DEPARTMENT OF TAXATION
2019 Fiscal Impact Statement

1. Patron Dawn M. Adams

2. Bill Number HB 2765
House of Origin:
X Introduced
_____ Substitute
_____ Engrossed

3. Committee House Rules

4. Title Income tax; Conformity; Increase in Standard Deduction; Refundable Income Tax Credit for Low-Income

Second House:
_____ In Committee
_____ Substitute
_____ Enrolled

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.

This bill would increase the Virginia standard deduction from $3,000 to $3,750 for individuals and married taxpayers filing separately, and from $6,000 to $7,500 for married taxpayers filing joint returns.

This bill would permit taxpayers that claim the Virginia Earned Income Tax Credit ("EITC") a refund in an amount equal to 60 percent of the amount by which the credit exceeds their Virginia income tax liability.

This bill would require that, in each fiscal year, an amount not to exceed $198 million of any additional revenues generated by the TCJA beyond those revenues necessary to offset the reduction in revenues resulting from the provisions in this bill, would be required to be transferred to the Revenue Stabilization Fund.

The provisions of this bill regarding the EITC would be effective for taxable years beginning on and after January 1, 2019, but before January 1, 2026. The other provisions of this bill would be effective for taxable years beginning on and after January 1, 2019.

6. Budget amendment necessary: Yes.
Item(s): Page 1, Revenue Estimates
273 and 275, Department of Taxation

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

7a. Expenditure Impact:

Fiscal Year	***Dollars***	***Positions***	***Fund***
2019-20	$103,471	0	GF
2020-21	$27,200	0	GF

7b. Revenue Impact:

Fiscal Year	***Dollars***	***Fund***
2018-19	($187.7 million)	GF
2019-20	($281.3 million)	GF
2020-21	($229.0 million)	GF
2021-22	($226.8 million)	GF
2022-23	($225.0 million)	GF
2023-24	($222.8 million)	GF
2024-25	($220.1 million)	GF

8. Fiscal implications:

<u>Administrative Costs</u>

This bill would result in administrative costs to the Department of Taxation ("the Department") of $103,471 in Fiscal Year 2020 and $27,200 in Fiscal Year 2021. Such funding would primarily cover costs to hire part-time employees for customer services to respond to taxpayer calls arising from this bill.

<u>Revenue Impact</u>

The tax policy changes proposed by this bill would result in a negative General Fund revenue impact of $289.3 million in Fiscal Year 2020, $243.9 million in Fiscal Year 2021, $248.9 million in Fiscal Year 2022, $253.6 million in Fiscal Year 2023, $258.5 million in Fiscal Year 2024, and $263.2 million in Fiscal Year 2025. In addition, it is projected that $198 million of additional revenues generated by the TCJA would be transferred to the Revenue Stabilization Fund.

The Introduced Executive Budget already assumes that Virginia's EITC will become fully refundable beginning in Taxable Year 2019. Accordingly, if this bill is enacted and the EITC changes set forth in this bill are adopted instead of those assumed in the Introduced Executive Budget, the budget would need to be adjusted to reduce General Fund revenues by $187.7 million in Fiscal Year 2019 and $281.3 million in Fiscal Year 2020.

The Department suggests a technical amendment to clarify that this bill would advance the date of conformity effective for Taxable Year 2018 (see Line 10). If such amendment is not adopted and Virginia specifically deconforms from the TCJA for Taxable Year 2018, both the negative revenue impact and administrative costs associated with this bill would increase.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: Yes.

This bill would advance Virginia's date of conformity to the IRC. However, because the first enactment clause states that this bill would be effective for Taxable Year 2019 and after, it does not advance Virginia's date of conformity for Taxable Year 2018. Therefore, as currently drafted, this bill would deconform from the IRC for Taxable Year 2018 and conform for Taxable Year 2019. This would result in significant issues to taxpayers, tax practitioners, and the Department. Therefore, the Department suggests that the General Assembly consider a technical amendment to specify that the provisions of this bill regarding conformity are effective for Taxable Year 2018 as well.

11. Other comments:

Virginia's Date of Conformity to the Internal Revenue Code

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 BBA 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.

Tax Cuts and Jobs Act

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.

Bipartisan Budget Act of 2018

On February 9, 2018, the BBA was signed into law. 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.

<u>Virginia Standard Deduction</u>

Taxpayers that do not itemize their deductions for federal purposes are permitted to claim a standard deduction on their Virginia income tax returns. The amount of the Virginia standard deduction is $3,000 for single individuals and $6,000 for married persons filing jointly, and it is not currently indexed for inflation. Virginia's standard deduction amounts increased from Taxable Year 1988 to the present, as shown below:

Year	Virginia Standard Deduction for Single Taxpayers	Virginia Standard Deduction for Married Persons Filing Jointly
1987	$2,000	$2,000
1988	$2,700	$2,700
1989-2004	$3,000	$5,000
2005-present	$3,000	$6,000

During the 2005 Session, the General Assembly increased the standard deduction for married persons filing jointly from $5,000 to $6,000. This was intended to eliminate the standard deduction marriage penalty at the state level, similar to how this issue was addressed at the federal level. Since 2005, the Virginia standard deduction amounts have remained at $3,000 for single taxpayers and $6,000 for married taxpayers filing jointly.

Prior to 1987, the Virginia standard deduction was not a fixed amount. For example, in Taxable Year 1986, the Virginia standard deduction was 15 percent of a taxpayer's federal adjusted gross income with a $1,300 minimum and a $2,000 maximum.

Virginia Low-Income Tax Credits

Virginia allows an individual to claim either a credit equal to 20 percent of the federal EITC that was claimed for the taxable year or the Tax Credit for Low-Income Individuals.

- Virginia allows a nonrefundable individual income tax credit equal to 20 percent of the federal EITC claimed by an individual for the taxable year. The credit is for any individual or married persons that are eligible for the federal EITC for the taxable year and claimed such a credit.

- The Tax Credit for Low-Income Individuals is a nonrefundable individual income tax credit equal to $300 each for the individual, the individual's spouse, and any person claimed as a dependent on such individual's or married person's income tax return for the taxable year.

No household may claim both credits in the same taxable year. For purposes of these credits, "household" means an individual or married persons, regardless of whether such married persons file joint or separate Virginia individual income tax returns.

Federal Earned Income Tax Credit

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 the worker's federal adjusted gross income ("AGI") and earned income. For purposes of the federal EITC, earned income includes any wages, salaries, tips, and other employee compensation includible in an individual's gross income, plus the individual's net earnings from self-employment without regard to the federal deduction for self-employment taxes. To qualify for the federal EITC for Taxable Year 2019, an individual's AGI and earned income must be less than:

- $50,162 ($55,592 for married filing jointly) if they have three or more qualifying children;
- $46,703 ($52,493 for married filing jointly) if they have two qualifying children;
- $41,094 ($46,884 for married filing jointly) if they have one qualifying child; or
- $15,570 ($21,370 for married filing jointly) if they do not have a qualifying child

The maximum federal EITC for Taxable Year 2019 is $6,557 for an individual with three or more qualifying children, $5,828 for an individual with two qualifying children, $3,526 for an individual with one qualifying child, and $529 for an individual with no qualifying children.

<u>Other States</u>

Twenty-eight states and the District of Columbia allow individuals to claim an EITC equal to a certain percentage of the federal EITC. There are also several localities (such as New York City, Montgomery County, Maryland, and San Francisco) that have credit programs based on EITC. Twenty-two states (California, Colorado, Connecticut, Illinois, Indiana, Iowa, Kansas, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Jersey, New Mexico, New York, Oregon, Rhode Island, Vermont and Wisconsin) and the District of Columbia allow such credits to be refundable. Six states (Delaware, Hawaii, Ohio, Oklahoma, South Carolina and Virginia) do not allow such credit to be refunded.

<u>Refundable Tax Credits</u>

For Taxable Year 2018, Virginia allows 35 income tax credits. Of these credits, three are currently refundable:

- Agricultural Best Management Practices Tax Credit;
- Motion Picture Production Tax Credit; and
- Research and Development Expenses Tax Credit.

<u>Proposed Legislation</u>

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.

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Similar Legislation

House Bill 1851, **House Bill 1980**, **House Bill 2086**, **House Bill 2110**, **House Bill 2529**, **House Bill 2673**, **Senate Bill 1211, Senate Bill 1225**, **Senate Bill 1443**, and **Senate Bill 1631** would make various, different tax policy changes.

Senate Bill 1531 would increase the standard deduction to $12,000 for single individuals and $24,000 for married taxpayers filing joint returns.

House Bill 2160 and **Senate Bill 1297** would make Virginia's EITC fully refundable.

House Bill 1618 and **Senate Bill 1237** would allow a taxpayer to elect either to claim the Virginia standard deduction or to itemize his or her deductions, regardless of whether the taxpayer elected for the taxable year to itemize deductions on his or her federal return, for Taxable Year 2019 through Taxable Year 2025.

House Bill 2708 would allow a taxpayer to elect either to claim the Virginia standard deduction or to itemize his or her deductions, regardless of whether the taxpayer elected for the taxable year to itemize deductions on his or her federal return, for Taxable Year 2019 and after.

Senate Bill 1320 and **Senate Bill 1372** would advance Virginia's date of conformity to the IRC to December 31, 2018.

House Bill 2704 would require, if the General Assembly does not enact legislation during the 2019 Session that provides at least $100 million in tax relief, that any additional revenues from the TCJA in Fiscal Year 2019-2020 be transferred to the Tax Policy Fund, and used to provide tax reform.

House Bill 2355 would advance Virginia's date of conformity to the IRC to December 31, 2018, and would require additional revenues from the permanent individual provisions of the TCJA for Fiscal Year 2019 and Fiscal Year 2020 be transferred to a fund and refunded to taxpayers that realized a Virginia tax increase as an indirect result of the TCJA.

Senate Bill 1739 would advance Virginia's date of conformity to the IRC to December 31, 2018, and require additional revenues from the TCJA for fiscal years beginning on and after July 1, 2018, but before July 2, 2026 to be transferred to a fund and refunded to individual income taxpayers.

Senate Bill 1744 would increase the standard deduction to $4,000 for single individuals and $8,000 for married taxpayers filing jointly for Taxable Year 2018 only, and the standard deduction would revert to its current amounts for Taxable Year 2019 and after.

cc : Secretary of Finance

Date: 1/28/2019 JLOF
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