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Frequently Asked Questions About Income Tax Conformity in Virginia

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What is meant by conformity?

Most states with income taxes conform (or match) some or all their rules to the federal Internal Revenue Code and the rulings of the IRS. Virginia's starting point for calculating tax is the federal adjusted gross income. That simplifies compliance. Until 2002 Virginia automatically conformed its rules to federal changes and in the years since has differed from federal rules on only a few provisions.

Following passage of the federal Tax Cuts and Jobs Act (TCJA) in December 2017, the 2018 General Assembly and Governor Ralph Northam decided to conform to none of its changed provisions. Unless the 2019 General Assembly acts on the issue and adopts rules that apply backwards to 2018, Virginia will remain under the 2017 rules and the differences between state and federal returns will be substantial, confusing and costly to many taxpayers.

The General Assembly is expected to act in some fashion to prevent that.

Is conformity a tax increase?

The federal tax law changed the rules on numerous deductions and credits, but also cut tax rates across the board. That means many taxpayers owe tax on a larger portion of their income, but the rates have gone down so much they are still paying less overall tax – at the federal level.

There have been no corresponding changes to state tax rates. If Virginia conforms to all the new rules on income and deductions and credits but makes no changes in its tax rates (up to 5.75 percent on individuals and 6 percent on corporations), then many families and companies will pay higher state taxes for 2018 and future years.

Will everybody's taxes go up?

No. A recent analysis of the impact on Virginia taxpayers of full conformity, commissioned by the state, estimated that only about one in four Virginia returns would show an increase in state taxes. A small percentage of taxpayers would see their state taxes decrease due to conformity and more than two out of three would see no change, or only a minor change. For some of those seeing a higher tax bill it will be significant. When the state and federal impacts are combined, only 16 percent of Virginia taxpayers will see an overall tax hike, while 68 percent will see a combined tax reduction.

What specific provisions might cause higher state taxes for some?

Under conformity, if a taxpayer takes the federal standard deduction they must also take the state standard deduction. With new federal limits on deductions and a higher federal standard deduction ($24,000 for a couple) it is assumed more than 600,000 Virginia taxpayers will switch from itemizing to using the standard deduction. Those who continue to itemize will find that many deductions have been limited or eliminated. One with a major impact involves limits on how business-related losses are treated under the tax code. There are a few other changes having a smaller impact on some taxpayers, but the changes dealing with deductions account for most of the new state tax liability.

How much additional tax would be collected if the General Assembly conforms?

Estimated Virginia Revenue Impact of the TCJA
Fiscal Years 2019 to 2024

	($Millions)						
	2019*	2020	2021	2022	2023	2024	Total
Individual Provisions	532.1	443.8	466.7	492.5	520.0	546.1	3,001.3
Business Provisions	29.4	114.6	181.5	300.3	417.2	398.2	1,441.3
International Provisions	32.6	52.7	5.5	5.8	6.0	6.3	108.8
Total, All Provisions	594.2	611.1	653.7	798.7	943.2	950.6	4,551.4

* Due to the likely timing of Virginia's conformity to the federal provisions, the full revenue impact for Taxable Year 2018 is recognized in FY 2019.

If the state conforms *and makes no changes to compensate*, both individual and business income tax collections are projected to rise. The first year, which is tax year 2018 (but overlaps fiscal year 2019), the amount is estimated to be $594 million. By the sixth year, FY 2024, it could approach $951 million. The chart above lists the projected revenue growth but provides no context. The personal income tax revenue growth is small compared to existing taxes, only 4 percent of the 2019 baseline, but the corporate income tax revenue grows more than 40 percent above the 2019 baseline. These figures are from a state-commissioned study by Chainbridge Software LLC.

In the first two years the state projects an additional tax of $85 million due to companies bringing home (repatriate) profits they held in foreign countries and distributing them as dividends. That is expected to fade after the initial wave.

The chart below shows the projected average state tax increase in three broad income categories. It excludes taxpayers who reside in other states, which are included in the chart above.

Individual results will vary widely, as many if not most taxpayers will see no increase.

Summary of Virginia Impact by Income Class
Residents Only (Taxable Year 2018)

Virginia Adjusted Gross Income	Total Change in Tax Liability	Total Returns	Net Average Per Taxpayer
Less than $50,000	$46,165,399	1,912,720	$24
50,000 to 100,000	$80,408,011	860,084	$93
$100,000 and above	$207,113,763	892,833	$232

What options are available to reduce the state tax impact of conformity?

The following are some things the General Assembly could do, but there are other possibilities:

- Increase Virginia's standard deduction, currently $6,000 for a couple. The state has projected that doubling that would reduce the tax increases (and the state's revenue) by $440 million.
- Reduce the income tax rates and brackets, which now start at 2 percent of the first dollar of taxable income and top out at 5.75 percent of taxable income above $17,000. Those rates and brackets have not been adjusted for inflation since 1987. (Had there been inflation adjustments, Virginia's top rate would now apply only to taxable income above $37,000.)
- Increase the personal exemption, now $930 per taxpayer and dependent (with extra exemptions for the elderly or disabled.)
- Make no immediate policy changes but set up a special fund to hold in reserve the additional tax revenue created by conformity, pending future action, which could return the dollars to taxpayers in later years.
- Some combination of the above, which was the approach taken in 1987 after a similar major adjustment in federal deductions and rates also threatened to hike state taxes.
- Approach this as an opportunity for a more comprehensive tax overhaul that also looks at the sales and use and other taxes collected by Virginia, perhaps to lower the state's reliance on the personal income tax as its main source of general fund revenue (77 percent.)
- Take a similar opportunity to review business taxes to make Virginia more competitive with other states as a location for new business or business expansions.

The changes at the federal level are so wide-ranging and inter-related it is not possible to change the state tax code in ways that protect every taxpayer from a conformity-driven increase. And as noted a failure to conform at all to the new rules leaves major headaches for taxpayers because the state and federal returns will be based on such different rules – more than 20 discrepancies between state and federal for individual and more than 30 for business returns. Compliance costs and enforcement will become a larger concern. There are several elements of the new rules which are positive for state taxpayers which would be lost if the state does not conform.

Could policy changes apply retroactively to Tax Year 2018?

Yes, but only if the General Assembly approves them in an emergency bill, which takes effect immediately upon the Governor's signature. That requires an 80 percent vote in both House and Senate, which is a challenge on controversial issues. Big changes to the rules that late in the tax process will be hard to implement (state tax returns are due May 1. Any bill not passed as an emergency bill takes effect July 1, 2019.

Could Virginians be allowed to itemize deductions only on their state return?

Yes. Letting people treat deductions differently on their state and federal returns has been suggested. It would create a series of new problems, and unless Virginia keeps all the pre-2018 deductions, the various changes to them would still result in additional tax for many. The state Tax Department would likely add audit staff since it would not be relying on the IRS for the initial reviews of returns. Also, with that rule change, people now taking the standard deduction at the state level might switch the other way and start to itemize, lowering taxes more than conformity had raised them.

The same thing happens with increases in the state standard deduction or reductions in the tax rates and brackets. Many people who are not paying more due to conformity would then see a tax cut.

What are the provisions that could raise taxes on corporations?

- Limits on the net interest deduction (adds $619 million in tax over six years.)
- Amortization of research and experimental expenses ($454 million)
- Repeal of the domestic production activities deduction, a popular provision with manufacturers ($274 million)
- Modification of the net operating loss deduction ($229 million)

People doing business as sole proprietors or in partnerships that are not incorporated report their business income directly on their individual returns. Several of those federal tax changes will also affect them. There are also federal changes which are highly positive for small businesses, which would not be available on state taxes absent conformity. It is because of some of those changes beneficial to business that the expected revenue increase shown below is slow to grow. Those low initial numbers for total revenue mask some very dramatic impacts for individual provisions.

	2019*	2020	2021	2022	2023	2024	Total
Fiscal Year Virginia Only Impact Business Provisions	29.4	114.6	181.5	300.3	417.2	398.2	1,441.3

* Due to the likely timing of Virginia's conformity to the federal provisions, the full revenue impact for Taxable Year 2018 is recognized in FY 2019

At the federal level the corporate tax rate was cut 40 percent, from 35 to 21 percent. The easiest way for the General Assembly to compensate for the changed business deductions would be to lower Virginia's 6 percent corporate tax rate. If the General Assembly does decide to take up broad tax reform, local business taxes may also be targets for change as they are often seen as more significant impediments to business growth than the state income tax.

What is Governor Northam's current recommendation?

The Northam administration has recommended full conformity with no rate or bracket changes for 2018, allowing the state to collect and keep the additional $594 million for that tax year. It has not ruled out tax policy changes which would ameliorate the tax increases in future years.

What is the Earned Income Tax Credit?

The Earned Income Tax Credit (EITC) was created by Congress in 1975 to supplement the income of lower-wage working families and is now the third largest anti-poverty program after Medicaid and SNAP (formerly food stamps). Only people with income from employment can claim the EITC. The amount they can claim from the federal government is tied to their income and the number of children they have. For 2018 the maximum federal EITC is $6,431 – in effect about $3 per hour for a full-time worker with three or more children.

The EITC is claimed on federal tax returns, and for many workers is enough to eliminate all federal tax liability on their income. If the federal credit amount is larger than the federal tax liability, then the taxpayer receives the additional money in a lump sum delivered the same way as a tax refund.

As part of the 2004 Virginia tax bill signed by Governor Mark Warner, Virginia created a state EITC to be claimed on state income tax returns, setting the amount at 20 percent of the federal credit. It also eliminates the state tax liability for many low-income workers. Unlike the federal program, however, Virginia does not pay the taxpayers cash for any credit amount that exceeds their state tax bill. It is not a "refundable" credit in Virginia.

The EITC has become a part of this discussion because Governor Northam has proposed taking that additional step and having the state pay out any excess state credit.

Another possibility, not discussed at this point, would be to raise the state EITC percentage above 20 percent to a higher share of the federal credit, which would wipe out state tax liability on additional working families but would not result in supplemental cash payments.

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Key References: Chainbridge Software LLC report to Virginia Department of Taxation.
Thomas Jefferson Institute and Tax Foundation White Paper
Charts are from the Chainbridge Software report or Secretary of Finance presentations

Stephen D. Haner of Richmond has joined the Thomas Jefferson Institute as a senior fellow. He has more than 30 years of experience in Richmond as a reporter, lobbyist, state employee and political adviser, with an emphasis on tax and business issues. His employers have included the Office of Attorney General, the Virginia Chamber of Commerce and Huntington Ingalls Industries. He may be reached at blackwalnut140@live.com.