DEPARTMENT OF TAXATION
2022 Fiscal Impact Statement

1. **Patron** Ryan T. McDougle

2. **Bill Number** SB 386
   House of Origin:
   X **Introduced**
   _____ **Substitute**
   _____ **Engrossed**

3. **Committee** Senate Finance and Appropriations

4. **Title** Virginia Affiliated Groups; Election to Change Corporate Filing Status

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

5. **Summary/Purpose:**

   This bill would provide that an affiliated group of corporations may elect to change the basis of the type of return filed from combined to consolidated, if:

   - The affiliated group of which they are members, as it has existed from time to time, has filed on the same basis for at least the preceding 20 years; and

   - At least one member of the affiliated group of which they are members is a related entity to a state or national bank that is exempt from filing a Virginia corporate income tax return because it is instead subject to the Virginia Bank Franchise Tax.

   Any eligible affiliated group that elects to change the basis of the type of return under this bill would be required to agree to file returns computing its Virginia income tax liability under both the new filing method and the former method and would be required to pay the greater of the two amounts for the taxable year in which the new election is effective and for the immediately succeeding taxable year.

   This bill would be effective for taxable years beginning on and after January 1, 2023 but before January 1, 2025.

6. **Budget amendment necessary:** No.

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

8. **Fiscal implications:**

   Administrative Costs

   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 an unknown negative General Fund revenue impact beginning as early as Fiscal Year 2026. This bill would allow certain corporate groups that are affiliated with a bank a one-time opportunity to change their filing status from combined to consolidated in either Taxable Year 2023 or Taxable Year 2024, during which they would be exempted from the normal rules regarding filing status changes. There would be a two-year transition period, during which they would be required compute their tax liability under their old filing status and their new filing status and pay the higher of the two computations.

It is anticipated that only those corporate groups that expect to reduce their overall Virginia income tax liability in the initial years after the two-year transition period would choose to make the filing status change that would be allowed under this bill. As a result, this bill would have a negative General Fund revenue impact beginning as early as Fiscal Year 2026 and the immediately subsequent fiscal years. However, the extent to which corporate groups would make a filing status change under this bill and the resulting revenue impact is unknown.

In addition, no provision in this bill would prevent an affiliated group from adding an entity to the affiliated group through acquisition that is related to a banking institution and potentially allow the group to qualify to switch its method of filing. The extent to which affiliated groups that would not otherwise qualify would utilize this planning technique to qualify and, therefore, increase the negative revenue impact of this bill is unknown. There may also be unforeseen planning opportunities that result in a similar outcome.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

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.

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, 27 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. However, some of these states provide a consolidated election, giving taxpayers the choice to file on a unitary combined return or consolidated return with varying rules regarding changing such election.

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 an election with membership and other rules that are substantially similar to the federal consolidated return rules. The remaining eight separate return states (Arkansas, Florida, Georgia, Indiana, Iowa, Missouri, North Carolina, and Oklahoma) offer taxpayers an election, under certain circumstances, with membership and other rules that are substantially similar to the federal consolidated return rules. 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.

On March 27, 2020, Congress enacted the Coronavirus Aid, Relief, and Economic Security ("CARES") Act (H.R.748). The CARES Act temporarily and retroactively increased the business interest limitation from 30 percent to 50 percent for Taxable Years 2019 and 2020. During the 2021 Session, the General Assembly enacted legislation generally conforming to the CARES Act but deconforming this provision. As a result, the business interest limitation for Virginia purposes remained at 30 percent for Taxable Years 2019 and 2020, the level set by the TCJA.

Work Group to Assess the Feasibility of Transitioning to Unitary Combined Reporting

During the 2021 Special Session I, House Joint Resolution Number 563 was passed, which directed the Division of Legislative Services, in conjunction with the Department, to establish a Work Group to assess the feasibility of transitioning to unitary combined reporting for corporate income tax purposes in Virginia. Such resolution also required the Work Group to submit a summary report with its findings and recommendations to the General Assembly. One of the recommendations of the Work Group was that Virginia should consider providing greater flexibility to taxpayers regarding change their filing elections by reducing the binding election period from 20 to 12 years but retaining the two-year transitional provisions under current law.

Proposed Legislation

This bill would provide that an affiliated group of corporations may elect to change the basis of the type of return filed from combined to consolidated, if:

- The affiliated group of which they are members, as it has existed from time to time, has filed on the same basis for at least the preceding 20 years; and

- At least one member of the affiliated group of which they are members is a related entity to a state or national bank that is exempt from filing a Virginia corporate income tax return because it is instead subject to the Virginia Bank Franchise Tax.

Any eligible affiliated group that elects to change the basis of the type of return under this bill would be required to agree to file returns computing its Virginia income tax liability

under both the new filing method and the former method and would be required to pay the greater of the two amounts for the taxable year in which the new election is effective and for the immediately succeeding taxable year. A taxpayer would be required to provide notification to the Department that an election under this bill is being made. Such notification would be required to be submitted on forms as prescribed by the Department.

This bill would provide that, if any its provisions are for any reason held to be invalid or unconstitutional by the decision of a court of competent jurisdiction, then that provision would not be deemed severable, and all provisions of this bill would expire and be unavailable for any affiliated group that has not made the election as of the date of such decision.

This bill would be effective for taxable years beginning on and after January 1, 2023 but before January 1, 2025.

Similar Legislation

House Bill 224 is identical to this bill.

House Bill 348 would reduce from 20 years to 12 years the time period during which an affiliated group of corporations must file under the same filing method before it may apply to the Department for permission to change to certain other filing methods without proving extraordinary circumstances.

cc : Secretary of Finance

Date: 1/30/2022 JJS
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