VIRGINIA'S CONFORMITY WITH THE INTERNAL REVENUE CODE

Virginia Department of Taxation
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This issue paper will provide background on the issues associated with Virginia's federal conformity.

Starting Point Conformity

In order to compute the proper Virginia income tax, taxpayers begin their computation with a number that was computed on their federal income tax return. For individuals, this is Federal Adjusted Gross Income (FAGI) and for corporations the number is Federal Taxable Income (FTI). For most of the period since 1972, Virginia has adopted "rolling conformity" to federal income tax. Under rolling conformity, any changes made to the calculation of the federal starting point have been automatically adopted by Virginia. Beginning with taxable year 2002 (and for certain selected periods previously), Virginia will use "fixed-date conformity." Under fixed-date conformity, the Virginia starting point is the federal calculation determined under federal law as it existed on a specific date. Federal changes made to the calculation of the federal starting point are not automatically adopted. An act of the General Assembly is required to adopt such changes.

Not all federal changes affect the computation of the Virginia income tax under the concept of starting point conformity. Federal changes are generally separated as either "above-the-line" changes which impact how FAGI or FTI is calculated and "below-the-line" changes which affect federal tax liability but not FAGI or FTI. For example, an above-the-line federal change, such as excluding disability income, would flow through to Virginia. On the other hand, a below-the-line federal change such as a credit or change in tax rates does not impact the Virginia tax liability.

Overall Conformity

In a broader sense, conformity can also be viewed in terms of how many changes Virginia makes to the federal starting point. Additions, subtractions, deductions and credits enacted by Virginia have the effect of deconforming to the federal tax base.

I. Rolling and Fixed-Date Conformity in Virginia

In 1972, Virginia adopted federal starting points for both corporate and individual income taxes and allowed the starting points to enjoy rolling conformity with the federal income tax. In 1993, Virginia adopted a provision that would have fixed Virginia's conformity to the IRC as it existed on December 31, 1992. However, this provision was repealed retroactively during the following year. Among the reasons that this provision was repealed were the increased administrative complexity for both taxpayers and the Department of Taxation, the uncertainty of the applicability of any federal rule or regulation changes made subsequent to the fixed-date of conformity, and the negative effect on many of the department's compliance programs.

Currently, Virginia income tax starting points are fixed to the calculation under the IRC as it existed on December 31, 2001. Certain 2001 Virginia income tax returns have already been affected by the Fixed-date Conformity as Congress has adopted new tax provisions since December 31, 2001, that are retroactive in nature. The majority of those 2001 returns already affected are the returns of businesses that were eligible to receive the special 30% bonus depreciation deduction under the new federal law.

However, in the coming years, businesses will not be the only taxpayers affected by fixed-date conformity. For example, on their 2002 Virginia income tax returns, teachers will be required to add back the above-the-line deduction for classroom expenses in order to calculate their Virginia taxable income. Likewise, certain foster care payments that are newly excluded from federal income will have to be added back to determine Virginia taxable income. These adjustments represent two of sixteen new federal provisions that must be adjusted for under the current fixed-date conformity. These provisions and any other indirect effects of these provisions will be accounted for on the 2002 Virginia income tax returns.

II. Deviations from the Federal Income Tax Base

States that conform to federal income tax law with their starting point may deconform to accomplish state specific policy by additions, subtractions and deductions that increase or decrease taxable Income. Virginia currently has 4 additions, 23 subtractions, and 10 deductions for individuals and 6 additions and 16 subtractions and deductions for corporations. States also deviate from the determination of income tax liability through tax credits. There are approximately 30 tax credits available to Virginia individuals and corporations.

While they are functionally identical when determining Virginia taxable income, there is a difference between subtractions and deductions. A subtraction is the removal of an item of income that Virginia has chosen not to subject to the income tax. One requirement of every Virginia subtraction is that the item of income must be included in FAGI or FTI before the taxpayer may take a subtraction. An example of a Virginia subtraction is the subtraction of social security income. Federal tax policy has chosen to tax a portion of social security income, whereas, Virginia has decided that social security income should not be subject to the Virginia income tax. Virginia's social security subtraction accomplishes this objective.

Deductions are typically reductions in Virginia taxable income related to an expense incurred by the taxpayer. An example of a Virginia deduction is the deduction for 25% of tuition costs incurred by teachers in attending required continuing education classes. Most deductions contain a provision that prohibits the Virginia deduction if a deduction has been taken on the federal return for the same expense. This is done to prevent taxpayers from receiving a double benefit on the Virginia income tax return for the same expense.

Credits differ from subtractions and deductions in that they are a direct offset of income tax liability rather than an adjustment made to determine Virginia taxable income. Credits generally are used to encourage a specific activity. For example, the Neighborhood Assistance Act credits are credits given to individuals for either monetary or in-kind charitable contributions to a qualified neighborhood assistance organization that perform a valued service.

Virginia has also used additions to selectively deconform from the federal income tax base. For example, Congress enacted the Economic Recovery Act of 1981, which included enhanced deductions for depreciation under the Accelerated Cost Recovery System (ACRS). Virginia enacted a series of additions and subtractions designed to mitigate the effect of the ACRS deductions on Virginia revenue. Another example of Virginia selectively deconforming with federal income tax law occurred in 1990. Congress enacted an above-the-line deduction that allowed self-employed individuals to deduct one-half of the self-employment tax. Virginia reacted with an addition that required taxpayers to add back this deduction. In both examples, taxpayers were allowed to recover these additions in later years.

III. Advantages of Federal Conformity

Federal conformity for Virginia was first recommended by the 1967 Virginia Income Tax Study Commission in their final report, Toward a Simplified Income Tax System for Virginia Taxpayers (1967 House Document No. 17). The report concluded that the primary reason for federal conformity was to eliminate complexity for taxpayers, which at the time was being caused by taxpayers having to comply with two different income tax systems simultaneously. Complexity in determining their income tax is a common complaint of many taxpayers. While Virginia cannot affect the amount of complexity at the federal level, the less the Virginia income tax deviates from the federal income tax, the less complexity Virginia will add to the income tax process.

Another advantage of federal conformity is the audit information that is available to Virginia from the Internal Revenue Service (IRS). Through a special agreement with the IRS, the IRS is able to provide the department with electronic data of taxpayer information that the department uses in compliance programs. A significant amount of revenue generated by the department is through the comparison of the IRS data and data filed with the department by taxpayers. Compliance programs using the IRS electronic data on the individual and corporate income taxes and the estate tax generated over $63 million in compliance revenue in Fiscal Year 2001. The ability to use federal data enables Virginia to conduct its individual income tax audit programs almost entirely through automated data and return matching. These automated programs are significantly less expensive than manual audits of taxpayers. The effectiveness of automated compliance programs is tied closely to the degree to which Virginia maintains federal conformity. For example, conformity facilitates efficient audit selection. The greater the degree of deconformity increases the possibility that some candidates will be selected for audit when no additional liability exists

IV. Disadvantages of Federal Conformity

The chief disadvantage of federal conformity is the unpredictability of the income tax base because it is dependent, in part, on federal law and policy changes. The 2002 federal changes in the Job Creation and Worker Assistance Act would have resulted in a $300 million revenue loss to Virginia over the first three tax years for which it is effective. Similar revenue impacts have occurred in the past. The most recent change was particularly damaging since Congress enacted the legislation during the filing season for 2001 tax returns and made many of the changes retroactive to taxable year 2001. This left states in a very vulnerable revenue position with almost no time to react effectively.

Utilizing fixed-date conformity, as Virginia now does, eliminates much of the revenue risk associated with federal changes, but creates an additional level of complexity in administration.