# DEPARTMENT OF TAXATION
# 2019 Fiscal Impact Statement

**1. Patron** S. Chris Jones

**2. Bill Number** HB 2355

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

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

**3. Committee** Senate Finance

**4. Title** Commonwealth's Tax System; Conformity with Federal Law; Taxpayer Relief Fund

**5. Summary/Purpose:**

This bill would advance Virginia's date of conformity to the Internal Revenue Code ("IRC") from February 9, 2018 to December 31, 2018. This bill would also repeal language currently deconforming Virginia from most of the provisions of the Tax Cuts and Jobs Act ("the TCJA") and the Bipartisan Budget Act of 2018 ("the BBA") that affect Taxable Year 2018 and after. This would allow Virginia to fully conform to the TCJA. The portion of this bill amending Virginia's conformity statute would be effective for Taxable Year 2018 and after.

This bill would also provide that, for Fiscal Years 2019 and 2020, any additional revenues generated as a result of the temporary individual income tax provisions of the TCJA that expire before January 1, 2026 are required to be transferred to a special nonreverting fund established by this bill and to be known as the Taxpayer Relief Fund. Such additional revenues would be estimated at $517.9 million for Fiscal Year 2019 and $434.4 million for Fiscal Year 2020.

This bill would require that, by August 1, 2019, the Department of Taxation ("the Department") submit a plan to be considered by the General Assembly during any special or regular session beginning prior to January 8, 2020, to appropriate and refund such revenues to affected taxpayers in the Commonwealth that experienced an increase in Virginia taxes as an indirect result of the provisions of the TCJA.

Because this bill would not contain an emergency clause making it in force from its passage, this bill would become effective on July 1, 2019.

**6. Budget amendment necessary:** Yes.
Item(s): <u>Page 1, Revenue Estimates</u>

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

**7b. Revenue Impact:**

| ***Fiscal Year*** | ***Dollars*** | ***Fund*** |
|---|---|---|
| 2018-19 | ($517.9 million) | GF |
| 2019-20 | ($434.4 million) | GF |

**8. Fiscal implications:**

<u>Administrative Costs</u>

Due to uncertainty about the systems and processing changes that may be required for the 2018 and 2019 income tax filing seasons, the Department is unable to assign administrative costs to this bill at this time. During 2017, Congress enacted the Tax Cuts and Jobs Act, which made substantial changes to federal tax law. At this time, it is uncertain what Virginia tax policy changes will be adopted in reaction to the federal law.

If substantial changes are enacted or required in response to state/federal law, it is possible that the Department may not have the ability to implement the changes set forth in this bill by the proposed effective date. Accordingly, the Department will reevaluate its costs once action is taken and may request additional funding or an amendment to delay the effective date of this legislation.

<u>Revenue Impact</u>

The portion of this bill advancing Virginia's date of conformity would have an estimated positive revenue impact of $594.2 million in Fiscal Year 2019; $611.1 million in Fiscal Year 2020; $653.7 million in Fiscal Year 2021; $798.7 million in Fiscal Year 2022; $943.2 million in Fiscal Year 2023; $950.6 million in Fiscal Year 2024; and $943.1 million in Fiscal Year 2025. No budget amendment would be necessary for this provision because the General Fund revenue impact of advancing Virginia's date of conformity is assumed in the Introduced Executive Budget. However, because this bill would not contain an emergency clause, it would not be in force from the date of its passage and would instead become effective on July 1, 2019. As a result, some of the estimated positive revenue impact could be shifted between Fiscal Year 2019 and Fiscal Year 2020 by an unknown amount.

This bill would also create a special nonreverting fund to be known as the Taxpayer Relief Fund, where any additional revenues generated by the TCJA in Fiscal Year 2019 and Fiscal Year 2020 would be required to be transferred. This portion of the bill would have an estimated negative General Fund revenue impact of $517.9 million in Fiscal Year 2019 and $434.4 million in Fiscal Year 2020. Accordingly, if this bill is enacted, the budget would need to be adjusted to reduce the revenue estimate by $517.9 million in Fiscal Year 2019 and $434.4 million in Fiscal Year 2020.

**9. Specific agency or political subdivisions affected:**

Department of Taxation

**10. Technical amendment necessary:** Yes.

This bill would require any additional revenues generated as a result of the temporary individual income tax provisions of the TCJA for Fiscal Year 2019 and Fiscal Year 2020 to be transferred to the Taxpayer Relief Fund. However, this bill would require the Department to submit a plan to appropriate and refund revenues in the Taxpayer Relief Fund to affected taxpayers that experienced an increase in Virginia taxes as an indirect result of all of the provisions of the TCJA. This would not limit taxpayers eligible to receive a refund solely to those that were impacted by the individual income tax provisions of the TCJA and, as currently drafted, would include taxpayers impacted by the permanent individual income tax provisions, corporate income tax provisions, and international tax provisions of the TCJA. If the intent is to limit the refund to individual taxpayers or to individual taxpayers impacted by the temporary individual income tax provisions of the TCJA, the Department suggests a clarifying technical amendment.

In developing a plan for appropriating and refunding revenues in the Taxpayer Relief Fund to taxpayers, the Department would be required to set forth a framework for providing relief solely to affected taxpayers in the Commonwealth that experienced an increase in Virginia taxes as an indirect result of the TCJA. There are an unlimited number of factors that may result in changes to a taxpayer's return from year-to-year, and the provisions of the TCJA represent a small portion of such factors. For example, the Department would not be able to ascertain whether a taxpayer chose to claim the standard deduction rather than itemizing because of the TCJA or because of other factors. Because the Department only receives limited data from taxpayer returns, the Department would be unable to precisely identify specific taxpayers in the Commonwealth that experienced an increase in Virginia taxes as an indirect result of the TCJA without additional information from taxpayers, especially given the tight timeframe of this bill. In addition, this bill would not account for taxpayers filing Taxable Year 2019 returns on extension nor would it take into account audit adjustments or other adjustments to taxpayers' liability.

**11. Other comments:**

<u>Current Law</u>

Virginia's date of conformity to the IRC is currently fixed to the IRC as it existed on February 9, 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.

In addition to these IRC provisions from which Virginia has historically deconformed, the General Assembly enacted legislation during the 2018 Session that deconformed Virginia from:

- The provision of the TCJA that temporarily increased the medical expenses deduction for Taxable Years 2017 and 2018; and
- All of the provisions of the TCJA and the Bipartisan Budget Act of 2018 that affect Taxable Year 2018 and after other than the provision of the TCJA providing tax relief for specified 2016 disaster areas and the provision extending combat zone benefits to members of the armed forces performing services in the Sinai Peninsula of Egypt.

<u>Tax Cuts and Jobs Act</u>

On December 22, 2017, the TCJA was signed into law. This federal tax reform legislation substantially changes the federal income taxation of individuals and businesses. The provisions that affect individual taxpayers include, but are not limited to:

- Increasing the standard deduction amount to $24,000 for joint filers and $12,000 for individual filers;
- Repealing the "Pease Limitation" that reduced the otherwise allowable amount of itemized deductions by 3 percent of the amount by which federal adjusted gross income exceeded a threshold amount (up to an 80 percent reduction);
- Expanding the charitable contribution deduction by increasing the percentage limitation on the amount of cash contributions that may be made to public charities;
- Imposing a $10,000 limitation on the state and local tax (“SALT”) deduction;

- Limiting the home mortgage interest deduction to interest expenses attributable to mortgage balances no greater than $750,000 (for mortgages incurred December 15, 2017 or later);
- Repealing the home mortgage interest deduction for all home equity loan interest expenses;
- Repealing certain miscellaneous deductions subject to 2 percent floor, such as the deduction for unreimbursed employee expenses (including travel and home office expenses) and the deduction for tax preparation fees; and
- Repealing the deduction for casualty losses other than for losses incurred in a federally-declared disaster area.

Most of the provisions of the TCJA impacting individual taxpayers are currently scheduled to sunset after December 31, 2025. Future legislation would be required to make the provisions effective beyond Taxable Year 2025.

The provisions that impact businesses include, but are not limited to:

- Expanding IRC § 179 small business expensing by raising the annual dollar limitation from $500,000 to $1 million of qualifying property and raising the threshold for reducing the deduction amount from $2 million to $2.5 million of qualifying purchases;
- Increasing first-year bonus deprecation from 50 percent to 100 percent of the purchase price of qualified property;
- Expanding the universe of taxpayers that can use the cash method of accounting by increasing the threshold for the cash method from $5 million in gross receipts (generally $1 million for those businesses that are required to use the inventory method) to $25 million;
- Imposing a 30 percent of adjusted income limit on the deduction for interest expenses for most businesses with gross receipts of over $25 million;
- Imposing an 80 percent of taxable income limitation on the net operating loss deduction, generally repealing the ability to carry back losses, and providing the ability to indefinitely carry forward losses;
- Repealing the IRC § 199 domestic production activities deduction; and
- Eliminating the ability of taxpayers to immediately deduct certain research and experimentation expenditures and requiring them to be amortized.

Most of the provisions of the TCJA impacting business taxpayers are effective beginning in Taxable Year 2018 and are permanent. However, the provision providing 100 percent bonus depreciation is currently scheduled to sunset after Taxable Year 2022.

The TCJA makes fundamental changes to the United States' international tax structure. In general, the TCJA shifts from the prior system of worldwide taxation with deferral to a participation exemption regime with current taxation of certain foreign income.

<u>Bipartisan Budget Act of 2018</u>

On February 9, 2018, the BBA was signed into law by Congress. In addition to providing a continuing resolution to fund the federal government, the BBA extends more than 30 tax provisions, commonly known as "extenders," which had expired at the end of 2016, so that they apply to Taxable Year 2017. The law expands the tax relief previously provided to victims of Hurricanes Harvey, Irma, and Maria so that it applies to victims of the 2017 California wildfires, clarifies the definition of "disaster areas" for Hurricanes Irma and Harvey, and makes other changes.

History of Virginia's Response to Federal Tax Reform

During the 1987 Session, the General Assembly enacted legislation in response to the federal Tax Reform Act of 1986 that increased the:

- Amounts of the personal exemption and standard deduction;
- Threshold for the top individual income tax rate bracket; and
- Individual income tax filing threshold.

This legislation also required excess revenues from federal tax reform to be set aside in a special fund for purposes of providing future tax relief. During the 1989 Session, the General Assembly enacted legislation that utilized such revenue to provide a one-time, nonrefundable individual income tax credit in an amount equal to $35 per personal and dependent exemption claimed. Taxpayers with Virginia adjusted gross income of less than $17,000 for individuals and $34,000 for married persons filing joint returns received the full amount of the credit. The amount of the credit declined gradually based on a taxpayer's income in excess of such amounts so that a taxpayer with Virginia adjusted gross income greater than $34,000 for individuals and $68,000 for married persons filing joint returns received no credit.

During the 1989 Session, the General Assembly also enacted a smaller $22.50 tax credit for Taxable Year 1990 through Taxable Year 1993. However, this credit was repealed during the 1990 Session in order to instead eliminate the sales and use tax on nonprescription drugs.

Proposed Legislation

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Similar Legislation

**House Bill 2529** would (i) increase Virginia's standard deduction from $3,000 to $4,000 for individuals and married persons filing separately, and from $6,000 to $8,000 for married taxpayers filing joint returns; (ii) provide that a taxpayer may elect either to claim the Virginia standard deduction or to itemize deductions on his or her Virginia return, regardless of whether the taxpayer elected to itemize deductions on his or her federal return; (iii) create a new individual income tax deduction for the amount of certain real property and personal property taxes not otherwise deducted on the state return solely on account of the federal limitation; and (iv) expand Virginia's existing corporate income tax subtraction for subpart F income so that it also applies to GILTI.

**Senate Bill 1372** would (i) advance Virginia's conformity to the Internal Revenue Code to December 31, 2018, (ii) increase Virginia's standard deduction from $3,000 to $4,500 for individuals and married persons filing separately, and from $6,000 to $9,000 for married taxpayers filing joint returns; (iii) create a new individual income tax deduction for up to $10,000 of the amount of certain real property and personal property taxes not otherwise deducted on the state return solely on account of a federal limitation; (iv) create a new subtraction for 20 percent of the amount of business interest disallowed as a deduction for federal income tax purposes on account of a federal limitation; (v) expand Virginia's existing corporate income tax subtraction for subpart F income so that it also applies to GILTI; (vi) provide a refund of up to $110 for certain individuals or $220 for married persons who file their returns before July 1, 2019; and (vi) require any additional revenues from the TCJA for Taxable Year 2018 to be transferred to a Tax Reform Fund and used to effectuate future temporary or permanent tax reform during the 2020-2022 biennium.

cc : Secretary of Finance

Date: 2/7/2019 JJS
HB2355FEH1161