



COMMONWEALTH of VIRGINIA

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MEMORANDUM

TO: The Honorable Janet D. Howell
 Chair, Senate Finance & Appropriations Committee

 The Honorable Luke Torian
 Chair, House Appropriations Committee

 The Honorable Vivian E. Watts
 Chair, House Finance Committee

FROM: Aubrey L. Layne, Jr.
 Secretary of Finance

SUBJECT: Estimated Revenue Impact of Federal Tax Conformity

During 2020, Congress enacted two major pieces of legislation that would have an impact on Virginia revenues if the General Assembly advances the date of conformity:

- ***Coronavirus Aid, Relief, and Economic Security (CARES) Act*** (H.R.748), signed into law on March 27, 2020
- ***Consolidated Appropriations Act (CAA), 2021*** (H.R.133), signed into law on December 27, 2020

This memo addresses the provisions of the CARES Act and the CAA that would directly impact Virginia taxpayers and Virginia's conformity to the Internal Revenue Code (IRC). Fully conforming to such legislation could have a significant revenue impact. For this reason, it is recommended that Virginia generally conform to the CARES Act and CAA while specifically deconforming from the following provisions:

- Enhanced deduction for net operating losses (NOLs)
- Deduction of excess business losses for noncorporate taxpayers

- Increased business interest deduction
- Double tax benefit for Paycheck Protection Program (PPP) loan and Economic Injury Disaster Loans (EIDL) fund recipients by allowing a deduction for business expenses funded by PPP loan and EIDL funding proceeds
- Extension of the 7.5% floor for purposes of the medical expense deduction

Advancing Virginia's date of conformity while specifically deconforming from these provisions would reduce General Fund revenues by a total of \$43 million in FY 2021 and \$77 million in FY 2022. The Governor's introduced budget already assumes a reduction of \$34.2 million in FY 2021 and \$7.5 million in FY 2022 as a result of conforming to the individual provisions set forth in the CARES Act. Accordingly, a budget amendment would be required to reduce revenues by \$9 million in FY 2021 and \$69.7 million in FY 2022.

Estimated Revenue Impact of Conformity Provisions

Conformity to the following provisions of the CARES Act is already assumed in the Governor's introduced budget:

Provision	FY 2021	FY 2022	FY 2023	FY 2024
COVID-19 Related Retirement Distributions	-	(\$8.5)	(\$1.4)	(\$0.2)
Above-the-Line Charitable Contributions Deduction	(\$11.1)	(\$2.8)	-	-
Deduction Limitations for Certain Charitable Contributions	(\$19.5)	\$4.3	\$5.8	\$2.3
Exclusion of Educational Payments	(\$3.6)	(\$0.5)	-	-
Total (CARES Act Provisions)	(\$34.2)	(\$7.5)	\$4.5	\$2.1

A budget adjustment would need to be made to account for the estimated impact of conforming to the following provisions of the CAA:

Provision	FY 2021	FY 2022	FY 2023	FY 2024
Extension of the \$300 deduction for non-itemizers to Taxable Year 2021	-	(\$21.5)	(\$5.4)	-
Enhancing the charitable deduction for individuals for certain contributions	(\$4.5)	(\$19.8)	\$5.4	\$7.2
Temporary full business meals deduction	-	(\$17.8)	(\$10.5)	(\$2.2)

Extension of exclusion for certain employer payments of student loans	-	(\$8.5)	(\$6.2)	(\$6.6)
Depreciation of certain residential rental property over a 30-Year Period	-	(\$8.1)	(\$1.4)	(\$0.9)
Temporary enhancement of the earned income tax credit for certain taxpayers	(\$3.2)	-	-	-
Repeal of the deduction for qualified tuition	-	\$7.7	\$7.9	\$7.4
All other provisions	(\$1.3)	(\$1.8)	(\$0.7)	(\$0.7)
Total (CAA Provisions)	(\$9.0)	(\$69.7)	(\$10.9)	\$4.3

Estimated Revenue Impact of Deconformity Provisions

To reduce the administrative burden on taxpayers and to increase compliance with Virginia's tax laws, it is generally recommended that Virginia conform to federal income tax changes. However, there is precedent for Virginia to deconform from select federal provisions in cases where a particular federal tax change would have a significant revenue impact on Virginia revenues or where there is a strong policy rationale for deconformity. Accordingly, it is recommended that Virginia deconform from five federal income tax changes that were enacted by Congress during 2020, as set forth below.

Provision	FY 2021	FY 2022	FY 2023	FY 2024
Enhanced Deduction for NOLs	-	(\$312.6)	\$13.1	\$26.8
Excess Business Losses for Noncorporate Taxpayers	-	(\$305.9)	-	-
Business Interest Deduction Limitation	-	(\$47.3)	(\$1.7)	(\$1.3)
Subtotal, CARES Act Provisions	-	(\$665.7)	\$11.4	\$25.5
Deductibility of Business Expenses Funded by PPP Loan and EIDL Fund Proceeds	(\$150-\$190)	(\$190-\$310)	Unknown	Unknown
Extension of 7.5% Floor for Medical Expense Deduction	-	(\$14.5)	(\$29.6)	(\$30.2)
Subtotal, CAA Provisions	(\$150-\$190)	(\$205-\$325)	Unknown	Unknown
Total	(\$150-\$190)	(\$871-\$991)	Unknown	Unknown

CARES Act Business Provisions

It is recommended that Virginia deconform from three business provisions of the CARES Act that would have a substantial Virginia revenue impact. Specifically, these provisions would do the following:

- Enhance the deduction of NOLs for Taxable Years 2018, 2019, and 2020 by allowing such NOLs to fully offset a taxpayer's taxable income and allow taxpayers to carry back NOLs generated in Taxable Years 2018, 2019, and 2020 for up to five years preceding the year of the loss. The *Tax Cuts and Jobs Act* (TCJA) previously limited the deduction of NOLs to 80 percent of a taxpayer's taxable and generally prohibited the carryback of NOLs. The CARES Act reverses these changes for Taxable Years 2018, 2019, and 2020 while also allowing an enhanced carryback period for losses generated in such taxable years.
- Allow noncorporate taxpayers to deduct excess business losses arising in Taxable Years 2018, 2019, and 2020. For Taxable Year 2019, excess business losses are active business losses in excess of \$255,000 (\$520,000 for married taxpayers filing jointly). The TCJA previously disallowed the deduction of excess business losses for Taxable Years 2018 through 2025. The CARES Act reverses this TCJA provision for Taxable Years 2018, 2019, and 2020.
- Increase the limitation on the deductibility of business interest from 30 percent of adjusted taxable income to 50 percent for Taxable Years 2019 and 2020. The TCJA previously limited the business interest deduction to an amount no greater than the sum of the businesses' interest income plus 30 percent of adjusted taxable income. In response to the limitation imposed by the TCJA, the General Assembly enacted a Virginia-specific deduction during the 2019 Session equal to 20 percent of the amount of business interest that is disallowed as a deduction for federal income tax purposes.

As noted above, these provisions would reverse certain changes in the TCJA that were estimated to generate revenues for Virginia. Such revenues were used, in part, to provide refunds to individual taxpayers in 2019 and to deconform from the state and local tax (SALT) deduction limitation set forth in the TCJA. Conforming to the reversal of these federal changes would generate a significant revenue loss.

In addition, there is precedent in Virginia for deconforming from federal provisions related to business losses that would generate a substantial revenue loss. Most recently, Virginia deconformed from the five-year carry back of certain NOLs generated in Taxable Years 2008 and 2009.

Double Tax Benefit for PPP Loan and EIDL Fund Recipients

It is recommended that Virginia deconform from a provision in the CAA that would provide a double tax benefit to recipients of PPP loans and EIDL funds. Based upon preliminary data from the Small Business Administration, the Department estimates that full conformity to the federal PPP loan and EIDL tax treatment could result in a significant negative General Fund revenue impact of up to \$900 million. The timing of this revenue loss would be determined by taxpayers' tax liability in Taxable Year 2020 and beyond, as well as their ability to utilize any business losses that are carried forward. Based on the data currently available, it is estimated that such impact could range between \$150 million and \$190 million in Fiscal Year 2021 and between \$190 million and \$310 million in Fiscal Year 2022.

In addition to the substantial revenue impact, this provision violates the tax policy principles of neutrality and horizontal equity by providing a double tax benefit to certain taxpayers. Accordingly, it is recommended that Virginia deconform from the federal treatment by disallowing business expense deductions funded by forgiven PPP loans and EIDL payments.

Medical Expense Deduction Floor

Finally, there is precedent for Virginia deconforming from a provision in the CAA that would permanently extend the 7.5% floor for the medical expense deduction. Under federal law, the medical expense deduction was previously allowed to the extent that such expenses exceeded 10% of a taxpayer's adjusted gross income. When Congress reduced this floor to 7.5% of AGI, Virginia deconformed from the federal reduction and maintained a 10% floor for Taxable Year 2017. Virginia conformed to the reduced 7.5% floor for Taxable Year 2018, but subsequently deconformed for Taxable Years 2019 and 2020. Therefore, deconforming from this provision would be consistent with Virginia's prior treatment.

Kristin Collins (TAX) will forward suggested conformity budget and legislative language for your consideration. If you have any questions or require additional information, please let me know.

cc: Ms. April Kees
Staff Director, Senate Finance & Appropriations Committee

Ms. Anne Oman
Staff Director, House Appropriations Committee

Ms. Kristin Collins
Policy Development Director, Virginia Department of Taxation