DEPARTMENT OF TAXATION
2023 Fiscal Impact Statement

1. **Patron** Joseph P. McNamara

2. **Bill Number** HB 2138
House of Origin:
X **Introduced**
___ **Substitute**
___ **Engrossed**

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

3. **Committee** House Finance

4. **Title** Income Tax: Business Interest Expense Deduction, Qualified Business Income Deduction, and Rate Reduction

5. **Summary/Purpose:**

This bill would reduce Virginia income taxes on business by:

- Beginning in Taxable Year 2023, providing for a new individual income tax deduction in an amount equal to fifty percent of certain federal qualified business income deductions, excluding qualified real estate investment trust dividends;

- Beginning in Taxable Year 2023, reducing Virginia's corporate income tax rate from six percent to five percent; and,

- Beginning in Taxable Year 2024, increasing the individual and corporate deduction for disallowed business interest expense from 30 percent to 50 percent.

This is an Executive Bill.

6. **Budget amendment necessary:** No.

7. **No Fiscal Impact:** 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 estimated negative General Fund Revenue impact of $71.9 million in Fiscal Year 2023, $462.6 million in Fiscal Year 2024, $467.4 million in Fiscal Year 2025, $486.7 million in Fiscal Year 2026, $504.7 million in Fiscal Year 2027, and $525.5 million in Fiscal Year 2028. No budget amendment is needed because revenue impact of this bill is assumed in the Introduced Executive Budget. The fiscal impact of each change made by this bill to Virginia's business income tax system is set forth in the chart below:

	FY 23	FY 24	FY 25	FY 26	FY 27	FY 28
Decrease Corporate Income Tax Rate to 5% (TY 23)	($71.9)	($290.2)	($334.0)	($348.4)	($360.6)	($374.6)
Introduce Qualified Business Income Deduction of 50% (TY 23)	---	($162.1)	($110.8)	($114.8)	($119.6)	($125.4)
Increase Disallowed Business Interest Deduction 50% (TY 24)	---	($10.3)	($22.6)	($23.5)	($24.5)	($25.5)
Total	**($71.9)**	**($462.6)**	**($467.4)**	**($486.7)**	**($504.7)**	**($525.5)**

The estimates regarding the qualified business income deduction assume adoption of the 5.5 percent individual income tax in Taxable Year 2024, as proposed in the Introduced Executive Budget. If such individual rate reduction were not enacted, the qualified business income estimates would be required to be adjusted.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: Yes

Line 12 after effective,
Strike: and

Line 12 after 58.1-400
Insert: ,and 58.1-402

11. Other comments:

Disallowed Business Interest Expense

On December 22, 2017, the federal Tax Cuts and Jobs Act ("the TCJA") was signed into law. This federal tax reform legislation substantially changed the federal income taxation of individuals and businesses. One of the provisions that impacted certain businesses was a limitation on the deductibility of business interest. Under the TCJA, the deduction of business interest is generally limited to the sum of business interest income, 30 percent of adjusted taxable income, plus the floor plan financing interest for such taxable year ("the business interest limitation"). Any business interest that is disallowed because of this business interest limitation is treated as business interest paid or accrued in the following taxable year, and may be carried forward indefinitely, subject to certain restrictions.

The business interest limitation does not apply to certain taxpayers including small businesses that have annual gross receipts for the three-taxable-year period ending with the prior taxable year equal to or less than $25 million. In addition, real property and farming businesses may opt out of the new limitation if they use the alternative depreciation system to depreciate certain property used in their businesses.

During the 2019 Session, the General Assembly enacted legislation generally conforming to the TCJA, including the federal business interest limitation. In addition, the legislation allowed a state-specific deduction beginning with Taxable Year 2018 to individuals and corporations subject to the federal business interest limitation. The state-specific deduction is equal to percentage of the amount of business interest that is disallowed as a deduction under the business interest limitation—20 percent for Taxable Years 2018 to 2021 and 30 percent for Taxable Years 2022 and thereafter.

The effect of this state-specific deduction is to accelerate a taxpayer's ability to claim their business interest for Virginia income tax purposes by allowing a larger aggregate deduction during the year in which interest expense is paid or accrued than is allowed on the federal return. However, in future taxable years, taxpayers are required to reconcile this acceleration on their Virginia income tax returns.

On March 27, 2020, Congress enacted the Coronavirus Aid, Relief, and Economic Security ("CARES") Act (H.R.748). The CARES Act temporarily and retroactively increased the business interest limitation from 30 percent to 50 percent for Taxable Years 2019 and 2020. During the 2021 Session, the General Assembly enacted legislation generally conforming to the CARES Act but deconforming to this provision. As a result, the business interest limitation for Virginia purposes remained at 30 percent for Taxable Years 2019 and 2020, the level set by the TCJA.

<u>Qualified Business Income Deduction</u>

The TCJA allows owners of sole proprietorships, partnerships, S corporations and some trusts and estates to claim a federal qualified business income ("QBI") deduction on their personal income tax returns. The QBI deduction does not apply to corporations. The QBI deduction allows eligible taxpayers to deduct the lesser of (i) up to 20% of their combined qualified business income plus twenty percent of qualified real estate investment trust ("REIT") dividends and qualified publicly traded partnership ("PTP") income, or (ii) twenty percent of taxable income less net capital gains.

The QBI deduction is subject to limitations depending on the taxpayer's income, including the type of trade or business that may qualify, the amount of W-2 wages paid by the business, and the unadjusted basis immediately after acquisition of certain depreciable property held by the trade or business.

On the federal return the QBI deduction is claimed after determining federal adjusted gross income ("FAGI"). FAGI is the starting point for Virginia and most other states' income tax returns, as a result Virginia and most other states do not conform to the QBI deduction. Only four states currently conform to the QBI deduction in some manner. Iowa is phasing in conformity with the deduction, and Colorado, Idaho, and North Dakota, which do not use FAGI as a starting point for their state income tax, fully conform to the QBI deduction.

Corporate Income Tax Rate

Virginia's corporate income tax is currently imposed at the rate of 6 percent on the Virginia taxable income of domestic and foreign corporations doing business in Virginia. A "corporation" is defined as any entity created as a corporation under the laws of any state or local domestic or foreign jurisdiction, and any association, joint stock company, or any other entity subject to corporate income tax under the Internal Revenue Code.

A corporation's taxable income is determined by allocation and apportionment when the income is derived from sources both within and without Virginia. Multistate corporations allocate and apportion federal taxable income after Virginia modifications are made to determine the amount of income attributable to Virginia. No allocation or apportionment is necessary when the entire business of a corporation is conducted or transacted within Virginia. Instead, the Virginia corporate income tax is imposed upon the entire Virginia taxable income of the corporation for each taxable year.

Virginia's corporate income tax rate has remained unchanged since 1972, when it was increased from 5 percent to 6 percent.

Proposed Legislation

This bill would reduce Virginia income taxes on businesses by:

- Beginning in Taxable Year 2023, providing for a new individual income tax deduction in an amount equal to fifty percent of certain federal qualified business income deductions, excluding qualified real estate investment trust dividends;

- Beginning in Taxable Year 2023, reducing Virginia's corporate income tax rate from six percent to five percent; and,

- Beginning in Taxable Year 2024, increasing the individual and corporate deduction for disallowed business interest expense from 30 percent to 50 percent.

Similar Legislation

Senate Bill 1355 is identical to this bill.

Senate Bill 1423 is identical to this bill, except that it would not increase the disallowed business interest expense deduction.

cc : Secretary of Finance

Date: 1/17/2023 RWC
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