DEPARTMENT OF TAXATION
2021 Fiscal Impact Statement

1. Patron Joseph P. McNamara

2. Bill Number HB 1788

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

3. Committee House Finance

4. Title Rolling Conformity with the Internal Revenue Code

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

5. Summary/Purpose:

This bill would conform Virginia to the Internal Revenue Code ("IRC") on a rolling basis. This would allow Virginia to conform to federal tax changes to the IRC as soon as they are enacted by Congress. This bill would conform Virginia fully to the Coronavirus Aid, Relief, and Economic Security ("CARES") Act (H.R.748) and the Consolidated Appropriations Act, 2021 (H.R.133) ("the CAA").

For taxable years beginning on and after January 1, 2021, this bill would deconform Virginia from any amendment to the IRC that would increase or decrease General Fund revenues by greater than 0.25 percent in the fiscal year in which the amendment was enacted or any of the succeeding four fiscal years. "Amendment" would mean a single amendment or a group of amendments enacted in the same legislation by Congress that collectively surpass such threshold.

If this bill is enacted during the 2021 Regular Session of the General Assembly, the portion that would conform Virginia to the IRC on a rolling basis would become effective July 1, 2021. The portion of this bill that would deconform from federal legislation based on the projected revenue impact would be effective for taxable years beginning on or after January 1, 2021.

6. Budget amendment necessary: Yes.

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

8. Fiscal implications:

<u>Administrative Costs</u>

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 significant negative General Fund revenue impact estimated between $1.1 billion and $1.3 billion in Fiscal Year 2022. The impact beyond Fiscal Year 2022 is unknown. This bill would fully conform Virginia to the CARES Act and the CAA, effective July 1, 2021. This includes an estimated $665.7 million revenue loss in Fiscal Year 2022 as a result of conforming to three significant business provisions within the CARES Act that are not assumed in the Introduced Executive Budget. It also includes an estimated revenue loss ranging between $433 million and $593 million in Fiscal Year as a result of conforming to the provisions of the Consolidated Appropriations Act.

Because this bill would become effective July 1, 2021, a significant portion of taxpayers would be required to file amended returns or file on extension to account for such changes on their Taxable Year 2020 returns. It is unknown to what extent taxpayers would comply. Therefore, it is assumed that taxpayers would make any adjustments to their returns during Fiscal Year 2022 rather than during the Taxable Year 2020 filing season.

Because the portion of this bill that would deconform from federal legislation based on the projected revenue impact would be effective for taxable years beginning on or after January 1, 2021, such revenue-based limitation would not apply to the provisions of the CARES Act and CAA that are effective prior to Taxable Year 2021. It is unknown to what extent rolling conformity for taxable years beginning on and after January 1, 2021 would have a General Fund revenue impact because it uncertain to what extent Congress will enact changes to the IRC that would impact Virginia income tax returns in the future and whether such provisions would be estimated to increase or decrease General Fund revenues by greater than 0.25 percent. For Fiscal Year 2022, it is estimated that such limitation would apply to any amendment estimated to increase or decrease Virginia revenues by more than $56.8 million in the fiscal year of enactment or in any of the succeeding four fiscal years.

Impact of the CARES Act

The Introduced Executive Budget assumes a reduction of $34.2 million in Fiscal Year 2021 and $7.5 million in Fiscal Year 2022 to account for the negative revenue impact of conforming to the individual provisions set forth in the CARES Act. This does not include the impact of conforming to the following business provisions within the CARES Act:

- Enhance the NOL deduction for Taxable Years 2018, 2019, and 2020;
- Allow noncorporate taxpayers to deduct excess business losses arising in Taxable Year 2018, 2019, and 2020; and
- Increase the limitation on the business interest deduction for Taxable Year 2019 and 2020.

Conformity to these business provisions of the CARES Act would result in an estimated negative General Fund revenue impact of $665.7 million in Fiscal Year 2022. These federal changes reverse limitations previously adopted by the Tax Cuts and Jobs Act and are retroactive to prior taxable years, thereby likely resulting in the filing of significant amended returns in Fiscal Year 2022 to take advantage of the enhanced incentives.

Impact of the Consolidated Appropriations Act

Because the CAA was not enacted by Congress until December 27, 2020, it was not assumed in the Introduced Executive Budget. Full conformity to this federal legislation effective July 1, 2021 would result in an estimated negative General Fund revenue impact ranging between $433 million and $593 million in Fiscal Year 2022. This negative revenue impact is primarily the result of conforming to tax-free Paycheck Protection Program loan forgiveness as provided in the CARES Act and allowing taxpayers to also deduct business expenses funded by such forgiven PPP loans as provided in the CAA. Conforming to these provisions alone, effective July 1, 2021, would result in an estimated negative revenue impact of between $340 million and $500 million in Fiscal Year 2022.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

<u>Virginia's Conformity to the IRC</u>

Beginning in 1972, Virginia automatically conformed to federal income tax laws. Whenever a federal income tax law change affected the definition of taxable income, it automatically affected Virginia income tax revenue, unless the General Assembly enacted a specific exception. In 2003, Virginia began conforming to the IRC as of a fixed date, usually December 31 of the preceding year, in order to protect Virginia revenues from automatically being impacted by major federal tax law changes. Since 2003, the General Assembly has generally advanced the date in order to conform to any federal changes made during the prior year.

Virginia's date of conformity to the IRC is currently fixed to the IRC as it existed on December 31, 2019. 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.

- **Suspension of the federal overall limitation on itemized deductions.** During the 2019 Session, Virginia deconformed from the federal suspension of the overall limitation on itemized deductions (the “Pease Limitation”). This has the effect of reinstating the Pease Limitation for Virginia income tax purposes only beginning with Taxable Year 2019.

- **The reduction in the medical expense deduction floor for Taxable Year 2019 and Taxable Year 2020.** During the 2020 Session, Virginia deconformed from the reduction of the adjusted gross income limitation on the medical expense deduction from 10 percent to 7.5 percent floor for Taxable Year 2019 and Taxable Year 2020. During the 2018 session, the General Assembly deconformed from this provision for Taxable Year 2017 as well.

<u>CARES Act</u>

On March 27, 2020, the CARES Act was signed into law. This federal legislation provides emergency economic assistance to businesses and individuals affected by COVID-19. Several of the changes made in the CARES Act will impact Virginia taxpayers. To conform to these federal tax provisions, Virginia would be required to enact legislation advancing its date of conformity.

Individual Provisions

There are four provisions in the CARES Act that have an impact on Virginia individual taxpayers preparing and filing their Virginia income tax returns during the 2021 tax filing season. These provisions include:

- Modifying federal rules with respect to COVID-19 related distributions from certain retirement plans;
- Expanding the types of educational payments that are excluded from an employee’s gross income to include eligible loan repayments made before January 1, 2021;

- Providing a $300 “above the line” charitable contributions deduction for Taxable Year 2020 to individual taxpayers that claim the standard deduction; and
- Enhancing the deduction limitations for individuals and corporations on cash contributions to certain charitable organizations.

Business Provisions

There are four provisions in the CARES Act that have an impact on Virginia business taxpayers preparing and filing their Virginia income tax returns during the 2021 tax filing season. These provisions include:

- Enhancing the NOL deduction for Taxable Years 2018, 2019, and 2020;
- Allowing noncorporate taxpayers to deduct excess business losses arising in Taxable Year 2018, 2019, and 2020;
- Increasing the limitation on the business interest deduction for Taxable Year 2019 and 2020; and
- Excluding the forgiveness of certain Paycheck Protection Program loans from taxation.

The first three provisions modify changes previously adopted by the Tax Cuts and Jobs Act (“TCJA”) and are retroactive to prior taxable years.

<u>Consolidated Appropriations Act, 2021</u>

On December 27, 2020, the CAA was signed into law. This federal legislation provides additional emergency economic assistance to businesses and individuals affected by COVID-19. This legislation contains 28 provisions that will impact Virginia returns

Individual Tax Provisions

A number of the federal tax provisions in the CAA will have an impact on Virginia individual taxpayers preparing and filing their Virginia income tax returns during the 2021 tax filing season. These provisions include:

- Making the 7.5 percent adjusted gross income floor for the medical expense deduction permanent;
- Expanding the educator expense tax deduction to include personal protective equipment and other supplies related to the prevention of the spread of COVID-19;
- Excluding certain emergency financial aid grants from gross income;
- Making the $300 deduction for non-itemizers applicable to Taxable Year 2021;
- Enhancing the charitable deduction for individuals for certain contributions;
- Repealing the deduction for qualified tuition;
- Temporarily enhancing the earned income tax credit for certain taxpayers;
- Permanently extending the exclusion from gross income for members of a qualified volunteer emergency response organization;
- Modifying the minimum age for distributions from certain pension plan trusts during working retirement;

- Temporarily providing special rules for health and dependent care flexible spending arrangements; and
- Exclusion for certain employer payments of student loans.

Business Tax Provisions

A number of the federal tax provisions in the CAA will have an impact on Virginia business taxpayers preparing and filing their Virginia income tax returns during the 2021 tax filing season. These provisions include:

- Allowing taxpayers to both deduct expenses paid with PPP loans and utilize tax-free forgiveness of such loans;
- Providing an exclusion from gross income for EIDL loans, EIDL grants, and certain loan repayment assistance, and allows taxpayers to deduct expenses paid with forgiven EIDL funds;
- Allowing farmers that opted to utilize the two-year carryback of NOLs prior to the CARES Act to continue to do so;
- Providing for the depreciation of certain residential rental property over a 30-year period; and
- Temporarily allowing a full deduction for certain business meals.

Disaster Relief Provisions

A number of disaster tax relief provisions in the CAA relating to persons affected by certain disasters in 2020 will have an impact on taxpayers preparing and filing their Virginia income tax returns during the 2021 tax filing season. These provisions include:

- Disaster-related rules for use of retirement funds;
- Disaster relief contributions; and
- Qualified disaster-related personal casualty losses.

These provisions provide relief to taxpayers affected by certain hurricanes and wildfires during 2020. Relief from disasters related to COVID-19 was previously provided by the CARES Act.

Federal Extenders

A number of the federal tax provisions that were extended in the CAA will have an impact on taxpayers preparing and filing their Virginia income tax returns during the 2021 tax filing season. These extender provisions include:

- Look-through treatment of payments between related controlled foreign corporations under foreign personal holding company rules;
- Modification and extension of exclusion from gross income of discharge of qualified principal residence indebtedness;
- Seven-year recovery period for motorsports entertainment complexes;
- Special expensing rules for certain film, television, and live theatrical productions;
- Certain empowerment zone tax incentives;

- Mortgage insurance premiums treated as qualified residence interest;
- Classification of certain race horses as 3-year property;
- Accelerated depreciation for business property on Indian reservations; and
- Energy efficient commercial buildings deduction.

Conformity in Other States

There are three distinct approaches to conforming to federal changes to the IRC: rolling conformity, fixed-date conformity, and selective conformity. Twenty-one states and the District of Columbia utilize the rolling conformity. Twenty states, including Virginia, use fixed-date conformity. Five states adopt only specific provisions of the IRC as of a specific date.

Proposed Legislation

This bill would conform Virginia to the IRC on a rolling basis. This would allow Virginia to conform to federal tax changes to the IRC as soon as they are enacted by Congress. This would also allow Virginia to conform to the CARES Act and the CAA.

For taxable years beginning on and after January 1, 2021, this bill would deconform Virginia from any amendment to the IRC that would increase or decrease General Fund revenues by greater than 0.25 percent in the fiscal year in which the amendment was enacted or any of the succeeding four fiscal years. “Amendment” would mean a single amendment or a group of amendments enacted in the same legislation by Congress that collectively surpass such threshold. This deconformity would not apply to any amendment that the General Assembly subsequently adopts.’

The Secretary of Finance, in consultation with the Chairmen of the Senate Committee on Finance and Appropriations and the House Committees on Appropriations and Finance, would be responsible for determining whether any amendment to the IRC is in excess of the 0.25 percent threshold. The Secretary of Finance would be required to annually provide a report on the fiscal impact of amendments to the IRC occurring since the adjournment of the prior year’s regular General Assembly Session to the Senate Committee on Finance and Appropriations and the House Committees on Appropriations and Finance. The report would be required to be presented no later than 60 days prior to the regular General Assembly Session. The Secretary of Finance would also be required to provide updates to the same chairmen on any further amendments to the IRC occurring between presentation of the required report and the first day of the subsequent regular General Assembly Session.

If this bill is enacted during the 2021 Regular Session of the General Assembly, the portion that would conform Virginia to the IRC on a rolling basis would become effective July 1, 2021. The portion of this bill that would deconform from federal legislation based on the projected revenue impact would be effective for taxable years beginning on or after January 1, 2021.

Similar Legislation

House Bill 1935 and **Senate Bill 1146** would advance Virginia's fixed date of conformity to the IRC from December 31, 2019 to December 31, 2020.

Senate Bill 1394 would exclude PPP loan forgiveness from income and would also permit taxpayers to deduct expenses forgiven by a forgiven PPP loan.

House Bill 1787 would exclude PPP loan forgiveness from income, but would not permit taxpayers to deduct expenses forgiven by a forgiven PPP loan.

cc : Secretary of Finance

Date: 1/17/2021 JLOF
HB1788F161