DEPARTMENT OF TAXATION
2019 Fiscal Impact Statement

1. Patron Timothy D. Hugo

2. Bill Number HB 2529

House of Origin:
_____ **Introduced**
__X__ **Substitute**
_____ **Engrossed**

3. Committee House Rules

4. Title Individual Income Tax; Virginia Tax Policy Changes

Second House:
_____ **In Committee**
_____ **Substitute**
_____ **Enrolled**

5. Summary/Purpose:

The Department of Taxation ("the Department") understands that the Patron intends to introduce a substitute for this bill. This fiscal impact statement is drafted based on the substitute version of this bill.

This bill would increase the Virginia standard deduction from $3,000 to $4,000 for individuals and married taxpayers filing separately, and from $6,000 to $8,000 for married taxpayers filing joint returns. This bill would provide that a taxpayer may elect either to claim the Virginia standard deduction or to itemize deductions on his or her Virginia income tax return, regardless of whether the taxpayer elected for the taxable year to itemize deductions on his or her federal income tax return. The provisions of the bill regarding the standard deduction would be effective for taxable years beginning on and after January 1, 2019, but before January 1, 2026.

This bill would provide an individual income tax deduction for the amount of real property and personal property taxes not otherwise deducted on the state return solely on account of the application of the cap on the federal deduction for state and local taxes paid that was imposed by the Tax Cuts and Jobs Act ("TCJA"). This bill would provide an individual income tax deduction for qualified residence interest not otherwise deducted on the state return solely on account of limitations imposed by the TCJA. These provisions would be effective for taxable years beginning on and after January 1, 2019.

This bill would require that any additional revenues generated by the federal TCJA for Fiscal Year 2019-2020 beyond what is necessary to offset the reduction in revenues resulting from the other provisions of this bill be transferred to a special nonreverting fund to be known as the Tax Policy Fund. The Governor would be required to submit, with the Introduced Executive Budget for the 2020-2022 biennium, a plan to provide tax reform to Virginia taxpayers with revenues in the Tax Policy Fund.

6. Budget amendment necessary: Yes.
Item(s): Page 1, Revenue Estimates
273 and 275, Department of Taxation

7. Fiscal Impact Estimates are: Preliminary. (See Line 8.)

7a. Expenditure Impact:

Fiscal Year	***Dollars***	***Positions***	***Fund***
2019-20	$1,017,712	10	GF
2020-21	$893,582	10	GF
2021-22	$893,582	10	GF
2022-23	$893,582	10	GF
2023-24	$893,582	10	GF
2024-25	$893,582	10	GF

7b. Revenue Impact:

Fiscal Year	***Dollars***	***Fund***
2019-20	($611.1 million)	GF
2020-21	($408.3 million)	GF
2021-22	($429.8 million)	GF
2022-23	($453.7 million)	GF
2023-24	($474.6 million)	GF
2024-25	($494.6 million)	GF

8. Fiscal implications:

Administrative Costs

This bill would result in administrative costs to the Department of Taxation ("the Department") of $1,017,712 in Fiscal Year 2020 and $893,582 in Fiscal Year 2021 and each fiscal year thereafter. Such funding would include costs for hiring five new full-time employees for customer service to respond to taxpayer calls arising from this bill and hiring five new full-time employees for compliance purposes.

Revenue Impact

This bill would result in a negative General Fund revenue impact of $611.1 million in Fiscal Year 2020; $408.3 million in Fiscal Year 2021; $429.8 million in Fiscal Year 2022; $453.7 million in Fiscal Year 2023; $474.6 million in Fiscal Year 2024; and $494.6 million in Fiscal Year 2025. If this bill is enacted, the budget would need to be adjusted to reduce the revenue estimate by $611.1 million in Fiscal Year 2020. As the Introduced Executive Budget assumes advancement of the date of conformity, and because this bill proposes both modifications to provisions within the TCJA and the distribution of additional revenues to taxpayers generated by the TCJA, these estimates assume that Virginia's date of conformity will be advanced to December 31, 2018 and that Virginia will otherwise conform to the TCJA.

This bill would create a special nonreverting fund to be known as the Tax Policy Fund, where any additional revenues generated by the TCJA in Fiscal Year 2020 beyond those revenues necessary to offset the reduction in revenues resulting from the provisions of this bill would be required to be transferred. It is estimated that $22.4 million would be transferred to this Fund in Fiscal Year 2020.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

<u>Federal Law</u>

When completing their federal income tax return, taxpayers are generally allowed to elect to claim either the total amount of their itemized deductions or the flat amount of their standard deduction. Taxpayers will generally choose to deduct the greater of the two amounts.

Federal Standard Deduction

The standard deduction is a fixed dollar amount that reduces a taxpayer's taxable income and varies according to their filing status. The current amount of the federal standard deduction is $12,000 for single taxpayers; $18,000 for heads of household; and $24,000 for married taxpayers filing jointly.

The federal standard deduction amounts have increased significantly since 1988. The federal Tax Reform Act of 1986 increased the standard deduction amount for Taxable Year 1988 to $3,000 for individuals; $4,400 for heads of household; and $5,000 for married taxpayers filing jointly. The Act also required, beginning in Taxable Year 1989, the Internal Revenue Service to adjust the amount of such deduction annually for inflation based on the percentage change in the Consumer Price Index for Urban Consumers ("CPI-U") for the preceding calendar year. Because of these inflation adjustments, the federal standard deduction increased annually from Taxable Year 1988 through Taxable Year 2002. For Taxable Year 2002, the standard deduction amounts were $4,700 for individuals; $6,900 for heads of household; and $7,850 for married taxpayers filing jointly.

The federal Jobs and Growth Tax Relief Reconciliation Act of 2003 increased the standard deduction for married couples filing jointly to $9,500, which was equal to twice the standard deduction for single taxpayers. This was intended to eliminate the standard deduction marriage penalty. From 2003 until 2017, the federal standard deduction continued to increase annually due to inflation adjustments. For Taxable Year 2017, the standard deduction amounts were $6,350 for individuals; $9,350 for heads of household; and $12,700 for married taxpayers filing jointly.

On December 22, 2017, Congress enacted the TCJA, which substantially increased the federal standard deduction amounts beginning with Taxable Year 2018 as follows:

- From $6,350 to $12,000 for single taxpayers;
- From $9,350 to $18,000 for heads of household; and
- From $12,700 to $24,000 for married taxpayers filing jointly.

In addition, beginning with Taxable Year 2019, the Internal Revenue Service is required to adjust the standard deduction amount based upon a new inflation measure, chained CPI-U.

Like the majority of the individual provisions of the TCJA, the increase in the federal standard deduction is currently scheduled to sunset after December 31, 2025, and revert to its pre-2018 amounts. Future legislation would be required to make such increases effective beyond Taxable Year 2025. However, the 2025 sunset date does not apply to the TCJA's substitution of a new inflation measure for indexing the federal standard deduction and other provisions.

Federal Itemized Deductions Generally

In lieu of deducting the standard deduction amount, taxpayers may elect to claim up to approximately a dozen separate deductions, referred to as "itemized deductions," on their federal return to the extent that they qualify for such deductions. The rationale for each itemized deduction is generally to take account of large or unusual personal expenditures that affect a taxpayer's ability to pay. Certain itemized deductions are also provided as a way of encouraging certain desired behaviors and activities. The most common expenses that may be claimed as an itemized deduction include:

- Home mortgage interest;
- State and local income taxes or sales taxes (but not both);
- Real estate and personal property taxes;
- Gifts to charities;
- Casualty or theft losses;
- Unreimbursed medical expenses; and
- Unreimbursed employee business expenses.

The TCJA included a number of provisions that greatly limit or repeal certain federal itemized deductions.

Itemized Deduction for Qualified Residence Interest

For federal income tax purposes, personal interest expenses for individuals are not generally deductible. However, federal law provides an exception to this rule with respect to qualified residence interest on an individual taxpayer's first or second home. This deduction is commonly known as the mortgage interest deduction.

Prior to the TCJA, individual taxpayers who chose to itemize their deductions were permitted to deduct up to $1 million in aggregate acquisition indebtedness and an additional $100,000 in home equity indebtedness. For taxable years beginning on and after January 1, 2018, but before January 1, 2026, the TCJA reduced the limitation on acquisition indebtedness to $750,000, and eliminated the additional $100,000 home equity indebtedness.

Itemized Deduction for State and Local Taxes

Under federal law, a deduction may be claimed for state and local taxes, such as income or sales tax (but not both), real estate tax, and personal property tax. Prior to the TCJA, taxpayers' deductions for state and local taxes were generally unlimited. For taxable years beginning January 1, 2018, but before January 1, 2026, the TCJA limited the deduction for state and local taxes which are not paid or accrued in carrying on a trade or business or an activity to $10,000 per taxable year.

<u>Virginia Law</u>

When completing their Virginia income tax returns, taxpayers are bound by the election they made for federal purposes regarding whether to claim a standard deduction or to itemize their deductions. Therefore, if they claimed the standard deduction on their federal income tax return, they are not allowed to claim itemized deductions on their Virginia return. In contrast, if they claimed itemized deductions on their federal income tax return, they are not allowed to claim the standard deduction on their Virginia return.

Virginia's Standard Deduction

Taxpayers that do not itemize their deductions for federal purposes are permitted to claim a standard deduction on their Virginia income tax returns. The current amount of the Virginia standard deduction is $3,000 for single individuals and $6,000 for married persons filing jointly. Virginia's standard deduction amounts increased from Taxable Year 1988 to the present, as shown below:

Year	**Virginia Standard Deduction for Single Taxpayers**	**Virginia Standard Deduction for Married Persons Filing Jointly**
1987	$2,000	$2,000
1988	$2,700	$2,700
1989-2004	$3,000	$5,000
2005-present	$3,000	$6,000

During the 2005 Session, the General Assembly increased the standard deduction for married persons filing jointly from $5,000 to $6,000. This was intended to eliminate the standard deduction marriage penalty at the state level, similar to how this issue was addressed at the federal level. Since 2005, the Virginia standard deduction amounts have remained at $3,000 for single taxpayers and $6,000 for married taxpayers filing jointly.

Prior to 1987, the Virginia standard deduction was not a fixed amount. For example, in Taxable Year 1986, the Virginia standard deduction was 15 percent of a taxpayer's federal adjusted gross income with a $1,300 minimum and a $2,000 maximum.

Virginia Itemized Deductions

Taxpayers that elect to itemize their deductions for federal purposes are permitted to claim such deductions on their Virginia income tax return as well. The amount of itemized deductions that may be claimed on such return is equal to the:

- Federally allowable amount of itemized deductions, *minus*
- Amount claimed as a federal deduction for income taxes paid to Virginia or any other state, locality, foreign country, or other taxing jurisdiction, *plus*
- Amount needed to increase the amount deducted federally for charitable contribution transportation to 18¢ per mile.

Virginia and the Itemized Deduction for State and Local Taxes

Virginia permits taxpayers that elect to itemize their deductions for federal income purposes to claim the federal deduction for state and local taxes on their Virginia income tax return. However, Virginia does not permit a taxpayer to deduct income taxes paid to Virginia or any other taxing jurisdiction. Therefore, for Virginia income tax purposes, the federal itemized deduction for state and local taxes is required to be reduced to the extent this limitation applies.

<u>Other States</u>

Of the 42 other states that impose an individual income tax, 21 states and the District of Columbia allow taxpayers to claim federal itemized deductions on their state returns. Eleven of these states (Colorado, Georgia, Maine, Maryland, Missouri, Nebraska, New Mexico, North Dakota, Oklahoma, South Carolina, and Vermont) and the District of Columbia only allow taxpayers to claim itemized deductions on their state return if they itemized for federal purposes. The remaining ten states (Arizona, Delaware, Hawaii, Idaho, Iowa, Kansas, Minnesota, Montana, New York, and Oregon) allow taxpayers to elect to itemize on their state return, regardless of whether they itemized for federal purposes.

The remaining 21 states that impose an individual income tax do not generally allow taxpayers to claim federal itemized deductions on their state return. Instead, such states have generally established their own rules for determining the state tax liability that may use state-specific credits or deductions that are substantially different from the federal itemized deduction structure.

<u>Proposed Legislation</u>

This bill would increase the Virginia standard deduction from $3,000 to $4,000 for individuals and married taxpayers filing separately, and from $6,000 to $8,000 for married taxpayers filing joint returns. This bill would provide that a taxpayer may elect either to claim the Virginia standard deduction or to itemize deductions on his or her Virginia income tax return, regardless of whether the taxpayer elected for the taxable year to itemize deductions on his or her federal income tax return. The provisions of the bill regarding the standard deduction would be effective for taxable years beginning on and after January 1, 2019, but before January 1, 2026.

This bill would provide an individual income tax deduction for the amount of real property and personal property taxes not otherwise deducted on the state return solely on account of the application of the cap on the federal deduction for state and local taxes paid that was imposed by the TCJA. This bill would provide an individual income tax deduction for qualified residence interest not otherwise deducted on the state return solely on account of limitations imposed by the TCJA. These provisions would be effective for taxable years beginning on and after January 1, 2019.

This bill would require that any additional revenues generated by the federal TCJA for Fiscal Year 2019-2020 beyond what is necessary to offset the reduction in revenues resulting from the other provisions of this bill be transferred to a special nonreverting fund to be known as the Tax Policy Fund. The Governor would be required to submit, with the Introduced Executive Budget for the 2020-2022 biennium, a plan to provide tax reform to Virginia taxpayers with revenues in the Tax Policy Fund.

Similar Bills

House Bill 1851, **House Bill 1980**, **House Bill 2086**, **House Bill 2110**, **House Bill 2529**, **House Bill 2673**, **House Bill 2765**, **Senate Bill 1225**, **Senate Bill 1443**, and **Senate Bill 1631** would make various, different tax policy changes.

Senate Bill 1531 would increase the standard deduction to $12,000 for single individuals and $24,000 for married taxpayers filing joint returns.

House Bill 1618 and **Senate Bill 1237** would allow a taxpayer to elect either to claim the Virginia standard deduction or to itemize his or her deductions, regardless of whether the taxpayer elected for the taxable year to itemize deductions on his or her federal return, for Taxable Year 2019 through Taxable Year 2025.

House Bill 2708 would allow a taxpayer to elect either to claim the Virginia standard deduction or to itemize his or her deductions, regardless of whether the taxpayer elected for the taxable year to itemize deductions on his or her federal return, for Taxable Year 2019 and after.

House Bill 2704 would require, if the General Assembly does not enact legislation during the 2019 Session that provides at least $100 million in tax relief, that any additional revenues from the TCJA in Fiscal Year 2019-2020 be transferred to the Tax Policy Fund, and used to provide tax reform.

Senate Bill 1739 would advance Virginia's date of conformity to the IRC to December 31, 2018, and require additional revenues from the TCJA for fiscal years beginning on and after July 1, 2018, but before July 2, 2026, to be transferred to the Taxpayer Relief Fund and distributed on September 1 of each year from 2019 through 2027 as a refund to Virginia taxpayers who filed a return in the immediately preceding taxable year.

Senate Bill 1744 would increase the standard deduction to $4,000 for single individuals and $8,000 for married taxpayers filing jointly for Taxable Year 2018 only, and the standard deduction would revert to its current amounts for Taxable Year 2019 and after.

cc : Secretary of Finance

Date: 1/22/2019 RWC
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