DEPARTMENT OF TAXATION
2020 Fiscal Impact Statement

1. Patron Vivian E. Watts

2. Bill Number HB 734

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

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

3. Committee House Finance

4. Title Rolling Conformity with the Internal Revenue Code; Nonconformance with Certain Amendments

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.

For taxable years beginning on and after January 1, 2020, this bill would deconform Virginia from any amendments to the IRC that have a projected revenue impact of greater than $10 million in the fiscal year in which the amendments were enacted or any of the succeeding four fiscal years. This would give the General Assembly the opportunity to consider whether to conform to such amendments.

This bill would be effective for taxable years beginning on and after January 1, 2019. Because some taxpayers will be preparing their 2019 Virginia returns while the General Assembly is in session, **this bill contains an emergency clause** which states that it would be in force from its passage.

6. Budget amendment necessary: Yes.

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

8. Fiscal implications:

<u>Administrative Costs</u>

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

<u>Revenue Impact</u>

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.

This bill would limit the potential immediate impact by deconforming from amendments to the IRC in excess of $10 million. However, Congress may enact several amendments below this threshold that result in a substantial positive or negative revenue impact in aggregate.

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; and
- 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 generally conform to these provisions, this bill would result in a similar General Fund revenue impact for Fiscal Year 2020 and Fiscal Year 2021.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

<u>Virginia's Conformity to the IRC</u>

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.

Further Consolidated Appropriations Act

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. This would also allow Virginia to conform to the Further Consolidated Appropriations Act, 2020 and the Virginia Beach Strong Act.

For taxable years beginning on and after January 1, 2020, this bill would deconform Virginia from any amendments to the IRC that have a projected revenue impact of greater than $10 million in the fiscal year in which the amendments were enacted or any of the succeeding four fiscal years. This would give the General Assembly the opportunity to consider whether to conform to such amendments. This deconformity would not apply to any amendments that the General Assembly subsequently adopts.

The Secretary of Finance, in consultation with the Chairmen of the Senate Committee on Finance and Appropriations and the House Committees on Appropriations and Finance, would be responsible for determining whether any amendments to the IRC are in excess of the $10 million threshold. The Secretary of Finance would be required to annually provide a report on the fiscal impact of amendments to the IRC occurring since the adjournment of the prior year's regular General Assembly Session to the Senate Committee on Finance and Appropriations and the House Committees on Appropriations and Finance. The report would be required to be presented no later than 60 days prior to the regular General Assembly Session. The Secretary of Finance would also be required to provide updates on any further amendments to the IRC occurring between presentation of the required report and the first day of the subsequent regular General Assembly Session.

This bill would be effective for taxable years beginning on and after January 1, 2019. Because some taxpayers will be preparing their 2019 Virginia returns while the General Assembly is in session, **this bill contains an emergency clause** which states that it would be in force from its passage.

Similar Legislation

House Bill 48 would conform Virginia to the IRC on a rolling basis.

House Bill 1413 and **Senate Bill 582** would advance 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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