

# DEPARTMENT OF TAXATION

## 2016 Fiscal Impact Statement

1. **Patron** R. Lee Ware, Jr.

2. **Bill Number** HB 402

3. **Committee** Passed House and Senate

**House of Origin:**

           **Introduced**

           **Substitute**

           **Engrossed**

4. **Title** Income Tax; Conformity to the Internal Revenue Code

**Second House:**

           **In Committee**

           **Substitute**

      X       **Enrolled**

### 5. **Summary/Purpose:**

This bill would advance Virginia's date of conformity to the Internal Revenue Code ("IRC") from December 31, 2014 to December 31, 2015. This bill would allow Virginia to conform to the provisions of the Protecting Americans from Tax Hikes Act of 2015 ("the PATH Act"), and other items of federal legislation that modified the IRC after December 31, 2014.

This bill would also permanently conform to the enhanced federal earned income tax credit ("EITC") provisions that were permanently extended for federal purposes.

Because some taxpayers will be preparing their 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.

**This is a Department of Taxation bill.**

6. **Budget amendment necessary:** Yes.

Page 1, Revenue Estimates.

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

#### 7b. **Revenue Impact:**

<i><b>Fiscal Year</b></i>	<i><b>Dollars</b></i>	<i><b>Fund</b></i>
2015-16	\$0	GF
2016-17	(\$220,000)	GF
2017-18	(\$80,000)	GF
2018-19	\$60,000	GF
2019-20	\$220,000	GF
2020-21	\$390,000	GF
2021-22	\$550,000	GF

## 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 a negative General Fund revenue impact of \$220,000 in Fiscal Year 2017 and \$80,000 in Fiscal Year 2018, and a positive General Fund revenue impact of \$60,000 in Fiscal Year 2019, \$220,000 in Fiscal Year 2020, \$390,000 in Fiscal Year 2021, and \$550,000 in Fiscal Year 2022.

Because the extension of expiring federal tax provisions in the PATH Act is assumed in the General Fund revenue forecast, conforming to such extensions would have no revenue impact. However, the modification of certain existing provisions and the inclusion of new federal income tax provisions would have a revenue impact on Virginia. The total negative General Fund revenue impact from conforming to such provisions would be \$490,000 in Fiscal Year 2017 and \$420,000 in Fiscal Year 2018 and each fiscal year thereafter. Such revenue impact would be substantially offset by conforming to a provision in the PATH Act related to the federal income tax treatment of real estate investment trusts (“REITs”) that would flow through to Virginia.

See the following table for a summary of the federal tax provisions in the PATH Act that have a General Fund revenue impact for Fiscal Years 2016 through 2018:

<b>Provision</b>	<b>FY 2016</b>	<b>FY 2017</b>	<b>FY 2018</b>
Modified IRC § 179 Deduction	\$0	(\$360,000)	(\$360,000)
Charitable Deduction for Food Inventory	\$0	(\$60,000)	(\$60,000)
Subtraction for Teacher Expenses	Minimal	Minimal	Minimal
Exclusion for Restitution Paid to Wrongfully Incarcerated Individuals (Kenneth McAlister)	\$0	(\$70,000)	\$0
REIT Anti-Spinoff Provisions	Minimal	\$270,000	\$340,000
<b>NET REVENUE IMPACT</b>	<b>\$0</b>	<b>(\$220,000)</b>	<b>(\$80,000)</b>

## 9. Specific agency or political subdivisions affected:

Department of Taxation

## 10. Technical amendment necessary: No.

## 11. Other comments:

### Current Law

Virginia's date of conformity to the IRC is currently fixed to the IRC as it existed on December 31, 2014. Virginia law currently deconforms from the following IRC provisions:

- Bonus depreciation allowed for certain assets under federal income taxation.
- The five-year carry-back of net operating losses ("NOLs") generated in certain taxable years.
- Tax exclusions under IRC § 108(i) related to cancellation of debt income.
- Tax deductions under IRC § 163(e)(5)(F) related to the application of the applicable high yield debt obligation rules.

### Provisions Extended by the Federal PATH Act

On December 18, 2015, Congress enacted the PATH Act (Division Q of H.R. 2029). This legislation extended a number of expiring federal provisions including:

- The increased expensing limitations and treatment of certain real property as IRC § 179 property.
- Several provisions related to the depreciation and expensing of certain types of property.
- The above-the-line deduction for certain expenses of elementary and secondary school teachers.
- The deduction for state and local general sales taxes.
- The above-the-line deduction for qualified tuition and related expenses.
- The exclusion for discharge of indebtedness on a principal residence.
- The deductibility of interest on mortgage insurance premiums as qualified residence interest.
- The federal income tax treatment of certain income related to S corporations.
- The federal income tax treatment of certain foreign income.
- The enhanced EITC.

### ***The Earned Income Tax Credit***

Virginia allows an individual to claim either the Tax Credit for Low-Income Individuals, equal to \$300 per taxpayer and dependent claimed on a Virginia income tax return that has a family adjusted gross income below a threshold amount, or a Virginia income tax credit equal to 20 percent of the federal EITC claimed for the taxable year. A taxpayer may not claim both credits for the same taxable year.

The federal EITC is a refundable tax credit for eligible individuals who have earned income in a taxable year that is below certain threshold amounts. The amount of the federal EITC is based on the presence and number of qualifying children in the worker's family, as well as the amount of adjusted gross income and earned income.

In 2009, the American Recovery and Reinvestment Act ("ARRA") temporarily increased the credit percentage for individuals with three or more qualifying children from 40 percent to 45 percent and reduced the EITC marriage penalty by increasing the phaseout amount for married couples.

The expanded calculation of the EITC was scheduled to sunset on December 31, 2010, reverting back to the calculation as it existed prior to Taxable Year 2009. However, the enhanced EITC provisions were extended through Taxable Year 2012 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. On January 2, 2013, Congress enacted the American Taxpayer Relief Act of 2012, which further extended the enhanced EITC provisions through Taxable Year 2017. On December 18, 2015, Congress enacted the PATH Act, which permanently extended the enhanced EITC provisions.

In 2010, the General Assembly elected to conform to the enhanced federal EITC provisions for Taxable Year 2009 only. During the 2011, 2012, and 2013 Sessions, the General Assembly elected to advance the date of conformity to these provisions one year at a time, to Taxable Years 2010, 2011, and 2012. During the 2014 Session, the General Assembly enacted legislation that extended Virginia's conformity to the enhanced federal EITC provisions through the sunset date of the federal provisions, Taxable Year 2017.

#### Provisions Modified or Added by the Federal PATH Act

The PATH Act also modified certain expiring provisions that were extended, and added several new federal tax provisions. Such provisions include:

#### ***The IRC § 179 Deduction***

Under IRC § 179, a taxpayer may expense up to \$500,000 of the cost of certain business assets placed in service during a taxable year, rather than depreciating such assets over time. This \$500,000 limitation is reduced by the amount by which the cost of qualifying property placed in service during a taxable year exceeds \$2 million, but may not be reduced below zero. For taxable years beginning on or after January 1, 2015, the \$500,000 deduction limit was scheduled to be reduced to \$25,000, and the \$2 million threshold was to be reduced to \$200,000.

In general, qualifying property includes depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Qualifying property also includes off-the-shelf-computer software and qualified real property (such as qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property). Of the \$500,000 expense amount available under IRC § 179, the maximum amount available with respect to qualified real property was limited to \$250,000 for each taxable year. Prior to 2015, qualifying property excluded investments in air conditioning and heating units.

The enactment of the PATH Act provides the following changes related to the deduction under IRC § 179:

- Permanently extends both the \$500,000 deduction limitation and the \$2 million threshold;
- Indexes both the \$500,000 limitation and the \$2 million threshold for inflation, rounded to the nearest \$10,000;
- Eliminates the \$250,000 cap on qualified real property;
- Permanently allows off-the-shelf computer software and qualified real property to qualify as eligible section 179 property;
- Allows air conditioning and heating units placed in service after Taxable Year 2015 to be eligible for expensing under IRC § 179.

### ***The Deduction for Certain Expenses of School Teachers***

Congress modified the above-the-line deduction for certain expenses of elementary and secondary school teachers by indexing the \$250 deduction limitation for inflation, rounded to the nearest \$50. The legislation also allows the deduction to be claimed for professional development expenses.

### ***The Charitable Deduction for Contributions of Food Inventory***

Congress enhanced the charitable deduction for contributions of food inventory by increasing the limitation on deductible contributions of food inventory from 10 percent to 15 percent of the taxpayer's adjusted gross income. This legislation also provides special rules for valuing food inventory.

### ***The Exclusion for Wrongfully Incarcerated Individuals***

Congress added a new exclusion from gross income for any civil damages, restitution, or other monetary awards received as compensation for wrongful incarceration.

### ***REIT Spinoffs***

The IRC allows corporations to spin off assets into newly-formed subsidiaries, including REITs, tax-free. Certain corporations have used this technique to spin off real estate assets to newly-formed REITs. Because such spinoffs are tax-free transactions, the corporation avoids paying the corporate income tax that would have been due if such real estate assets had been sold. When a REIT that received real estate assets in a tax-free spinoff sells such assets for a gain and distributes the proceeds to its shareholders as dividends, it pays no tax on such transaction because it is permitted to deduct the amount of dividends paid to its shareholders. The REIT's shareholders remain subject to taxation on any dividends received from the REIT. Congress effectively eliminated this tax planning strategy by prohibiting such spin-offs involving REITs from qualifying as a tax-free spinoff.

## Other Federal Tax Legislation Enacted During 2015

On July 31, 2015, congress enacted the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (H.R. 3236). This legislation changed the due date for federal corporate income tax returns from the fifteenth day of the third month (March 15 for calendar year filers) to the fifteenth day of the fourth month (April 15 for calendar year filers), which is the same as the due date for Virginia's corporate income tax return. This bill would not change Virginia's corporate income tax return due date.

On May 22, 2015, Congress enacted The Don't Tax Our Fallen Public Safety Heroes Act (H.R. 606). This legislation provides an income tax exemption for certain income received from a state program by the surviving dependents of public safety officers who die in the line of duty. The exemption does not apply to any amounts that would have been payable if the death of the public safety officer had occurred other than as the direct and proximate result of a personal injury sustained in the line of duty.

On November 2, 2015, Congress enacted the Bipartisan Budget Act of 2015 (H.R. 1314). This legislation changed the Internal Revenue Service procedure for auditing partnerships. It also clarified that for an unincorporated organization to be considered a partnership, it must have been formed to conduct an active trade or business regardless of whether a partner received via gift a capital interest in such partnership. A person that owns a capital interest in a partnership may be considered a partner, whether such interest was obtained by purchase or by gift. Certain taxpayers previously argued that the "active trade or business" requirement does not apply to a partnership if a partner receives via gift a capital interest in such partnership where capital is a material income-producing factor.

Conforming to the above federal legislation would result in a minimal General Fund revenue impact.

## Proposed Legislation

This bill would advance Virginia's date of conformity to the IRC from December 31, 2014 to December 31, 2015. This would allow Virginia to conform to the PATH Act, and other items of federal legislation that modified the IRC after December 31, 2014.

Virginia would continue to disallow any bonus depreciation allowed for certain assets under federal income taxation and any five year carry-back of NOLs allowed for NOLs generated in either Taxable Year 2008 or 2009. In addition, Virginia would continue to disallow the federal treatment of tax deductions related to applicable high yield discount obligations. Virginia would continue to deconform from any tax exclusions related to 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.

This bill would also permanently conform to the enhanced federal EITC provisions that were permanently extended for federal purposes by the PATH Act.

Because some taxpayers will be preparing their 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

**Senate Bill 545** is identical to this bill.

cc : Secretary of Finance

Date: 2/1/2016 MTH  
HB402FER161