Estimated Impact of the TCJA

November 19, 2018

Virginia Tax

Importance of Tax Conformity

Tax Conformity

Why We Conform to the Internal Revenue Code ("IRC")

- Virginia tax returns start with federal determination of income
  - Taxpayers do not have to recalculate with different Virginia definitions and rules
  - The Department can rely on federal data and compliance measures for accuracy; benefits include:
    - Reducing potential revenue loss attributable to noncompliance
    - Reducing administrative compliance costs (e.g., audits)
- Virginia forms and compliance focus on Virginia additions, subtractions and credits

Current Conformity Status

Conformity Legislation Enacted During 2018 Session (HB 154/SB 230)

- Virginia has not yet fully conformed to the Internal Revenue Code for Taxable Year 2018
- Virginia advanced the date of conformity from December 31, 2016 to February 9, 2018, but did not generally conform to federal changes for Taxable Year 2018 and after
  - This was intended to address the immediate issue of conformity for taxpayers filing their Taxable Year 2017 income tax returns
  - Virginia specifically deconformed from most federal tax law changes effective for Taxable Year 2018 and after

Importance of Enacting New Conformity Legislation

Addressing Conformity As Soon As Practical

- Virginia does not currently conform to any Tax Cuts and Jobs Acts (“TCJA”) provisions to the extent they are effective for Taxable Years 2018 and after
- It is important for Virginia to enact legislation to conform to such changes as early as practical because taxpayers will begin filing their 2018 income tax returns in January 2019
- Without early adoption of conformity legislation, taxpayers will not know how to compute their Taxable Year 2018 returns
- Taxpayers, tax practitioners, and software vendors have historically assumed that Virginia will advance its date of conformity each year

Importance of Enacting New Conformity Legislation

Impact of Deconformity on Individuals and Businesses

- Failure to enact timely conformity legislation would negatively impact many constituents, including hundreds of thousands of individual taxpayers
- Many individuals, especially those who itemize, would be required to complete additional forms to make up to 20 complex modifications to their Taxable Year 2018 returns
- Many businesses would be required to complete additional forms to make up to 30 complex modifications to their Taxable Year 2018 returns

Tax Reform Act of 1986

Response to the Tax Reform Act of 1986

Federal Tax Reform Act of 1986

- In 1984, the US Treasury Department conducted a study of the federal tax system at the direction of President Reagan and provided recommendations regarding tax reform
- In May 1985, President Reagan submitted a tax reform proposal to Congress
- After much consideration, and several hearings and revisions, the House and Senate passed the Tax Reform Act of 1986 in September 1986
- On October 22, 1986, President Reagan signed this legislation into law
- The legislation primarily made the following changes:
  - Consolidated the individual brackets and made rate changes; and
  - Increased the standard deduction, personal exemption, and earned income credit

Response to the Tax Reform Act of 1986

Virginia's Response to the Federal Tax Reform Act of 1986

- In response to potential federal tax reform, the Virginia Secretary of Finance created the Tax Reform Task Force in March 1985 to analyze the potential impact on Virginia and to help develop a response
- In addition, the Department hired a consultant to develop a revenue estimate regarding the impact of federal tax reform
- Because Virginia started reviewing the impact of federal tax reform more than two years before it was enacted, Virginia was able to develop a relatively quick response
- Virginia's tax reform legislation (the "Virginia Tax Reform Act of 1987") was introduced on January 21, 1987 and enacted on February 20, 1987

Virginia's Response to the Federal Tax Reform Act of 1986

- The Virginia Tax Reform Act of 1987 made several individual income tax changes:
    - Top bracket threshold increased over four years from $12,000 to $17,000
    - Personal exemption increased from $600 to $800 over two years
    - Standard deduction increased to $3,000(single)/$5,000(married) over two years
    - Filing threshold increased to $5,000 (single) and $8,000 (married)
    - Provided a deduction to hold aged and blind taxpayers harmless
    - Established an Individual Income Tax Transition Fund for excess revenues
- 1989 legislation returned excess individual income tax revenues by providing a one-time credit of $35 per personal exemption claimed on the 1989 return

Estimated Virginia Revenue Impact from the TCJA

Estimated Virginia Revenue Impact (in millions)

	FY 2019*	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	Total (FY19-24)
Individual Income Tax Provisions	$532.1	$443.8	$466.7	$492.5	$520.0	$546.1	$3,001.3
Business Tax Provisions**	$29.4	$114.6	$181.5	$300.3	$417.2	$398.2	$1,441.3
International Provisions***	$32.6	$52.7	$5.5	$5.8	$6.0	$6.3	$108.8
Total	**$594.2**	**$611.1**	**$653.7**	**$798.7**	**$943.2**	**$950.6**	**$4,551.4**

** Due to the likely timing of Virginia's conformity to the federal provisions, the full impact for TY 2018 is recognized in FY 2019*
*** Due to the existence of pass-through entities such as partnerships and LLCs, the business tax provisions impact both individual and corporate income tax revenues*
**** The impact of the international provisions includes both the direct impact, which only flows through to corporations, and the indirect impact on individual investors*

Individual Provisions – Impact (in millions)

	FY 2019*	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	Total
Standard Deduction Modification	$147.8	$100.5	$99.7	$99.2	$99.0	$99.0	$645.2
Alternative Inflation Measure	$14.2	$9.4	$9.8	$9.8	$10.3	$10.8	$64.4
Loss Limitation	$125.9	$103.6	$102.8	$101.5	$100.5	$100.0	$634.3
Repeal/Limit Itemized Deductions	$366.9	$283.0	$303.2	$324.4	$346.8	$370.9	$1,995.2
Limit for Charitable Contributions	($0.9)	($0.7)	($0.7)	($0.8)	($0.8)	($0.9)	($4.9)
Repeal of Pease Limitation	($96.7)	($72.2)	($74.9)	($77.7)	($80.7)	($84.1)	($486.3)
Treatment of Moving Expenses	$6.2	$4.3	$4.4	$4.6	$4.8	$4.9	$29.1
Medical Expense Deduction	($45.6)	$0.0	$0.0	$0.0	$0.0	$0.0	($45.6)
Treatment of Alimony Payments	$0.8	$1.1	$1.6	$2.2	$2.9	$3.7	$12.2
Mortgage Interest Deduction	$13.7	$15.1	$21.2	$29.0	$37.3	$42.7	$158.9
Other Off-Model Estimates	-	($0.3)	($0.4)	$0.2	-	($0.9)	($1.4)
Total, All Provisions	**$532.1**	**$443.8**	**$466.7**	**$492.5**	**$520.0**	**$546.1**	**$3,001.3**

** Due to the likely timing of Virginia's conformity to the federal provisions, the full impact for TY 2018 is recognized in FY 2019*

Virginia Tax

Effective Dates and Assumptions

- Unless otherwise noted, the individual provisions are effective for TY 2018 and are currently set to expire after TY 2025
- When estimating the revenue impact, the Chainbridge model assumes that taxpayers will minimize their combined federal and state tax liability
  - For example, the model assumes that taxpayers will make a decision whether to itemize or claim the standard deduction based on their combined federal and Virginia income tax liability

Major Individual Provisions

Increase in the Federal Standard Deduction

- Virginia does not conform to the federal standard deduction amount
- A taxpayer may only itemize on the Virginia return if itemizing on the federal return
- As a result of the federal provision, certain taxpayers will begin claiming the federal standard deduction and, therefore, the Virginia standard deduction
- Comparison of the Virginia and federal standard deduction amounts:

Filing Status	Virginia Standard Deduction	2017 Federal Standard Deduction	2018 Federal Standard Deduction
Single (or Married Filing Separately)	$3,000	$6,350	$12,000
Married Filing Jointly	$6,000	$12,700	$24,000

Virginia Tax

Major Individual Provisions

Repeal and Limitation of Itemized Deductions

- $10,000 limitation on the state and local tax (SALT) deduction
  - Because Virginia disallows the deduction for income taxes, taxpayers would be impacted on the Virginia return to the extent they have real and personal property taxes (and sales taxes) in excess of the $10,000 cap
- Repeal of certain miscellaneous deductions subject to 2% floor
  - Includes unreimbursed employee expenses (such as travel and home office expenses) and tax preparation fees
- Repeal of the casualty and theft deduction

Major Individual Provisions

Repeal and Limitation of Itemized Deductions (impact in millions)

	FY 2019*	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	Total
Switching to Standard Deduction on Federal Return	$121.9	$94.7	$102.2	$109.9	$118.4	$127.9	$675.0
$10,000 SALT Deduction Limitation	$109.6	$91.6	$98.3	$105.5	$113.0	$121.2	$639.3
Repeal of Miscellaneous Itemized Deductions	$133.7	$95.4	$101.5	$107.7	$113.9	$120.3	$672.4
Repeal of the Casualty and Theft Deduction	$1.6	$1.2	$1.3	$1.4	$1.4	$1.5	$8.5
Total for Simulation #4	**$366.9**	**$283.0**	**$303.2**	**$324.4**	**$346.8**	**$370.9**	**$1,995.2**

** Due to the likely timing of Virginia's conformity to the federal provisions, the full impact for TY 2018 is recognized in FY 2019*

Requested Individual Income Tax Revenue Estimates

Requested Revenue Estimates

Increasing Virginia's Standard Deduction

- Virginia's standard deduction is $3,000 for single taxpayers and $6,000 for married taxpayers filing joint returns
- The amount of Virginia's standard deduction has not been increased for single taxpayers since it was increased from $2,700 beginning in 1989 and for married taxpayers filing joint returns since it was increased from $5,000 beginning in 2005
- Estimated impact of increasing the standard deduction, effective for TY 2019:

Standard Deduction Amount	Est. Revenue Impact (TY 2019)
$4,500 ($9,000 joint returns)	($220 million)
$6,000 ($12,000 joint returns)	($440 million)

Requested Revenue Estimates

Increasing Virginia's Personal Exemption

- Virginia's personal exemption is currently $930; the additional exemptions for blindness and age are $800.
- Virginia's personal exemption has not increased significantly since 1972 when it was $600; it was last increased in 2008 from $900 to $930
- Estimated impact of increasing the personal exemption and the exemptions for blindness and age, effective for TY 2019:

Increase	Personal Exemption Amount	Age/Blind Exemption	Est. Revenue Impact (TY 2019)
$100 Increase	$1,030	$900	($37.14 million)
Double Current Amount	$1,860	$1,600	($334 million)

Allowing Virginia-Specific Itemization

- When completing federal income tax returns, taxpayers may elect to claim either the federal standard deduction or itemized deductions
- When completing Virginia returns, taxpayers are bound by their federal election
- Allowing taxpayers to itemize regardless of their federal election would have a negative General Fund revenue impact of $369.97 million in FY 2020 and $255.07 million in FY 2021* (assuming a Taxable Year 2019 effective date)
- This estimate includes the impact of taxpayers affected by the TCJA (run through the Chainbridge model), as well as an estimate of the impact of taxpayers who claimed the standard deduction under prior law

** Estimates of cash flow are based on November 2017 General Fund revenue forecast and are subject to change*

Requested Revenue Estimates

Eliminating Virginia’s Two Lowest Personal Income Tax Brackets

- Current rate structure:

Income	Rate
Up to $3,000	2%
$3,001-$5,000	3%
$5,001-$17,000	5%
More than $17,000	5.75%

- Impact of eliminating the two lowest brackets:

Fiscal Year	Est. Revenue Impact*
2020	($571.78 million)
2021	($381.08 million)

** Estimates of cash flow are based on November 2017 General Fund revenue forecast and are subject to change*

Appendix: Impact of Business Provisions

Business Provisions – Impact (in millions)

	FY 2019*	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	Total
Increase IRC § 179 Expensing	($89.9)	($46.2)	($22.6)	($19.2)	($13.8)	($9.9)	($201.6)
Limit Net Interest Deduction	$122.8	$90.0	$93.4	$98.7	$105.1	$109.3	$619.1
Modification of NOL Deduction	$8.0	$23.3	$42.2	$52.7	$51.8	$50.8	$228.7
Repeal IRC § 199 Deduction	$52.0	$40.8	$42.6	$44.3	$46.2	$48.0	$273.9
Small Business Accounting	($107.3)	($33.1)	($16.5)	($14.4)	($11.8)	($12.2)	($195.3)
Amortization of R&D Expenses	-	-	-	$94.4	$195.7	$164.2	$454.3
Other Off-Model Estimates	$43.92	$39.87	$42.41	$43.84	$44.07	$48.18	$262.29
Total, All Provisions	$29.4	$114.6	$181.5	$300.3	$417.2	$398.2	$1,441.3

** Due to the likely timing of Virginia's conformity to the federal provisions, the full impact for TY 2018 is recognized in FY 2019*

Business Provisions

Effective Dates and Assumptions

- Four of the largest business provisions were estimated using the model; most of the business provisions were estimated “off-model” based on the federal JCT estimates
- Because they affect both corporations and pass-through entities such as partnerships and LLCs, the business provisions impact both individual and corporate income tax revenues
- The business provisions are generally permanent
- One of the largest business provisions, the amortization of research and experimental expenditures, is not effective until TY 2022, increasing the Virginia revenue impact beginning in FY 2022

Business Provisions

IRC 179 Expensing

- Prior to Taxable Year 2018:
  - Businesses could expense up to $500,000 of qualifying property instead of depreciating it
  - The deduction amount was reduced when qualifying purchases exceeded $2 million
- Beginning in Taxable Year 2018:
  - The expense deduction increases to $1 million of qualifying property and
  - The threshold is increased to $2.5 million

Business Provisions

Interest Deduction

- Prior to TY 2018, the deduction of investment interest was limited
  - For individuals, the deduction is limited to investment income
  - For corporations, interest may be disallowed if debt-to-equity ratio exceeds 1.5/1.0 and net interest expense exceeds 50% of adjusted income
  - Disallowed interest may be carried forward
- Beginning in 2018, the deduction is limited to 30% of the business's adjusted income
  - Special rules or exemptions for partnerships, certain utilities, and businesses with gross receipts less than $25 million
  - Disallowed interest may be carried forward

Business Provisions

Net Operating Losses

- Prior to Taxable Year 2018, NOLs could generally be carried back two years and carried forward 20 years
  - In 2002 and 2009, Congress extended the maximum carryback period for NOLs generated during 2001-2002 and 2008-2009 from two years to five years
  - Virginia deconformed from the 2002 and 2009 extended carryback provisions
- Beginning in Taxable Year 2018:
  - NOLs are limited to 80% of taxable income
  - NOLs generally cannot be carried back, but can be carried forward indefinitely

Business Provisions

Domestic Production Activities Deduction

- For TY 2005 through 2017, companies could claim a deduction equal to a percentage of income from certain activities conducted in the United States
  - This deduction was enacted as part of the American Jobs Creation Act of 2004 to replace an export subsidy that was in violation of an international treaty
  - The deduction was phased in; for 2010 and after, it was increased from 6% to 9% of qualifying income
- In 2010, Virginia partially deconformed from this provision to allow only 2/3 of the deduction (i.e., 6%); Virginia fully conformed for TY 2013 and after
- The deduction is repealed, effective for TY 2018 and after

Small Business Accounting Rules

- The following apply beginning in Taxable Year 2018:
  - An expansion of 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
  - An increase in the exemption from the uniform capitalization (“UNICAP”) rules from $10 million or less in gross receipts to $25 million or less
  - An increase in the exception for accounting for long-term contracts from $10 million or less in gross receipts to $25 million or less

Business Provisions

Amortization of Research Expenses

- Prior to Taxable Year 2022, taxpayers may:
  - Elect to immediately deduct the amount of certain reasonable research or experimentation expenditures paid or incurred with a trade or business; or
  - Capitalize such expenditures and amortize them ratably over at least 5 years
- For research expenses paid or incurred in Taxable Year 2022 and thereafter:
  - The immediate deduction will no longer be permitted; and
  - Taxpayers will be required to capitalize such expenditures and amortize them ratably over a period of at least 5 years, 15 years for foreign expenditures