

DEPARTMENT OF TAXATION

2020 Fiscal Impact Statement

1. **Patron** Lynwood W. Lewis, Jr.
3. **Committee** Senate Finance and Appropriations
4. **Title** Virginia Affiliated Groups; Election to Change Corporate Filing Status

2. **Bill Number** SB 1058
House of Origin:
 Introduced
 X **Substitute**
 Engrossed

Second House:
 In Committee
 Substitute
 Enrolled

5. Summary/Purpose:

The Department of Taxation (“the Department”) understands that the Patron intends to introduce a substitute for this bill. This fiscal impact statement is drafted based on the substitute version of this bill.

This bill would provide that an affiliated group of corporations may elect to change from the Virginia combined to the consolidated filing status if it meets the following requirements:

- It has filed on the same basis for at least the preceding 20 years;
- At least one member of the affiliated group is:
 - A related entity to either a state or national bank that is exempt from filing a Virginia corporate income tax return; or
 - An entity that is classified under North American Industrial Classification System (“NAICS”) Code 3364, aerospace product and parts manufacturing; and
- The affiliated group agrees to file returns computing its Virginia income tax liability under both the new filing method and the former method and pay the greater of the two amounts for the taxable year in which the new election is effective.

The bill would require a taxpayer to provide notification to the Department that an election pursuant to this bill is being made.

Under current law, an affiliated group is required to request permission from the Department to make changes to or from the consolidated filing status. Absent extraordinary circumstances, permission to change to or from the consolidated filing method is generally not granted by the Department. In addition, Virginia law provides an exception to make such a change if the affiliated group has filed on the same basis for at least the preceding 20 taxable years and meets certain additional requirements.

This bill would be effective for taxable years beginning on and after January 1, 2020, but before January 1, 2022.

6. Budget amendment necessary: Yes.

7. Fiscal Impact Estimates are: Not available. (See Line 8.)

8. Fiscal implications:

Administrative Costs

The Department considers implementation of this bill as routine, and does not require additional funding.

Revenue Impact

This bill would have an unknown, but potentially significant, negative General Fund revenue impact in Fiscal Year 2021.

Based upon preliminary Taxable Year 2018 corporate income tax return data, the aggregate amount of Virginia corporate income tax paid by affiliated groups that file on a combined basis and that would be eligible to change their filing method as provided in this bill was approximately \$25 million. The Department anticipates that this bill would allow certain eligible taxpayers to significantly reduce, and in certain cases, eliminate their corporate income tax liability in the year after they switch and going forward. Therefore, a significant portion of the \$25 million in revenue may be lost due to tax planning if this bill is enacted.

The Department identified less than 20 affiliated groups that may be eligible to change their filing method under this bill. However, the actual number of eligible affiliated groups may be greater and, thereby, increase the potential negative revenue impact. This bill would limit eligible affiliated groups to those with at least one member that is:

- A related entity to a state or national bank that is exempt from filing a Virginia corporate income tax return; or
- Classified under the NAICS Code for aerospace product and parts manufacturing

It is unclear to what extent affiliated groups have a member that is related to an entity that is a state or national bank that is exempt from filing a Virginia corporate income tax return. The Department does not have comprehensive data regarding the relationship between members of an affiliated group and these, potentially, unaffiliated banking institutions.

Corporate taxpayers are required to include a NAICS Code on their Virginia corporate income tax filings. However, that information is not dispositive as one entity may be involved in several different lines of business. Therefore, a given entity may be included within several different NAICS Codes that are not all necessarily reported on their Virginia income tax filings. Because this bill does not limit eligibility to entities that reported during Taxable Year 2018 using the aerospace products and parts manufacturing NAICS Code or that are primarily involved in such industry, the Department is unable to determine the total number of affiliated groups that may be eligible under this bill.

In addition, no provision in this legislation would prevent an affiliated group from adding an entity to the affiliated group through formation or acquisition that would allow the group to qualify to switch its method of filing. The extent to which affiliated groups that would not

otherwise qualify would restructure to qualify and, therefore, increase the negative revenue impact of this bill is unknown.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: Yes.

Because this bill would provide a preferential election that may be easier for certain Virginia-based companies to qualify for, the Department recommends the following technical amendment to ensure that, if for any reason held the bill were held invalid or unconstitutional by a court, this bill's requirements would not be deemed severable:

Line 59 after by the Department of Taxation

Insert: E. The General Assembly of Virginia finds that job creation and capital investment are essential to the continued fiscal health of the Commonwealth. In this modern economy, states often compete for quality banks and aerospace product and parts manufacturing companies, businesses that consistently create many jobs and undertake major investments in infrastructure. Accordingly, the provisions of subsection D relating to electing to change the basis of the type of return filed from combined to consolidated for certain affiliated groups with members that are banks and aerospace product and parts manufacturing companies are integral for such groups to create new jobs and undertake new capital investment in the Commonwealth. If any provision of subsection D is for any reason held to be invalid or unconstitutional by the decision of a court of competent jurisdiction, then that provision shall not be deemed severable, and all provisions of subsection D shall expire beginning with the taxable year that immediately follows the date of such decision.

11. Other comments:

Federal Corporate Tax Filings

For federal income tax purposes, an affiliated group of corporations has the option of filing a consolidated return in lieu of separate returns for each corporation. If a consolidated return is filed, the affiliated group members are treated as one entity and their financial activities are combined for purposes of computing their federal income tax liability. A corporation generally meets the federal requirements for affiliation if it possesses at least 80 percent of the total voting power and at least 80 percent of the total value of a corporation's stock.

Virginia Corporate Tax Filings

Virginia is a separate return state. As a result, Virginia allows each corporation with nexus with the state the ability to elect to file a separate Virginia return, regardless of its federal tax filings. In addition, Virginia allows corporations that are members of an affiliated group of corporations with Virginia nexus the ability to elect to file on a consolidated or Virginia combined basis. All returns for subsequent years are required to be filed on the same basis unless permission to change is granted by the Department. If a new corporation becomes a member of an affiliated group, the new corporation must follow the filing method previously elected by the group.

The table below provides information regarding the usage of each filing status based upon preliminary Taxable Year 2017 data:

Taxable Year 2017	Number of Taxpayers	Percentage of All Returns	Income Tax Paid	Percentage of Total Income Tax Paid
Separate Returns	65,236	96%	\$502 million	58%
Consolidated Returns	1,937	3%	\$211 million	25%
VA Combined Returns	447	1%	\$146 million	17%
All Returns	67,620	100%	\$859 million	100%

Virginia Affiliated Group Filing Methods

If an affiliated group of corporations elects to file separately, each corporation in the affiliated group that has nexus in Virginia is required to file its own separate corporate income tax return and report only its income, expenses, gains, losses, and allocation and apportionment factors on such return. This type of reporting follows the separate entity concept, in which each corporation in an affiliated group is treated as distinct and separate from the other corporations in such group for purposes of determining each corporation's corporate income tax liability.

A consolidated return includes the aggregate income, expenses, gains, and losses, allocation and apportionment factors of all of the corporations in an affiliated group that have nexus with Virginia. The corporate income tax liability of the affiliated group is computed in the aggregate, and the entire affiliated group files one corporate income tax return.

In a Virginia combined return, each corporation in an affiliated group that has nexus with Virginia determines its income, expenses, gains, losses, and allocation and apportionment factors separately. Each corporation then separately computes its individual corporate income tax liability. The final corporate income tax liability, after apportionment, of each corporation is then combined and included on one corporate income tax return.

Changing Corporate Filing Status

The Department has the statutory authority to grant or deny requests by corporations to change their Virginia tax filing status. Because switching to or from the consolidated filing status affects the allocation and apportionment formulas and may distort the business done in Virginia and the income arising from activity in Virginia, the Department generally will grant permission to change to or from a consolidated filing status only in extraordinary circumstances. In contrast, separate and Virginia combined returns do not affect the allocation and apportionment formulas for each corporation. Therefore, permission to change from separate to Virginia combined returns or from Virginia combined to separate returns is generally granted.

During the 2003 Session, the General Assembly enacted legislation that effectively provided an exception to the Department's general rule against switching to or from the consolidated filing status. This legislation provided that an affiliated group that has filed on the same basis

for at least the preceding 20 years is allowed to change the basis of the type of return filed from consolidated to separate or from separate or combined to consolidated if:

- The tax computed under the affiliated group's requested return basis would be equal or greater than the tax for the full taxable year immediately preceding the taxable year for which the requested return basis would be applicable; and
- The affiliated group agrees to compute its tax liability under both the requested return basis and the elected return basis and would be liable for the greater of the two amounts for the taxable year in which the requested basis is effective and the immediately succeeding taxable year.

Other States

Of the jurisdictions that impose a corporate income tax, twenty-seven states and the District of Columbia have enacted mandatory unitary combined reporting. In these states, taxpayers are generally required to file a return with all of their affiliates with which they have a unitary relationship. This differs from Virginia combined reporting, which is based solely on affiliated corporations with Virginia nexus. They are not given the option to file a separate return for each corporation in the affiliated group.

The remaining 15 states are separate return states like Virginia. Seven of these states (Delaware, Louisiana, Maryland, Mississippi, Pennsylvania, South Carolina, and Tennessee) do not offer taxpayers the option to file on a consolidated basis. The remaining eight separate return states (Arkansas, Florida, Georgia, Indiana, Iowa, Missouri, North Carolina, and Oklahoma) allow taxpayers to file on a consolidated basis under certain circumstances. All of the separate return states that allow consolidated filing require taxpayers to apply for permission from a state tax agency before they can change their filing method. These states impose varying restrictions on granting such permission.

From preliminary research completed by the Department, Virginia's restrictions on switching filing status are generally similar in nature to those imposed by other states.

Federal Tax Cuts and Jobs Act

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, and floor plan financing interest ("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 20 percent of the amount of business interest that is disallowed as a deduction under the business interest limitation. 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.

Proposed Legislation

This bill would provide that an affiliated group of corporations may elect to change from the Virginia combined to the consolidated filing status if it meets the following requirements:

- It has filed on the same basis for at least the preceding 20 years;
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 - A related entity to either a state or national bank that is exempt from filing a Virginia corporate income tax return; or
 - An entity that is classified under NAICS Code 3364, aerospace product and parts manufacturing; and
- The affiliated group agrees to file returns computing its Virginia income tax liability under both the new filing method and the former method and pay the greater of the two amounts for the taxable year in which the new election is effective.

The bill would require a taxpayer to provide notification to the Department that an election pursuant to this bill is being made. Such notification would be required to be submitted in a form as prescribed by the Department.

Under current law, an affiliated group is required to request permission from the Department to make changes to or from the consolidated filing status. Absent extraordinary circumstances, permission to change to or from the consolidated filing method is generally not granted by the Department. In addition, Virginia law provides an exception to make such a change if the affiliated group has filed on the same basis for at least the preceding 20 taxable years and meets certain additional requirements.

This bill would be effective for taxable years beginning on and after January 1, 2020, but before January 1, 2022.

cc : Secretary of Finance

Date: 2/4/2020 JJS
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