State Tax Implications of Federal Tax Reform in Virginia

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Key Findings

- The new federal tax law cuts federal taxes for most filers in Virginia, but absent legislative action, many Virginians will experience an unlegislated increase in their state tax liability.
- This additional liability is because federal tax reform broadened the tax base while reducing tax rates, with some of the base-broadening provisions–but not the corresponding rate reductions–flowing through to many states, including Virginia.
- Anticipated changes in taxpayer behavior, including investment decisions and how taxpayers elect to file for federal tax purposes, will also impact Virginia revenues.
- If lawmakers elect to avoid a state tax increase, the added revenue provides an opportunity to pay down reforms to Virginia's tax code.

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Introduction

In Virginia, tax conformity has always been backward-looking, with each session yielding legislation to conform Virginia's tax code with the federal Internal Revenue Code (IRC) as it existed at the end of the previous tax year. These conformity updates happened like clockwork until 2018, when legislators and Governor Ralph Northam (D) conformed to the IRC as it existed on February 8, 2018, with one big exception: practically the entirety of the provisions of the federal Tax Cuts and Jobs Act of 2017.[1]

This means that despite the 2018 conformity date, many provisions of the new federal tax law have yet to be incorporated into Virginia's own system of taxation. Nevertheless, several consequential changes are transpiring even without state action, while others are likely to take effect with next year's conformity update. It is important to recognize, therefore, that while tax reform meant a tax cut for the vast majority of taxpayers at the federal level, the effect runs in the opposite direction on Virginians' state tax returns.

This short paper provides a brief overview of which provisions of the federal Tax Cuts and Jobs Act (TCJA) affect state tax liability in Virginia and offers a few recommendations for how Virginia policymakers can respond, particularly if they wish to avoid an unintentional increase in tax revenues. As in many other states, federal tax reform creates both an opportunity and an impetus for tax reform in Virginia—an opportunity because the new tax law provides the state with additional revenue which can be used to pay down reforms, and an impetus because, as changes in the federal tax code encourage additional domestic investment, policymakers may wish to position the Commonwealth to best compete for that investment.

General Overview

Each state has its own approach to taxation–its own combination of tax types, rates, and structures, and rules and exemptions–but even the most freewheeling state tax structures draw upon the federal tax code. This reality, always significant, has become far more pertinent with the implementation of the federal Tax Cuts and Jobs Act.[2]

Some states adopt large swaths of the federal tax code by reference; others use it as a starting point, then tinker endlessly; and still others incorporate federal provisions and definitions more sparingly. In some states, the federal tax code is mirrored; in others, echoed. The differences matter greatly, but so do the points of agreement. Virginia takes an expansive approach, incorporating federal definitions into the state tax code unless a different meaning is clearly required, and adopting by reference all provisions of the Internal Revenue Code touching state tax systems except those from which it expressly decouples.[3]

1 Va. Gen. Assem., House Bill 154 and Senate Bill 230, 2018 Reg. Sess.

2 This section has been adapted from a longer paper on tax conformity. See Jared Walczak, "Tax Reform Moves to the States: State Revenue Implications and Reform Opportunities Following Federal Tax Reform," Tax Foundation, Jan. 31, 2018, https://taxfoundation.org/state-conformity-federal-tax-reform/.

3 VA Code § 58.1-301.

States conform to provisions of the federal tax code for a variety of reasons, but largely to reduce the compliance burden of state taxation. Doing so allows state administrators and taxpayers alike to rely on federal statutes, rulings, and interpretations, which are generally more detailed and extensive than what any individual state could produce.[4]

It provides consistency of definitions for those filing in multiple states and reduces duplication of effort in filing federal and state taxes. It permits substantial reliance on federal audits and enforcement, along with federal taxpayer data. It helps to curtail tax arbitrage and reduce double taxation. For the filer, it can make things easier by allowing the filer to copy lines directly from their federal tax forms. In the words of one scholar, federal conformity represents a case of "delegating up," allowing states to conserve legislative, administrative, and judicial resources while reducing taxpayer compliance burdens.[5]

Delegating up, of course, means ceding a certain amount of control, hence the myriad of ways that states modify or decouple from the Internal Revenue Code. Most states, including Virginia, stand to see increased revenue due to federal tax reform, with expansions of the tax base reflected in state tax systems while corresponding rate reductions fail to flow down. The extent to which this is true depends on *how* and *when* states conform.

Five Ways Federal Tax Reform Affects Virginia State Revenue

There are at least five broad categories of ways that federal tax reform can drive state revenue changes, and technically only one of them is contingent upon an updated conformity statute. In Virginia and most other states, however, the revenue implications are significantly larger with up-to-date conformity. The five sources of revenue changes are as follows:

1. **Income starting point.** Some tax changes are incorporated by the state's choice of an income starting point. Calculations of Virginia taxable income begin with federal adjusted gross income,[6] the definition of which has changed slightly under the new tax law. These modifications, including the virtual elimination of the moving expense deduction, are now part of Virginia's tax system even though Virginia has not yet conformed to the Tax Cuts and Jobs Act.

4 Kirk J. Stark, "The Federal Role in State Tax Reform," *Virginia Tax Review* 30 (December 2010), 423, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1718606.

5 Ruth Mason, "Delegating Up: State Conformity with the Federal Tax Base," *Duke Law Journal* 62:7 (April 2013), https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=3382&context=dlj.

6 VA Code § 58.1-322.

2. **Specific conformity provisions.** Virginia, like most states, follows federal treatment and definitions in many areas, from the parameters of the mortgage interest deduction to Section 179 small business expensing and many things in between. While some states conform selectively, Virginia adopts most of these provisions automatically, with a few provisions from which it expressly decouples (such as accelerated business depreciation, discussed later). Because Virginia begins with federal adjusted gross income rather than federal taxable income, moreover, the Commonwealth does not mirror the federal standard deduction or personal exemption. These provisions will not change unless Virginia conforms to the new law.

3. **Filing uniformity requirements.** Thirty-one states require that taxpayers use identical filing statuses on their federal and state returns, meaning, for instance, that married couples which elect to file jointly for federal tax purposes could not avail themselves of the option of married filing separately on their state forms. Similarly, nine states and the District of Columbia require the choice to itemize or take the standard deduction to carry through from the federal to the state form. Since the optimal choice at the federal level may not also be optimal at the state level, mandating uniformity may result in higher state tax payments.

   In Virginia, which links both filing status and itemization choices to the decisions made for federal filing purposes, additional revenue can be expected–even without a broader conformity update–because roughly two-thirds of those who previously itemized will now find it advantageous to take the more generous federal standard deduction. These taxpayers will lose their itemized deductions in Virginia as well, even though in many cases their state liability will be higher when shifting to the state's $3,000 standard deduction ($6,000 for joint filers).[7]

4. **International income.** Some states incorporate what is known as Subpart F income into their tax base, which allows them to reap a short-term windfall from the "deemed" repatriation provision in the new federal law. Virginia is not among these states, so the effect of changes to the treatment of international income under the TCJA will be modest for Virginia tax purposes. However, the Commonwealth does conform to the establishment of a new participation exemption system for the taxation of foreign income, which should increase Virginia collections somewhat.[8]

5. **Dynamic economic effects.** The new law changes incentive structures and favors additional investment.[9] All states, regardless of what they do about tax conformity, will reap the benefits of economic expansion brought about by federal tax reform, though the degree to which they participate in the additional economic activity depends on many factors, including the states' own tax codes.

7 VA Code § 58.1-322.03.

8 KPMG, "Tax Reform – KPMG Report on New Tax Law: Analysis and Observations," Feb. 6, 2018, 108-109, https://home.kpmg.com/content/dam/kpmg/us/pdf/2018/02/tnf-new-law-book-feb6-2018.pdf.

9 Tax Foundation, "Preliminary Details and Analysis of the Tax Cuts and Jobs Act," Dec. 18, 2017, https://taxfoundation.org/final-tax-cuts-and-jobs-act-details-analysis/.

New Federal Tax Provisions with Virginia Tax Impacts

As Virginia lawmakers grapple with the state tax code in the aftermath of federal tax reform, they should pay particular attention to certain provisions which have undergone a change due to the new federal law:

- **The personal exemption.** Virginia charts its own course on both the standard deduction and personal exemption—mostly. The Commonwealth's personal exemption is a $930 deduction for "each personal exemption allowable to the taxpayer for federal income tax purposes."[10] This introduces a certain amount of ambiguity, because the new federal law *functionally* eliminates the personal exemption by setting its value at $0 but does not remove it outright.[11] While taxpayers are unable to claim a now-worthless exemption on their new federal tax returns, technically they may still be *eligible* for the exemption.

  The Virginia formulation of "allowable to the taxpayer for federal income tax purposes" allows for multiple possible interpretations in this new environment. One can be eligible for something without claiming it, but is the exemption *allowable* if it cannot be claimed? Similarly, does "for federal income tax purposes" mean something closer to "for purposes of filing and remitting your federal income tax" or "under the provisions of the Internal Revenue Code"? At present, the Virginia Department of Taxation is operating under the assumption that Virginia's personal exemption will continue to be available to taxpayers, but should lawmakers wish to ensure its preservation, resolving this textual ambiguity would be advisable. If policymakers wish the personal exemption to remain available, they should amend the code to make that clear.

- **The moving expense deduction.** Virginia follows the federal government in eliminating the moving expense deduction for all but military personnel on active duty who move pursuant to a military order. Because this is an above-the-line deduction, the change is in immediate effect in Virginia, increasing state revenues.

- **The mortgage interest deduction.** Virginia mirrors the new federal limitations on the mortgage interest deduction, and upon conformity, will only allow the deduction to be taken for interest on the first $750,000 in mortgage debt, down from the first $1 million. This change also increases state revenues.

- **The medical expense deduction.** Federal tax reform legislation retroactively expanded eligibility for the medical expense deduction for tax year 2017, making it available to taxpayers for whom medical expenses exceeded 7.5 percent of adjusted gross income, down from a standard threshold of 10 percent. This retroactive adjustment would not have been captured automatically, but was specifically adopted in Virginia's 2018 conformity bill.[12] This change reduces state revenues slightly.

10 VA Code § 58.1-322.03.

11 This policy choice was driven by the constraints of operating under budget reconciliation procedures; similarly, the individual mandate penalty was set at $0 rather than being eliminated outright, which would have exceeded what can be accomplished in a reconciliation bill.

12 Va. Gen. Assem., House Bill 154 and Senate Bill 230, 2018 Reg. Sess.

- **The property tax deduction.** Much has been made of the new $10,000 cap on the state and local tax deduction, but less notice has been paid to its partial incorporation into many state tax codes, including Virginia's. While Virginia necessarily disallows the portion of the deduction provided for state income tax payments–which would be recursive–it does allow a deduction for local property taxes, which would be subject to a $10,000 cap under TCJA conformity. This change increases state revenues.

- **Section 179 small business expensing.** Under the new federal law, small businesses can deduct a larger share of their investments in the first year, with the cap increasing from $500,000 to $1 million and phaseout of the benefit beginning at $2.5 million, up from $2 million.[13] Virginia would conform to these changes, which improve the tax treatment of capital investment, making this the rare conformity provision which reduces Virginia tax collections.

- **Net operating losses.** Corporate income taxes are intended to fall upon net income (essentially profits), but because business cycles do not neatly follow the calendar, achieving this requires businesses to be able to offset gains in one year with losses from another. Virginia adopts the federal approach to the treatment of net operating losses, which changed under tax reform. Previously, losses could be carried forward for 20 years and back for two, with no caps on the amount carried forward or backward. With conformity, losses could only be carried forward–not back–and for an unlimited number of years, though under the new system, carryforwards cannot reduce tax liability by more than 80 percent in any given year.[14] This change increases state revenues.

- **Business interest deduction limitation.** At the federal level, businesses receive the benefit of full and immediate expensing of investments in machinery and equipment, but in return, receive less generous treatment of their net interest expenses.[15] This trade-off breaks down in Virginia, which expressly decouples from accelerated depreciation regimes like full expensing, but would conform to the new interest expense limitations, which restrict deductions for business interest. This change increases state revenues.

- **The Section 199 manufacturing deduction.** The Section 199 domestic production activities deduction, which was largely a manufacturing deduction but also had relevance to businesses engaged in construction, engineering, and agricultural processing, among other activities, has been eliminated at the federal level and, once Virginia conforms to the TCJA, will disappear at the state level as well, increasing state revenues.

- **The dividends received deduction.** The dividends received deduction has been reduced in value, with new provisions for foreign-source income. Virginia will incorporate these federal changes, increasing state revenue slightly.

13 Jared Walczak, Joseph Bishop-Henchman, and Nicole Kaeding, "Details of the Conference Report for the Tax Cuts and Jobs Act," Tax Foundation, Dec. 15, 2017, https://taxfoundation.org/conference-report-tax-cuts-and-jobs-act/.

14 Id.

15 Stephen J. Entin, "Conference Report Limits on Interest Deductions," Tax Foundation, Dec. 17, 2017, https://taxfoundation.org/conference-report-limits-interest-deductions/.

- **Like-kind exchanges.** Virginia follows the federal government's lead in eliminating like-kind exchanges for personal property, another provision ameliorated by the policy of full expensing of machinery and equipment purchases at the federal level, but not offset in Virginia.

Responding to the New Law

Virginia lawmakers have a range of options available to them in the wake of federal tax reform. They can do nothing and reap additional revenue; they can seek to reverse certain changes to hold taxpayers harmless; or they can identify rate cuts or tax reforms intended to improve the Commonwealth's tax competitiveness while avoiding an unlegislated tax increase.

Many of the provisions which increase aggregate tax liability in Virginia represent the elimination of targeted tax preferences, making the restoration of the old *status quo* undesirable. Instead, Virginia policymakers wishing to avoid a net tax increase should use the new revenue to pay down more meaningful reforms.

They might, for instance, improve the state's treatment of capital investments, since full expensing is one of the more pro-growth elements of federal tax reform and represents the proper treatment of capital expenditures. They could opt for modest rate reductions or the consolidation of state income tax brackets. They could eliminate the state's marriage penalty under which joint filers pay more than they would if they filed separately, and which is partially, but not completely, addressed by a Spouse Tax Adjustment credit. Simply doubling the state's income tax brackets for married filers, as done in most other states, would go a long way to simplifying what amounts to a complicated band-aid put in place years ago.

To the extent that state revenue agencies are uncertain about the state revenue effects of federal tax reform, reforms could be implemented or phased in on a revenue-contingent basis using tax triggers, ensuring revenue adequacy and only implementing reforms for which additional revenue is available.

Inaction results in higher taxes, and in ways which do not necessarily abide by the preferences of policymakers even if they were to develop revenue-raisers intentionally. Federal tax reform lowers federal tax burdens for most taxpayers. It also gives Virginia lawmakers an opportunity to improve the Commonwealth's tax competitiveness—but only if they act.