherited accounts within 10 years.

Miscellaneous Tax Provisions

The federal legislation also makes a number of miscellaneous tax law changes, including the:

- Modification of income for purposes of determining tax-exempt status of certain mutual or cooperative telephone or electric companies;
- Repeal of UBTI on certain fringe benefits;
- Repeal of several Affordable Care Act excise taxes; and
- Correcting of technical drafting errors within the Tax Cuts and Jobs Act.

<u>Virginia Beach Strong Act</u>

On December 20, 2019, the Virginia Beach Strong Act (H. R. 4566) was signed into law. This legislation clarifies that the Virginia Beach Tragedy Fund is entitled to federal tax-exempt status. This legislation provides that certain payments made by a tax-exempt organization to the spouse or dependent of the dead or wounded victims of the Virginia Beach tragedy will be treated as related to such organization's tax-exempt purpose and not for the benefit of any private individual. This protects the tax-exempt status of such entities. In addition, this legislation ensures that cash contributions made specifically for the relief of families of the dead or wounded victims of the Virginia Beach tragedy qualify for the charitable contributions deduction. To conform to these federal tax provisions, Virginia would be required to enact legislation advancing its date of conformity.

Conformity in Other States

There are three distinct approaches to conforming to federal changes to the IRC: rolling conformity, fixed-date conformity, and selective conformity. Twenty-one states and the District of Columbia utilize the rolling conformity. Twenty states, including Virginia, use fixed-date conformity. Five states adopt only specific provisions of the IRC as of a specific date.

Proposed Legislation

This bill would conform Virginia to the IRC on a rolling basis. This would allow Virginia to conform to federal tax changes to the IRC as soon as they are enacted by Congress. The General Assembly would have to enact legislation in order to deconform from a change to the IRC. This would also allow Virginia to conform to the Further Consolidated Appropriations Act, 2020 and the Virginia Beach Strong Act.

If enacted during the 2020 Regular Session of the General Assembly, this bill would become effective July 1, 2020.

Similar Legislation

House Bill 734 would conform Virginia to the IRC on a rolling basis, but would deconform from provisions with a revenue impact greater than $10 million in order to give the General Assembly the opportunity to determine whether to specifically conform to such provisions.

House Bill 1413 and **Senate Bill 582** would continue fixed-date conformity by advancing Virginia's date of conformity to the IRC from December 31, 2018 to December 31, 2019.

cc : Secretary of Finance

Date: 1/26/2020 JLOF
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