Virginia Legislative Issue Brief

Federal Tax Reform: Virginia Impacts

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Introduction

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (TCJA).[1] The legislation will impact Virginia's tax system significantly. The Tax Department is planning to provide a detailed analysis of its revenue impacts, but this memorandum gives a preliminary overview of some of the legal effects.

This memorandum reviews some of the major changes in the TCJA, including:

- Eliminating personal exemptions;
- Increasing the standard deduction;
- Capping the deduction for state and local taxes;
- Establishing a new deduction for certain income from pass-through entities;
- Increasing bonus depreciation;
- Increasing small business expensing; and
- Changing the taxation of international income.

Changes to federal tax laws affect Virginia because Virginia conforms to the federal definition of adjusted gross income (AGI). Each year, the General Assembly has passed legislation enacting conformity as of a certain date.[2] This year, the two conformity bills, if passed in their current form, will conform as of December 31, but only to certain TCJA provisions that affect taxable years 2016 and 2017.[3] Broadly speaking, the General Assembly can choose to conform completely to the TCJA's provisions that affect taxable years 2018 and beyond, or it can deconform from certain provisions of the TCJA.

Eliminating Personal Exemptions

The Virginia personal exemption is tied to the existence of the federal personal exemption.[4] The TCJA leaves in place the federal personal exemption but reduces its value to zero dollars.[5] Zeroing out the federal personal exemption will not affect the Virginia personal exemption because each federal taxpayer is still allowed the same number of personal exemptions, and the value of each exemption is determined by Virginia law.

Increasing the Standard Deduction

The TCJA increases the federal standard deduction to almost twice its current value and eliminates or scales back several itemized deductions.[6] At the federal level, this likely will cause more taxpayers to choose the standard deduction instead of itemizing.[7]

Virginia's standard deduction is about half the value of the current federal deduction.[8] State law requires a taxpayer who claims the standard deduction on his federal return to claim the state standard deduction.[9] Federal tax consequences usually determine a person's choice to itemize or claim the standard deduction, so by incentivizing federal taxpayers to claim the standard deduction, the TCJA will cause more state taxpayers to do the same.

Because the state standard deduction is smaller than the standard deduction, this will have two effects, absent state legislative response. First, it will increase the state tax burden for taxpayers who previously itemized at the state level but now claim the smaller state standard deduction. Second, it will increase state revenues because state taxpayers who previously claimed a larger value of itemized deductions now will claim a smaller value standard deduction.

Capping the Deduction for State and Local Taxes

Under current law, taxpayers may claim a deduction for state and local taxes paid (the SALT deduction), limited only by the overall limit on itemized deductions.[10] The TCJA caps this deduction at $10,000, but the limit applies only to individuals.[11] Taxes accrued in carrying on a trade or business remain deductible.[12]

By capping the SALT deduction, the TCJA makes each dollar of Virginia tax liability over $10,000 more expensive with respect to a Virginia taxpayer's federal return, because he can no longer offset that liability with a federal deduction. Data shows Virginia taxpayers rely heavily on the SALT deduction.[13]

The consequences of the cap on a Virginia taxpayer's state return are different. Current state law does not allow taxpayers to claim the SALT deduction for income taxes paid,[14] so for purposes of the state return, the $10,000 cap only affects taxpayers who claim the SALT deduction for tax liability that is not based on income, such as property and sales taxes.

Establishing a Deduction for Pass-Through Entities

The TCJA established a 20 percent qualified business income (QBI) deduction for pass-through entities.[15] The deduction only applies to earnings from capital (not wages), so salaries paid to pass-through entity owners are not eligible for the deduction. The deduction phases out above certain income thresholds for certain "specified services"—lawyers, accountants, and doctors among them—for individual filers between $160,000 and $210,000.

The QBI deduction is allowed against taxable income, not AGI. Taxable income represents a later stage in the computation of an individual's federal tax liability. Virginia uses AGI as its starting point in calculating state tax liability,[16] not taxable income. Therefore, even if Virginia conforms to the TCJA definition of adjusted gross income, the QBI deduction will not impact Virginia.

Increasing Bonus Depreciation

Under current federal law, businesses are allowed to expense 50 percent of certain capital investments.[17] The TCJA increases this percentage to 100 percent for five years, allowing businesses to immediately, fully expense short-term capital investments.[18] Under current law, this deduction is not allowed for purposes of Virginia taxes, so this federal change will not impact Virginia directly.[19]

Increasing Small Business Expensing

Under current federal law, taxpayers can, for qualifying property, choose to deduct the property's cost (subject to certain limitations) rather than recover it through depreciation deductions over a multiyear depreciation schedule.[20] Under current law, the maximum expensing amount is $500,000; the TCJA increases that limit to $1 million.[21] Current law provides a $2 million phaseout threshold, which is raised to $2.5 million under the TCJA.[22] The amounts are indexed starting with taxable year 2018.

Virginia conforms to this deduction, known as small business expensing, so this federal increase will decrease state revenues unless Virginia deconforms.

Changing the Taxation of International Income

The TCJA transforms the way the federal government taxes international income. It changes international taxation from a global system with deferral of foreign subsidiary income until repatriated to a territorial system with base erosion provisions, as well as a one-time transitional tax on repatriated income. One element of this change is the TCJA's creation of a new category of income called global intangible low-taxed income (GILTI).

Generally speaking, foreign income is not subject to state income tax. State tax law provides subtractions, for corporations, for amounts included "by the operation of § 951 of the Internal Revenue Code (subpart F income)" and for "foreign source income."[23]

GILTI could be treated as Virginia income due to a technicality. The TCJA provides that GILTI comes in under a new section of the Internal Revenue Code, Section 951A.[24]

The federal law creates an ambiguity in state law. This new category of income does not technically fit the quoted language above ("by the operation of § 951"). The plain text of the Virginia statute indicates that the subtraction does not apply to GILTI income, since § 951A is not § 951.

On the other hand, the general purpose of the state subtraction is to remove foreign income from the Virginia tax base. Further, the parenthetical phrase refers to "subpart F income," and § 951A is also in Subpart F of the relevant part of the Internal Revenue Code. Either reading could prevail if the issue were litigated.

Temporariness

Many of the changes in the TCJA are temporary, sunsetting within the next 10 years. The switch from the consumer price index (CPI) to the chained consumer price index (CPI-U) is permanent, as well as the repeal of the Affordable Care Act's individual mandate penalty. Many of the other changes—to the personal exemption, the standard deduction, and other provisions—are not. Therefore, any policy response to the TCJA is set against the backdrop of the risk of the federal provisions expiring in 2025.

Conclusion

These are just a few of the questions raised by the enactment of the TCJA. By choosing to conform or deconform from specific provisions, the General Assembly will make important policy decisions that affect Virginia taxpayers and the state revenue system.

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Endnotes

[1] The Act's official name is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," H.R. 1, 115th Cong. (2017) [hereinafter TCJA]. References to TCJA sections are followed in parentheses by citations to the Internal Revenue Code sections at which the changes will be codified.

[2] Virginia, along with 17 other states, uses static conformity, which means it conforms to federal AGI as of a specific date. VA. CODE § 58.1-301(B). An additional 20 states use rolling conformity, meaning they adopt changes to the federal Internal Revenue Code as such changes occur. Although Virginia generally conforms, past sessions of the General Assembly have chosen to deconform from certain changes to federal AGI. For example, before the TCJA, federal law allowed a five-year carryback for net operating losses, but Virginia disallowed this carryback. VA. CODE § 58.1-301(B)(2). In addition to conforming to federal AGI, Virginia also conforms to the federal definition of taxable income for corporations. VA. CODE § 58.1-402. Forty other states do the same.

[3] *See* HB 154 (2018); SB 230 (2018).

[4] *See* VA. CODE § 58.1-322.03(2)(a) (allowing a personal exemption "for each personal exemption allowable to the taxpayer for federal income tax purposes"). The current federal personal exemption is $4,150. Virginia allows a $930 personal exemption as well as an additional $800 exemption for each blind or aged taxpayer.

[5] TCJA § 11041 (I.R.C. § 151).

[6] For example, the TCJA eliminates the deduction for home equity indebtedness interest payments and caps the deduction for home mortgage interest payments at $750,000 (down from $1 million). TCJA § 11043 (I.R.C. § 163).

[7] Under current federal law, the standard deduction is $6,500 for single filers and $13,000 for joint filers. The TCJA increases the standard deduction to $12,000 for single filers and $24,000 for joint filers. TCJA § 11021 (I.R.C. § 63).

[8] Virginia allows a standard deduction of $3,000 for single filers and $6,000 for joint filers. VA. CODE § 58.1-322.03(1)(b). Legislation first established the standard deduction in 1989, and did not index it for inflation.

[9] *See* VA. CODE § 58.1-322.03(1)(a).

[10] I.R.C. § 164.

[11] TCJA § 11042 (I.R.C. § 164) (providing that the SALT deduction limit applies only "[i]n the case of an individual").

[12] TCJA § 11042 (I.R.C. § 164) (stating that the SALT deduction limit "shall not apply to . . . any taxes [eligible for the SALT deduction] which are paid or accrued in carrying on a trade or business").

[13] A recent study by the Pew Charitable Trusts reported that, among the states, Virginia ranked fifth in terms of its taxpayers' utilization of the SALT deduction, with about 37 percent of Virginia taxpayers claiming it, above the national average of 30 percent. *The Distribution of Select Federal Tax Deductions and Credits Across the States*, PEW CHARITABLE TRUSTS (Oct. 31, 2017), http://www.pewtrusts.org/en/multimedia/data-visualizations/2014/federal-tax-deductions-and-credits.

[14] If a taxpayer itemizes, Virginia law requires him to reduce his state itemized deduction by the amount he claims under the federal SALT deduction for income taxes paid. *See* VA. CODE § 58.1-322.03(1)(a) (requiring taxpayers to add back "the amount of income taxes imposed by the Commonwealth or any other taxing jurisdiction and deducted on such federal return"). This reduction does not apply to property taxes paid.

[15] TCJA § 11011 (I.R.C. § 199A).

[16] *See* VA. CODE § 58.1-322 ("The Virginia taxable income of a resident individual means his federal adjusted gross income for the taxable year").

[17] I.R.C. § 168(k). Generally, investments that qualify are property with a useful life of 20 years or less and computer software. *See* I.R.C. § 168(k)(2).

[18] TCJA § 13201 (I.R.C. § 168). This form of "bonus" depreciation applies to expenses like machinery or other equipment. After five years, the amount of the deduction will be phased out by 20% per year.

[19] VA. CODE § 58.1-301(B)(1).

[20] *See* I.R.C. § 179.

[21] TCJA § 1301 (I.R.C. § 179).

[22] *Id.*

[23] VA. CODE § 58.1-402(C)(7)-(8).

[24] TCJA § 14201 (I.R.C. § 951A).