DEPARTMENT OF TAXATION
2010 Fiscal Impact Statement

1. Patron Walter A. Stosch

2. Bill Number SB 179

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

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

3. Committee Senate Finance

4. Title Income Tax: Conformity with Internal Revenue Code

5. Summary/Purpose:

This bill would advance Virginia's date of conformity to the Internal Revenue Code (IRC) from December 31, 2008 to December 31, 2009 for taxable years that begin in calendar year 2009, and to December 31, 2010, for taxable years that begin in calendar year 2010. Virginia would continue to disallow most bonus depreciation, and any five year carry-back of certain net operating losses (NOL) allowed for NOLs generated in taxable years 2001 or 2002.

This bill would disallow the tax deductions related to applicable high yield discount obligations and the ratable deferral of cancellation of debt income allowed under the American Reinvestment and Recovery Act (ARRA) of 2009.

In addition, this bill would deconform from the deduction allowed for domestic production activities effective for taxable years beginning on and after January 1, 2010.

Finally, this bill would provide that amendments to the IRC would not apply for Virginia income tax purposes in taxable years beginning in the calendar year in which the amendments were enacted, if the Tax Commissioner determined that (i) the amendment, or combination of related amendments, would reduce Virginia tax revenue by $5 million or more in any fiscal year, or (ii) any group of amendments would together reduce Virginia tax revenue by $25 million or more in any fiscal year.

This bill contains an emergency clause and would be in force from its passage.

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

7. Budget amendment necessary: No.

8. Fiscal implications:

Administrative Costs

TAX has not assigned any administrative costs to this bill because the changes required by a single bill such as this can be implemented as part of the annual changes to our systems and forms. As stand-alone legislation, TAX considers implementation of this bill as "routine," and does not require additional funding.

TAX will provide specific administrative costs on any legislation that is not "routine." Additionally, TAX will review all state tax legislation likely to be enacted prior to the passage by each house. If the aggregate number of routine bills likely to pass either house is unusually large, it is possible that additional resources will be required. If so, TAX will identify the costs at that time.

Revenue Impact

The revenue impact of the date change to December 31, 2009 is assumed in the Introduced Executive Budget. The following amounts attributable to conformity with the ARRA are incorporated into the Introduced Executive Budget.

Fiscal Year	***Dollars***	***Fund***
2009-10	($14.72 Million)	GF
2010-11	$23.63 Million	GF
2011-12	$32.07 Million	GF
2012-13	$1.65 Million	GF
2013-14	$0.06 Million	GF
2014-15	($1.44 Million)	GF
2015-16	($1.13 Million)	GF

This bill would avoid the impact of two provisions in the ARRA – the discount on applicable high yield discount obligations and the cancellation of debt provision. Deconforming from these provisions eliminates a loss of $99.39 million in FY 2010 and $38.47 million in FY 2011 in General Fund revenue.

This bill also includes a provision to disallow the deduction for domestic production activities under § 199 of the IRC effective for taxable years beginning on and after January 1, 2010. It is estimated that deconforming to this deduction will increase General Fund revenues by approximately $30 million a year.

The impact of advancing the date of conformity to December 31, 2010, for taxable years beginning in calendar year 2010 is unknown, but would be limited to $25 million based on the authority granted to the Tax Commissioner in this bill. While Congress has not passed legislation thus far that would impact this provision of the bill, it could do so at any time.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Current Law

Virginia's conformity to the IRC is currently fixed to the IRC as it existed on December 31, 2008. Since that date, Congress has enacted one significant measure that would affect income taxation in Virginia:

- The American Recovery and Reinvestment Act of 2009, which provides a variety of monetary provisions for states and localities to help improve the economy and tax relief for individuals and families.

Unless the date of IRC conformity is advanced, none of the provisions of this Act will flow through to Virginia taxable income. Because federal adjusted gross income (individuals) and federal taxable income (corporations) are the starting point for Virginia tax returns, if this bill is not enacted, Virginia taxpayers would be required to make complex "Fixed-Date Conformity" adjustments to remove the changes made by this Act when they prepare their Virginia tax returns.

Federal Law

In 2009, the American Recovery and Reinvestment Act (ARRA) was enacted. This legislation provides a variety of monetary provisions for states and localities to help improve the economy and tax relief for individuals and families. Among the significant tax provisions was a temporary increase in the earned income tax credit for 2009 and 2010 and an extension of the temporary increase in the expensing of certain business assets.

ARRA also added IRC § 108(i). This section allows deferral of cancellation of debt income realized in connection with a reacquisition of business debt at a discount after December 31, 2008 and before January 1, 2011. Such income is then recognized ratably over the five-year tax period beginning in the fifth taxable year following a 2009 reacquisition and in the fourth taxable year following a 2010 reacquisition.

In addition, ARRA established a provision under IRC § 163(e)(5)(F) that suspends the application of the applicable high yield debt obligation (AHYDO) rules for certain debts issued after September 30, 2008 and before January 1, 2010. Under this provision corporate and certain partnership debt that would have otherwise created deferred or non-deductible interest will be provided immediate tax deductions under general interest deductibility principles.

In 2004, Congress created a provision under IRC § 199, which allows a tax deduction for domestic production by certain businesses. The intent of the change was to reduce the effective tax rate on domestic manufacturing. The deduction is equal to 3% of qualified production activities income of the taxpayer in tax years 2005 and 2006, 6% in 2007 through 2009, and 9% in 2010 and thereafter. If taxable income is less than this amount, then the deduction is equal to taxable income. Additionally, the deduction is limited to 50% of the W-2 wages paid by the taxpayer for that taxable year. Virginia conformed to this provision in 2005.

The activities eligible for the deduction include not only the manufacture of personal property but also software development; film and music production; the production of water, natural gas, and electricity; and construction, engineering, and architectural activities and services.

Proposed Legislation

This bill would advance Virginia's date of conformity to the Internal Revenue Code (IRC) from December 31, 2008 to December 31, 2009 for taxable years that begin in calendar year 2009, and to December 31, 2010, for taxable years that begin in calendar year 2010. Virginia would continue to disallow most bonus depreciation, any five year carry-back of certain net operating losses (NOL) allowed for NOLs generated in taxable years 2001 or 2002.

In addition, this bill would deconform from the following provisions:

- IRC § 108(i), relating to the ratable deferral of cancellation of debt income;
- IRC § 163(e)(5)(f), relating to the tax deductions related to applicable high yield discount obligations; and
- IRC § 199, enacted in 2004, relating to the deduction of a percentage of income attributable to domestic production activities, effective for taxable years beginning on and after January 1, 2010.

Finally, this bill would provide that amendments to the IRC would not apply for Virginia income tax purposes in taxable years beginning in the calendar year in which the amendments were enacted, if the Tax Commissioner determined that (i) the amendment, or combination of related amendments, would reduce Virginia tax revenue by $5 million or more in any fiscal year, or (ii) any group of amendments would together reduce Virginia tax revenue by $25 million or more in any fiscal year.

The only state that TAX could identify with a similar method of conformity is Maryland. The Maryland General Assembly passed a law similar to this bill in 2002. The dollar threshold amount in Maryland is $5 million.

As of January 13, 2010, staff from the Bureau of Revenue Estimates of Maryland could recall only two instances in which Maryland automatically decoupled from a federal amendment. There have been a number of instances, however, in which federal amendments were passed that nearly met or exceeded the threshold. Had the federal amendments in those instances met or exceeded the threshold, there would have been administrative problems because Maryland would not have had time to revise and re-print tax forms and instructions in time for the start of the tax filing season. In addition to the administrative challenges, the staff reported that acquiring the necessary data to produce an accurate revenue impact of federal amendments has been very challenging.

This bill contains an emergency clause and would be in force from its passage.

Similar Legislation

House Bill 614 and Senate Bill 545 would advance the date of conformity to the IRC from December 31, 2008, to December 31, 2009. This bill would add three IRC sections that Virginia would deconform from: § 108 (i), the deferral of certain income; § 163 (e)(5)(F), the tax deductions related to applicable high yield discount obligations; and § 199, the amount of the deduction allowed for domestic production activities. Neither bill contains provisions relating to the conformity to amendments to the IRC based on the Tax Commissioner's determination of their fiscal impact.

cc : Secretary of Finance

Date: 1/17/2010 TG
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