TAX BULLETIN 16-1

Virginia Department of Taxation

February 5, 2016

IMPORTANT INFORMATION REGARDING 2015 VIRGINIA INCOME TAX RETURNS

VIRGINIA INCOME TAX FIXED-DATE CONFORMITY ADVANCED TO DECEMBER 31, 2015

Under emergency legislation (House Bill 402; Chapter 2 of the 2016 Acts of Assembly) passed by the 2016 General Assembly and signed by Governor McAuliffe on February 5, 2016, Virginia's fixed-date of conformity to the terms of the Internal Revenue Code ("IRC") will advance from December 31, 2014 to December 31, 2015. This notice is intended to provide taxpayers with directions on how to reconcile this legislation with their 2015 Virginia income tax returns.

Virginia Income Tax

For approximately thirty years, Virginia conformed to federal income tax law. Whenever federal income tax law changed, the changes automatically affected Virginia income taxes, unless otherwise exempted. In 2003, Virginia began conforming to the IRC as of a specific, fixed date, moving the date nearly every year.

On February 5, 2016, Governor McAuliffe signed legislation advancing the date as of which Virginia conforms to the IRC from December 31, 2014 to December 31, 2015. This will allow Virginia to conform to federal tax legislation enacted during 2015 that would impact the filing of Virginia income tax returns. This bulletin explains the conformity adjustments that may be necessary on taxpayers' Taxable Year 2015 income tax returns.

Conformity to the Internal Revenue Code for Taxable Year 2015

Effective for taxable years beginning on and after January 1, 2015, Virginia's fixed-date of conformity to the terms of the IRC will advance from December 31, 2014 to December 31, 2015, with limited exceptions. Virginia will continue to disallow the five-year carry back of net operating losses ("NOL") allowed for NOLs generated in Taxable Years 2008 and 2009.

Conformity to Expiring Provisions Extended by the Federal PATH Act

Virginia will conform to the provisions of the Protecting Americans from Tax Hikes Act of 2015 ("the PATH Act"), which was enacted by Congress on December 18, 2015. This federal legislation extended a number of expiring federal provisions including:

- The increased expensing limitations and treatment of certain real property as IRC § 179 property.
- Several provisions related to the depreciation and expensing of certain types of property.
- The above-the-line deduction for certain expenses of elementary and secondary school teachers.
- The deduction for state and local general sales taxes.
- The above-the-line deduction for qualified tuition and related expenses.
- The exclusion for discharge of indebtedness on a principal residence.
- The deductibility of interest on mortgage insurance premiums as qualified residence interest.
- The federal income tax treatment of certain income related to S corporations.
- The federal income tax treatment of certain foreign income.
- The enhanced EITC.

Conformity to New Provisions Under the Federal PATH Act

The PATH Act also modified certain expiring provisions that were extended, and added several new federal tax provisions. Virginia will conform to such federal provisions.

- <u>The IRC § 179 Deduction</u>: The PATH Act makes the following changes related to the deduction under IRC § 179:

    - Permanently extends both the $500,000 deduction limitation and the $2 million threshold;
    - Indexes both the $500,000 limitation and the $2 million threshold for inflation, rounded to the nearest $10,000;
    - Eliminates the $250,000 cap on qualified real property;
    - Permanently allows off-the-shelf computer software and qualified real property to qualify as eligible section 179 property; and

    - Allows air conditioning and heating units placed in service after Taxable Year 2015 to be eligible for expensing under IRC § 179.

- <u>The Indexed Deduction for Certain Expenses of School Teachers</u>: Congress modified the above-the-line deduction for certain expenses of elementary and secondary school teachers by indexing the $250 deduction limitation for inflation, rounded to the nearest $50. The legislation also allows the deduction to be claimed for professional development expenses.

- <u>The Enhanced Charitable Deduction for Contributions of Food Inventory</u>: Congress enhanced the charitable deduction for contributions of food inventory by increasing the limitation on deductible contributions of food inventory from 10 percent to 15 percent of the taxpayer's adjusted gross income. This legislation also provides special rules for valuing food inventory.

- <u>An Exclusion for Compensation to Wrongfully Incarcerated Individuals</u>: Congress added a new exclusion from gross income for any civil damages, restitution, or other monetary awards received as compensation for wrongful incarceration.

- <u>Special Rules for REIT Spinoffs</u>: The IRC allows corporations to spin off assets into newly-formed subsidiaries, including REITs, tax-free. Certain corporations have used this technique to spin off real estate assets to newly-formed REITs. Because such spinoffs are tax-free transactions, the corporation avoids paying the corporate income tax that would have been due if such real estate assets had been sold. When a REIT that received real estate assets in a tax-free spinoff sells such assets for a gain and distributes the proceeds to its shareholders as dividends, it pays no tax on such transaction because it is permitted to deduct the amount of dividends paid to its shareholders. The REIT's shareholders remain subject to taxation on any dividends received from the REIT. Congress effectively eliminated this tax planning strategy by prohibiting such spin-offs involving REITs from qualifying as a tax-free spinoff.

Other Federal Tax Legislation Enacted During 2015

On July 31, 2015, Congress enacted the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015. This legislation changed the due date for federal corporate income tax returns from the fifteenth day of the third month (March 15 for calendar year filers) to the fifteenth day of the fourth month (April 15 for calendar year filers), which is the same as the due date for Virginia's corporate income tax return. This bill did not change Virginia's corporate income tax return due date.

On May 22, 2015, Congress enacted The Don't Tax Our Fallen Public Safety Heroes Act. This legislation provides an income tax exemption for certain income received from a state program by the surviving dependents of public safety officers who die in the line of duty. The exemption does not apply to any amounts that would have been payable if the death of the public safety officer had occurred other than as the direct and proximate result of a personal injury sustained in the line of duty.

On November 2, 2015, Congress enacted the Bipartisan Budget Act of 2015. This legislation changed the Internal Revenue Service procedure for auditing partnerships. It also clarified that for an unincorporated organization to be considered a partnership, it must have been formed to conduct an active trade or business regardless of whether a partner received via gift a capital interest in such partnership. Certain taxpayers previously argued that the "active trade or business" requirement does not apply to a partnership if a partner receives via gift a capital interest in such partnership where capital is a material income-producing factor. This provision clarifies that a person who owns a capital interest in a partnership may be considered a partner, whether such interest was obtained by purchase or by gift.

Exceptions to Conformity

Bonus Depreciation

Virginia will continue to disallow any bonus depreciation allowed for certain assets under IRC § 168(k). The fixed-date conformity will not include any bonus depreciation that is allowed under IRC §§ 168(l), 168(m), 1400L, and 1400N. These sections allow bonus depreciations in limited circumstances and were designed to benefit the following:

- Cellulosic biofuel plant property – IRC § 168(l);
- Reuse and recycling property – IRC § 168(m);
- New York Liberty Zone property – IRC § 1400L; and
- Gulf Opportunity Zone property – IRC § 1400N.

Virginia will allow any bonus depreciation that is allowed under IRC § 168(n), which is designed to benefit qualified disaster assistance property.

When reporting any adjustments related to bonus depreciation, the adjustments for all of the categories of bonus depreciation should be grouped together on the applicable line of the taxpayer's income tax return.

Applicable High Yield Discount Obligations

Virginia will continue to disallow the income tax deductions related to applicable high yield discount obligations under IRC § 163(e)(5)(F). The American Recovery and Reinvestment Act of 2009 ("ARRA") established a provision that suspends the application of the applicable high yield debt obligation ("AHYDO") rules for certain debts issued after September 30, 2008, and before January 1, 2010. Virginia will continue to deconform from this federal tax provision.

Cancellation of Debt Income

Under IRC § 108(i), the income realized upon the reacquisition of certain business debt during 2009 and 2010 was allowed to be deferred and reported in Taxable Years 2014 through 2018. Virginia disallowed the income tax exclusions related to cancellation of debt income realized in connection with a reacquisition of business debt at a discount after December 31, 2008, and before January 1, 2011.

However, for Virginia income tax purposes, taxpayers were permitted to elect a partial deferral of these exclusions for specific debt reacquired in Taxable Year 2009. This treatment was extended to Taxable Year 2010, provided that the transaction was completed on or before April 21, 2010. Taxpayers that made this election were required to report the Virginia addition over three taxable years.

A taxpayer that reported such cancellation of debt income for Virginia income tax purposes for Taxable Years 2009, 2010, 2011, or 2012 may continue to claim a subtraction on their Virginia income tax returns for Taxable Years 2014 through 2018 to the extent such income is reported on his or her federal income tax return.

Instructions for Taxpayers

Individuals and corporations should consult the instructions for the appropriate 2015 Virginia income tax return for information about how to make adjustments related to the carry back of certain NOLs, bonus depreciation, applicable high yield discount obligations, and cancellation of debt income. In addition, individuals and corporations who have already filed a 2015 Virginia income tax return but need to make a conformity adjustment should consult the instructions for the appropriate income tax return for further information about filing an amended return.

Further Instructions

If you have additional questions, please visit the Department's website at http://www.tax.virginia.gov, or contact the Department at (804) 367-8031 for individual income tax questions or (804) 367-8037 for corporate income tax questions.