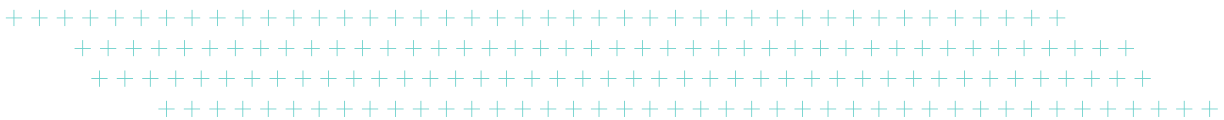
ROLLING INCOME TAX CONFORMITY:

A BETTER OPTION FOR VIRGINIA

A VSCPA White Paper



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EXECUTIVE SUMMARY

The Virginia Society of Certified Public Accountants (VSCPA) is the professional association of the Commonwealth's CPAs, representing more than 13,000 members in public accounting, business and industry, government and education. The VSCPA has a longstanding position to promote certainty for Virginia taxpayers. As a follow-up to the 2018 white paper "Virginia Tax Conformity: 2018 and Beyond," the VSCPA has developed a recommendation on rolling income tax conformity for consideration by the Virginia General Assembly and governor. Originally issued in 2019, this white paper has been revised and updated as of October 2022. The VSCPA believes adoption of rolling conformity would provide Virginia taxpayers a better ability to plan for and prepare Virginia taxes, allow more timely updates to tax preparation software, and offer potential administrative cost savings to the Commonwealth.

WHAT IS TAX CONFORMITY?

For the purposes of this paper, the VSCPA defines tax conformity as the adoption of federal definitions of income. Conformity DOES NOT include alignment to federal tax rates, tax brackets, exemption amounts, deduction amounts, or credits. Virginia sets its own tax rates, tax brackets, exemption amounts, deduction amounts, and credits. To put it simply, in Virginia, conformity for individuals is the calculation of federal adjusted gross income; for businesses, it is federal taxable income.

Forty-three states and the District of Columbia (D.C.) impose an income tax on individuals, while 45 states and D.C. impose an income tax on corporations. States conform to provisions of the federal tax code primarily to reduce the compliance burden of state taxation. How much each state conforms varies significantly, but all states that impose an income tax incorporate parts of the federal code into their state taxation systems.

Three approaches to conformity exist.

Rolling conformity

Unless the state specifically elects to decouple from a provision, implementation of federal income tax changes is adopted automatically as they are enacted. Nineteen states plus D.C. use rolling conformity for individuals and 22 states plus D.C. use it for corporations.

Fixed date (or "static") conformity.

Conformity with federal law is adopted as of a specific date. Twenty states use fixed date conformity for individuals, while 21 states use it for corporations. Virginia is among the states that uses fixed date conformity for both individuals and corporations.

Selective conformity.

For individuals, four states selectively incorporate certain federal income tax provisions and/or definitions, mainly by referencing them in their own code. Two states use their own definitions for corporations.

The starting point for calculating state income taxes varies as well. For individuals, 29 states, including Virginia and D.C., use federal adjusted gross income as the starting point, while six use federal taxable income. Six other states use state-specific definitions of income. (The remaining two states only tax interest and dividend income.)

For corporations, 16 states, including Virginia, start with federal taxable income, while 21 start with federal taxable income before net operating losses and special deductions. Three use federal taxable income before net operating losses only. The remaining eight states plus D.C. use different methods.

THE CHALLENGES OF FIXED DATE CONFORMITY IN VIRGINIA

Virginia has conformed to federal income tax law since 1972. For 30 years, its conformity to federal tax law changes was automatic, using rolling conformity. The passage of S.B. 1049 during the 2003 General Assembly session switched Virginia to fixed date conformity and decoupled from two provisions of federal law that would have had a negative impact on Virginia's revenue.

Only one of these actions was necessary. The General Assembly could have simply decoupled on the two provisions because of their fiscal impact and otherwise continued with rolling conformity. In fact, the introduced version of S.B. 1049 did exactly that. (The language that appears in the box below restores the language as it appeared in S.B. 1049 as introduced.) Fixed date conformity is not necessary to achieve decoupling; rather, simply including "except for" achieves this aim.

Fixed date conformity requires emergency legislation each year that retroactively rolls forward the date with which Virginia law conforms to federal law. This delay creates uncertainty for Virginia taxpayers, hinders their ability to plan during the year and leaves them unclear about their actual Virginia tax liability until after the tax year has ended. Taxpayers required to make quarterly estimated tax payments are particularly hindered by this model because their payments are due during the course of the tax year; retroactive legislation could cause them to incur penalties and interest through no fault of their own.

PROPOSED CHANGE IN LANGUAGE

§ 58.1-301. Conformity to Internal Revenue Code.

A. Any term used in this chapter shall have the same meaning as when used in a comparable context in the laws of the United States relating to federal income taxes, unless a different meaning is clearly required.

B. Any reference in this chapter to the laws of the United States relating to federal income taxes shall mean the provisions of the Internal Revenue Code of 1954, and amendments thereto, and other provisions of the laws of the United States relating to federal income taxes, as ~~they existed on December 31, 2018~~ *the same may be or become effective at any time or from time to time, except for:*

While making changes retroactively is not ideal, up until recently the General Assembly has generally been able to tackle conformity legislation quickly and easily after session starts in January, passing it unanimously more often than not. It is typically signed by the governor within the first two weeks of February.

However, in recent years several pieces of federal legislation making significant tax changes have exacerbated the issue of uncertainty for Virginia taxpayers, beginning with the passage of the Tax Cuts and Jobs Act (TCJA) in late 2017. The tremendous complexity of the TCJA, the most significant federal tax legislation since 1986, coupled with a significant fiscal impact to Virginia created a longer-than-usual delay between its passage and Virginia's adoption.

The Virginia legislature is a part-time body, meeting for only a short time early each year unless a special session is called. The session coincides with the beginning of tax season and Virginia taxpayers and tax practitioners anxiously await the passage of conformity legislation so they can prepare and file Virginia returns. This is particularly true of Virginia's farmers, fishermen and merchant seamen, who must file their returns by March 1 to avoid estimated tax penalties.

Most legislation passed by the General Assembly and signed by the governor has an effective date of July 1 (or later, if specified) after adjournment of the regular session of the legislature. Virginia individual income tax returns are due by May 1, making regular legislation unworkable. Instead, the bill must be passed as emergency legislation, requiring an 80% majority of the Assembly and taking effect immediately upon approval by the governor.

Due to the late 2017 passage of the TCJA and uncertainty about its full impact on Virginia, the 2018 General Assembly limited conformity to TCJA changes affecting 2017 returns only, with certain decoupling provisions. One of those provisions — the denial of the lowered medical expense deduction floor — created difficulties for affected taxpayers, tax preparers and tax administrators because it meant that taxpayers had to calculate deductible medical expenses twice, once for the federal return and again for the Virginia return.

This legislation did not take effect until Feb. 22, 2018, less than two weeks before the March 1 filing deadline for certain taxpayers. There was tremendous confusion, particularly since some taxpayers had already filed their returns, and because of inadvertent errors in the worksheet created to address this decoupling.

ROLLING CONFORMITY IS BEST FOR VIRGINIA TAXPAYERS

Rolling conformity will provide certainty for Virginia taxpayers, tax preparers, software manufacturers, and the Virginia Department of Taxation itself. Virginia currently conforms to all but a small number of federal provisions, and few of those affect the average taxpayer.

For those taxpayers and the system that supports them — tax preparation software companies, tax preparers, and the Virginia Department of Taxation — rolling conformity provides certainty about how the amount of tax is determined, aiding in tax planning and reducing associated costs.

Rolling conformity **would not** prohibit lawmakers from enacting legislation to decouple from federal law. It is even possible to impose specific guardrails to trigger decoupling until further review and analysis can occur. Rather than putting specific guardrails in place, the VSCPA recommends adding a reporting provision whereby the Secretary of Finance is required to annually report on any federal tax change with a fiscal impact . This report would be presented to the House and Senate money committees so they can determine whether specific decoupling is necessary. This would protect the Commonwealth from significant negative impacts to the state budget and taxpayers from significant tax increases. If there are no federal changes, or if federal changes do not necessitate decoupling, no additional legislation would be required.

This proposal in no way restricts the actions of the Virginia General Assembly. The body could still enact emergency legislation if significant changes are needed.

It was another year before legislation was passed that covered conformity for 2018 returns. There was significant uncertainty leading up to its passage, arising primarily from differing ideas about what to do with additional revenues generated by federal tax changes. The political climate, the short session, and 2019 being an election year for all 140 seats in the legislature contributed to delayed passage. At one point, it appeared that emergency legislation might not pass. It is important to note that it was mostly federal policy changes, not conformity itself, that caused the increased revenues. Without additional tax policy changes, Virginia revenues would have increased significantly regardless of adoption of a new conformity date. However, failure to advance the date of conformity to adopt TCJA changes would have caused greater complexity for Virginia taxpayers — requiring up to 20 adjustments to individual returns and up to 30 for corporate returns.

Despite the challenges of passing emergency tax conformity legislation post-TCJA, they didn't hold a candle to delays created by the need to pass conformity in the wake of the Coronavirus Aid, Relief, and Economic Security (CARES) Act and Consolidated Appropriation Act (CAA) of 2020. Significantly, the CARES Act created the Paycheck Protection Program (PPP), which provided forgivable federal loans to assist employers during the mandated shutdowns in the wake of the COVID-19 pandemic. The debate over the tax treatment of PPP funds delayed passage of the entire emergency tax conformity bills and ultimately delayed tax season by not becoming effective until March 15, 2021 (i.e. after the March 1 filing deadline of certain taxpayers). Significantly, there was little to no debate regarding the other provisions of the bills. The delay was entirely related to PPP.

The 2022 General Assembly revisited treatment of PPP and other forgiven federal loans and also addressed the American Rescue Plan Act (ARPA) of 2021. Once again, much of the debate was centered around PPP; the General Assembly reversed course and allowed PPP loans to be fully deductible for tax years beginning on or after Jan. 1, 2021. No new deconforming provisions were introduced in relation to ARPA.

It is important to note that in the nearly 20 years since switching to fixed date conformity in 2003, Virginia still only deconforms on 10 items. Four of the 10 come from the CARES Act, and two of the provisions were eventually brought back into conformity for subsequent years after initially being deconformed. (See the chart outlining provisions on page 5.)

After experiencing several consecutive General Assembly sessions with delayed passage of emergency tax conformity legislation, the VSCPA has concluded that reinstating some version of rolling tax conformity is a better option for Virginia.

TIMELINE OF VIRGINA'S DECONFORMING PROVISIONS

PROVISION	HOW IT DECONFORMS	EFFECTIVE	REPEALED
5-year NOL carryback	Only 2-year carryback	2001	
Bonus depreciation §168(k)	Not allowed	2002	
Bonus depreciation §§ 168(i), 168(m), 1400L, 1400N	Not allowed	2008	
Exclusions related to cancellation of debt income	Not allowed[1]	2009	
Deductions related to high yield debt obligations	Not allowed	2009	
Domestic production activities deduction	Only 2/3rd of federal deduction (2010–2012)	2010	2018
Medical deduction floor	10% (vs 7.5% federal)	2017	2018
Medical deduction floor	10% (vs 7.5% federal)	2019	
Suspension of Pease limitation on itemized deductions	Not suspended	2019	
Suspension of NOL limitations for 2018–2020[2]	Not suspended	2018 (adopted 2019)	
Suspension of the excess business loss limitation for 2018–2020[3]	Not suspended	2018 (adopted 2019)	
Increased business interest limitation for 2019 and 2020[4]	Not increased	2019	
Expenses paid with PPP funds	Not deductible[5]	2019	2021
Expenses paid with EIDL funds	Not deductible[6]	2019	2021

1. IRC permitted income from 2009 and 2010 to be deferred to 2014–2018. Virginia allowed it to be spread over three years (2009, 2010, 2011).
2. For these three years, IRC suspended the TCJA (2017) limitation that NOLs could only offset 80% of taxable income. In addition, the TCJA did not allow NOL carrybacks. This CARES Act change allowed the losses to be carried back five years.
3. For these three years, IRC suspended the TCJA limitation on excess business losses (CARES Act).
4. The TCJA limited the business interest expense deduction to 30% of adjusted taxable income (ATI), to which Virginia conformed. However, Virginia allowed a deduction of 20% of the disallowed interest expense (effective 2018). The CARES Act increased the deduction to 50% of ATI.
5. The CAA allowed full deduction for these expenses. Virginia limited the deduction to $100,000. Initially this was only for tax year 2020, but in 2021 it was made retroactive to 2019. Virginia allowed the full deduction beginning in 2021.
6. The CAA allowed full deduction for these expenses. No Virginia deduction was allowed. Initially this was only for tax year 2020, but in 2021 it was made retroactive to 2019. Virginia allowed the full deduction beginning in 2021.

Other provisions

The below were not included in the conformity statute and are not discussed above.

- Global intangible low-taxed income (GILTI): Virginia allows a subtraction for net GILTI under the expanded subtraction for Subpart F income.
- Rebuild VA grants: The grants are income for both federal and Virginia purposes. Virginia allows a subtraction of up to $100,000 for 2019 and 2020.

Notes

- 5-year NOL carryback provision. The IRC reference provided in the Virginia Code no longer exists. (It was removed in 2014.) Initially, this deconforming provision related to NOLs from 2001 and 2002. Subsequently, it covered a five-year carryback for NOLs generated in 2008 and 2009. Consideration should be given to removing this from the Virginia Code unless there is another reason for keeping it. (Note that the TCJA established no carryback provision for NOLs and Virginia conformed to this. Thus, the deconformity in the current statute is appropriate.)
- Exclusions related to cancellation of debt income. The effects of this deconformity should have ended in 2018. Unless there are other reasons, consideration should be given to removing this from the Virginia Code.

CONCLUSION

Returning to modified rolling conformity in Virginia would create certainty in the tax system for all parties by reducing the burden on taxpayers, the legislature, tax practitioners, and the Department of Taxation without removing the authority from the General Assembly to make amendments in the future. We urge the General Assembly and the governor to quickly adopt our proposal to the benefit of all.

Please direct questions to VSCPA Vice President, Advocacy Emily Walker, CAE, at ewalker@vscpa.com or (804) 612-9428.

FURTHER READING

"Virginia Tax Conformity — 2018 and Beyond," VSCPA 2018 white paper: vscpa.com/sites/default/files/resources/TaxConformityWhitepaper.pdf

VSCPA Tax Conformity Resource Center:
vscpa.com/taxconformity

VSCPA GUIDING PRINCIPLES OF VIRGINIA TAX POLICY

The VSCPA has developed guiding principles in tax policy to use as a framework when developing positions on tax-related legislative and regulatory matters. These guidelines recommend that Virginia tax laws and regulations meet the following guiding principles:

Conformity: Virginia's tax laws should conform with federal tax laws whenever and as expeditiously as possible. Consideration should be given to minimize lag time for Virginia to adopt federal tax changes as such a delay creates complexity and uncertainty for Virginia taxpayers.

Simplicity: The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.

Transparency: Taxpayers should know who and what is being taxed and why.

Equity: The tax system should include both horizontal and vertical equity. Similarly situated taxpayers should be taxed similarly. The tax system should also account for taxpayers' capacity to pay.

Certainty: The tax rules should clearly specify when a tax is to be paid, where and how it is to be paid, and how the tax is to be determined.

Competitiveness: Virginia's tax structure should enhance the Commonwealth's competitive position.

Information security: Taxpayer information should be protected from unintended and unauthorized disclosure.

Having to wait for conformity legislation to pass each year creates uncertainty for Virginia taxpayers by hindering their ability to plan during the year, and leaves them unclear about their actual Virginia tax liability until after the tax year has ended.