Federal Tax Reform

January 15, 2018

Virginia Tax

Why We Conform to the Internal Revenue Code

- Virginia return starts with federal determination of income
  - Taxpayer does not have to recalculate with possibly different Virginia definitions and rules
  - Department can rely on federal data and compliance measures for accuracy
    - Reduces potential revenue loss attributable to noncompliance
    - Reduces administrative compliance costs (e.g., audits)
- Virginia forms and compliance focus on Virginia additions, subtractions and credits

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Rolling v. Fixed Conformity

- From 1972 until 2002, Virginia relied on the new constitutional provision to automatically conform to any Congressional changes in the definition of income
- The 2002 Appropriation Act included a provision temporarily fixing the date of conformity to the IRC as of December 31, 2001
- In 2003 the General Assembly adopted fixed date conformity by:
  - Adopting the IRC as it existed on December 31, 2002; and
  - Specifically excepting the depreciation and NOL provisions modified by JCWAA
- Annual conformity bills have advanced the date of fixed conformity and revised the list of exceptions as needed

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Tax Reform Act of 1986

Federal Changes

- Enacted in October 1986 and designed to be revenue neutral
  - Consolidated individual brackets from fifteen to four, decreased top rate, and raised bottom rate
  - Individual standard deduction, personal exemption, and earned income credit increased
  - Top corporate marginal rate declined from 46 percent to 34 percent and definition of business taxable income was broadened
  - Corporate alternative minimum tax increased
- Created a Virginia windfall ranging from $173-$253 million (FY 1988-1991)

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Virginia's Response

- Threshold for top bracket increased over 4 years from $12,000 to $17,000
- Personal exemption increased from $600 to $800 over 2 years
- Standard deduction increased to $3,000 (single) and $5,000 (married) over 2 years
- Filing threshold increased to $5,000 (single) and $8,000 (married)
- Provided deduction to hold aged and blind taxpayers harmless
- Repealed accelerated depreciation modifications under ACRS
- Established three funds to capture any excess tax reform revenues to transition revenue impacts from year-to-year (Individual Income Tax Transition Fund; Tax Reform Reserve Fund; and Excess Cost Recovery Repeal Fund)

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Summary

- The Tax Cuts and Jobs Act is the most substantial federal tax legislation since 1986
- Certain provisions, such as rate and bracket changes, have no Virginia impact
- Many provisions do have a Virginia revenue impact
- The Department is working on estimating the Virginia revenue impact
  - Generally, Virginia relies on Joint Committee on Taxation (JCT) estimates as a starting point for estimating the Virginia impact of federal tax legislation
  - Due to the interaction between the federal provisions, including some that do not impact Virginia, this approach does not work for the 2017 tax reform bill

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Estimating the Virginia Revenue Impact

- The Department has contracted with Chainbridge Consulting, LLC, to use Virginia's existing individual income tax model and federal tax data for Virginia taxpayers to estimate the impact
  - The CEO of Chainbridge worked for the JCT during the Tax Reform Act of 1986
  - The company has experience building income tax models for other states
- The Chainbridge model will use the same stacking order as the JCT to estimate the impact of the federal changes
- It will also estimate the impact of Virginia law changes compared to the new law

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Tax Cuts and Jobs Act of 2017

Major Provisions with a Virginia Impact

Individual Provisions	Business Provisions
Increase in Federal Standard Deduction (+)	Interest Deduction (+)
State and Local Tax Deduction (+)	NOL Rules (+)
Mortgage Interest Deduction (+)	Amortization of Research Expenses (+)
Limitation on Losses for Noncorporate Taxpayers (+)	Domestic Production Activities Deduction (+)
Medical Expenses Deduction (-)	Repeal of Certain Like-Kind Exchanges (+)
Overall Limitation on Itemized Deductions (-)	Limitations on Fringe Benefits (+)
	Increase IRC 179 Expensing (-)
	Simplified accounting rules for small businesses (-)

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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

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State and Local Tax (SALT) Deduction

- Individuals can generally deduction the amount paid in state and local income taxes (or sales taxes), real property taxes, and personal property taxes
- Effective beginning in Taxable Year 2018, the SALT deduction is capped at $10,000
- Because Virginia disallows the deduction for income taxes, taxpayers will 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
- Many individuals attempted to prepay their 2018 property taxes before December 31 in order to avoid the $10,000 limitation
- However, case law and a recent IRS announcement state that payments will not be allowed as a 2017 deduction in cases where the tax had not yet been assessed

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Mortgage Interest Deduction

- Taxpayers may currently deduct interest paid on up to $1 million of home mortgage debt, as well as a second place of residence
  - This limitation is reduced to $750,000 beginning in Taxable Year 2018
  - However, a grandfathering provision applies to debt incurred before December 15, 2017; the $1 million limitation will continue to apply to such debt
- Additionally, taxpayers may currently deduct interest paid on up to $100,000 of home equity debt
  - Beginning in Taxable Year 2018, this will no longer be allowed

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Medical Expenses Deduction

- Currently, taxpayers may claim an itemized deduction for medical expenses in excess of 10% of adjusted gross income (7.5% for taxpayers age 65 and older)
- For taxpayers age 65 and older, the floor was scheduled to increase to 10% in 2017
- For Taxable Years 2017 and 2018, this floor is reduced to 7.5% of AGI

Taxable Year(s)	Under Age 65	Age 65 and Older
Prior to Taxable Year 2013	7.5%	7.5%
Taxable Years 2013-2016	10%	7.5%
Taxable Years 2017 and 2018	7.5%	7.5%
Taxable Year 2019 and After	10%	10%

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Repeal of Overall Limitation on Itemized Deductions (Pease Limitation)

- Prior to Taxable Year 2018, itemized deductions were subject to an overall limitation that reduced the otherwise allowable amount by 3% of the amount by which AGI exceeded a threshold amount (up to an 80% reduction)
  - For Taxable Year 2017, this limitation begins with incomes of $261,500 or more ($313,800 for married couples filing jointly)
  - The limitation does not apply to certain deductions, such as medical expenses, investment expenses, gambling losses, and certain theft and casualty losses
- Beginning in Taxable Year 2018, this limitation does not apply

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Limitation on Losses for Noncorporate Taxpayers

- Active business losses in excess of $250,000 ($500,000 for joint filers) cannot be claimed against non-business income; instead such excess losses become part of NOL carryforward
- Expands the limitation on excess farming loss to other noncorporate taxpayers
- **Example**: In 2018, a single taxpayer has business deductions of $500,000 and business income of $200,000. His excess business loss is computed as follows:
  - $500,000 – ($200,000 + $250,000) = $50,000
  - He may claim deductions against non-business income = $250,000
  - He may carryforward the $50,000 excess business loss as an NOL

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Interest Deduction

- Prior to Taxable Year 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 Taxable Year 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

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Net Operating Losses

- Effective 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
- Prior to Taxable Year 2018
  - In 2002, Congress extended the maximum carryback period for NOLs generated during 2001 and 2002 from two years to five years
  - In 2009, Congress extended the maximum carryback period for NOLs generated during 2008 and 2009 from two years to five years
- In 2003 and 2010, the GA deconformed from both NOL carryback extensions

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Major Business Provisions

Amortization of Research Expenses

- Prior to Taxable Year ~~2018~~ 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 or experimentation expenditures 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

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Domestic Production Activities Deduction

- Responding to complaints that certain provisions were an export subsidy that violated a treaty, Congress replaced them with the Domestic Production Activities Deduction as part of the American Jobs Creation Act of 2004 (IRC § 199)
  - The deduction was phased in; for 2010 and after, it was increased from 6% to 9% of qualifying expenses
- In 2010, Virginia partially deconformed from this provision to allow only 2/3 of the deduction (i.e., 6%)
- In 2012, the provision was modified to allow the full deduction for 2013 and after
- The Tax Cuts and Jobs Act repeals IRC § 199 for 2018 and after

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Like-Kind Exchanges

- Prior to Taxable Year 2018, gain or loss resulting from like-kind exchanges of personal property, real property not held primarily for sale, and intangible property was not recognized for income tax purposes
- Effective beginning in Taxable Year 2018:
  - Gain or loss resulting from like-kind exchanges of personal property and intangible property is now recognized for income tax purposes
  - Gain or loss resulting from like-kind exchanges of real property not held primarily for sale will remain unrecognized for income tax purposes

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Employer Fringe Benefits

- Effective beginning in Taxable Year 2018:
    - Business deductions for a qualified transportation fringe are disallowed
        - This includes van pools, subway or transit cards, and qualified parking expenses
        - The value of a qualified transportation fringe benefit provided by an employer to an employee remains excluded from the employee's income
    - Business deductions for entertainment, amusement, and recreation are disallowed
    - The exclusion for qualified bicycle commuting reimbursements is disallowed

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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 is reduced when qualifying purchases exceed $2 million
- The Tax Cuts and Jobs Act increases the expense deduction to $1 million of qualifying property
  - The deduction amount is reduced when qualifying purchases exceed $2.5 million

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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

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