DEPARTMENT OF TAXATION
2019 Fiscal Impact Statement

1. Patron Robert D. Orrock, Sr.

2. Bill Number HB 2701

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

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

3. Committee House Rules

4. Title Corporate Income Tax; Business Interest Subtraction

5. Summary/Purpose:

This bill would provide a corporate income tax subtraction for the amount of business interest that is disallowed as a deduction for federal income tax purposes.

If enacted during the 2019 Regular Session of the General Assembly, this bill would become effective July 1, 2019.

6. Budget amendment necessary: No.

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

7b. Revenue Impact:

Fiscal Year	*Dollars*	*Fund*
2019-20	($193.9 million)	GF
2020-21	($84.5 million)	GF
2021-22	($88.1 million)	GF
2022-23	($91.7 million)	GF
2023-24	($95.4 million)	GF
2024-25	($99.4 million)	GF

8. Fiscal implications:

Administrative Costs

Due to uncertainty about the systems and processing changes that may be required for the 2018 and 2019 income tax filing seasons, the Department of Taxation ("the Department") is unable to assign administrative costs to this bill at this time. During 2017, Congress enacted the Tax Cuts and Jobs Act ("TCJA"), 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.

Revenue Impact

This bill would result in an estimated negative General Fund revenue impact of $193.8 million in Fiscal Year 2020, $84.5 million in Fiscal Year 2021, $88.1 million in Fiscal Year 2022, $91.7 million in Fiscal Year 2023, $95.4 million in Fiscal Year 2024, and $99.4 million in Fiscal Year 2025. If this bill is enacted, the budget would need to be adjusted to reduce the revenue estimate by $193.8 million in Fiscal Year 2020. As the Introduced Executive Budget assumes advancement of the date of conformity, and because this bill proposes modifications to the business interest deduction provisions within the TCJA, these estimates assume that Virginia's date of conformity will be advanced to December 31, 2018 and that Virginia will otherwise conform to the TCJA.

These revenue estimates also assume that, because the effective date of this bill is not specified, taxpayers would amend their Taxable Year 2018 returns to claim the proposed subtraction. Some of this impact could be shifted to Fiscal Year 2019 if taxpayers adjust their Taxable Year 2018 returns or payments prior to July 1 in anticipation of the law change. These revenue estimates also assume the bill would be amended to prevent taxpayers from receiving a double tax benefit (See Line 10). If such amendments are not adopted, the negative revenue impact would increase. Such estimated negative revenue impact would also increase if a similar subtraction were provided for individual income tax purposes.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: Yes.

The TCJA imposed a much more restrictive cap on the federal business interest deduction than what existed under prior law. However, taxpayers may carry forward disallowed business interest deductions indefinitely and use them to reduce their federal tax liability in future taxable years. This effectively spreads a taxpayer's business interest deduction over several taxable years for federal income tax purposes.

This bill would permit a corporate taxpayer to subtract the full amount of the business interest deduction they are entitled to for Virginia income tax purposes. However, it does not provide a corresponding corporate income tax addition in the later taxable years when the taxpayer would be able to deduct the disallowed amounts for federal income tax purposes. Without such an offsetting addition, this would permit taxpayers to claim their full business interest deduction for Virginia income tax purposes in the first year, and then realize a double benefit going forward as their Virginia taxable income would be reduced to the extent they claim the disallowed carry forward on their federal income tax returns in future taxable years.

To prevent taxpayers from receiving a double tax benefit for Virginia income tax purposes, the Department recommends that the General Assembly add a corresponding business interest addition to this bill.

11. Other comments:

Federal Business Interest Deduction

For federal income tax purposes, a taxpayer may claim a deduction for interest paid or accrued on certain debts related to their trades or businesses. Prior the enactment of the TCJA, only corporations were permitted to claim this deduction and it was not subject to a percentage limitation. Instead, the deduction was limited for certain types of interest if the taxpayer's debt-to-equity ratio exceeded 1.5 to 1.0 and the taxpayer's net interest expense exceeded 50 percent of the taxpayer's adjusted taxable income.

The TCJA permits all businesses, regardless of entity type, to claim the business interest deduction. However, the TCJA generally limited the amount of the deduction to the sum of a taxpayer's:

- Business interest income;
- 30 percent of a taxpayer's adjusted taxable income; and
- Floor plan financing interest.

For purposes of the deduction, "adjusted taxable income," is defined as the taxable income of the taxpayer without regard to:

- Items of income, gain, deduction or loss not allocable to a trade or business;
- Any business interest or business interest income;
- Any net operating loss deduction;
- Any "pass-through" deduction under Internal Revenue Code Section 199A; and
- For taxable years commencing prior to January 1, 2022, any depreciation, amortization or depletion deductions.

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.

Proposed Legislation

This bill would provide a corporate income tax subtraction for the amount of business interest that is disallowed as a deduction for federal income tax purposes.

If enacted during the 2019 Regular Session of the General Assembly, this bill would become effective July 1, 2019.

Similar Bills

Senate Bill 1697 is identical to this bill.

Senate Bill 1443 and **Senate Bill 1631** would provide a subtraction for business interest disallowed as a deduction for federal income tax purposes, and would make several tax policy changes.

cc: Secretary of Finance

Date: 1/22/2019 RWC
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