

**DEPARTMENT OF TAXATION
2025 Fiscal Impact Statement**

- 1. **Patron** Bill DeSteph
- 3. **Committee** Senate Commerce and Labor
- 4. **Title** Individual Income Tax; Portable Benefit Accounts

- 2. **Bill Number** SB 1276
House of Origin:
 X **Introduced**
 Substitute
 Engrossed

Second House:
 In Committee
 Substitute
 Enrolled

5. Summary/Purpose:

This bill would authorize a Virginia resident who has worked as an independent contractor to establish a portable benefit account. Under the bill, a portable benefit account offered through and administered by a bank, credit union, or other depository institution and distributions from the account may be used for the payment of various health-related costs. The bill would establish a deduction for Taxable Years 2025 and 2026 for individuals who contribute to a portable benefit account. The Department would pro-rate claimed deductions to ensure that the associated revenue loss did not exceed five million dollars.

The provisions of this bill establishing the deduction would be effective for taxable years beginning on and after January 1, 2025, and before January 1, 2027. The remaining provisions of this bill, if enacted during the regular session of the 2025 General Assembly, would become effective July 1, 2025.

This fiscal impact statement is limited to the tax provisions of this bill administered by the Department.

- 6. **Budget amendment necessary:** No.
- 7. **Fiscal Impact Estimates are:** Preliminary. (See Line 8.)
- 8. **Fiscal implications:**

Administrative Costs

The Department of Taxation’s (“the Department’s”) administrative costs to implement the bill are unknown, but it is anticipated that the costs would be significant. This is because the Department is unable to limit the revenue impact of deductions through a front-end process as is possible with tax credits. If the revenue impact cap of the proposed deduction is reached, this will only be discovered after taxpayers have filed their returns, and the Department will not have the data necessary to prorate the deduction until all returns for the taxable year have been filed, including late returns. As a result, taxpayers

would be required to file amended returns to pay additional tax and interest, or the Department would have to send out assessments to each such taxpayer, again to pay additional tax and interest. The administrative cost of processing such amended returns and/or sending out assessment letters is unknown as it is unknown how many amended returns and/or assessments would be required as a result of prorated deductions.

Revenue Impact

This bill would result in an unknown, but potentially significant revenue loss beginning in Fiscal Year 2026. Reliable data does not exist for the number of independent contractors in Virginia. Moreover, it is unknown how many of those independent contractors would contribute to a portable benefit account or the amount of their contributions.

As noted above, the Department is unable to limit the revenue impact of deductions through a front-end process as is possible with tax credits. As a result, it is possible that the revenue impact of this bill could exceed the \$5 million revenue cap for a given fiscal year, and the Department would have to recover such revenue losses in a subsequent fiscal year either by requiring taxpayers to file amended returns or sending them assessment letters.

Contributions would not be limited to earnings from work as an independent contractor. As a result, an individual with substantial earnings from employment or investments could do minimal work as an independent contractor and then contribute enough funds to a portable benefit account to reduce his Virginia tax income.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Virginia's Individual Income Tax Modifications

Federal Adjusted Gross Income

Virginia's Individual Income Tax substantially conforms to federal income tax law by using federal adjusted gross income ("FAGI") as the starting point for computing Virginia income taxes. Virginia law then provides various modifications to FAGI that must be taken into account that figure in determining Virginia taxable income.

Virginia Adjusted Gross Income

When completing a Virginia individual income tax return, a taxpayer starts with the amount of FAGI reported on his federal return. A taxpayer then calculates Virginia adjusted gross income by making two types of adjustments: (1) "additions" which increase the amount of income taxable by Virginia and (2) "subtractions" which reduce such

amount. These adjustments are made only to the extent that they have not already been included or excluded from FAGI.

Virginia Taxable Income

The taxpayer calculates his Virginia taxable income by making another type of modification referred to as “deductions,” which further reduce the amount of income taxable by Virginia. These modifications are made regardless of federal treatment unless specifically stated otherwise in the provision.

Please find below an illustration of how taxable income is computed for federal and Virginia income tax purposes and how they interrelate:

Federal Income Tax	Virginia Income Tax
+Wages and Other Income	= <i>Federal Adjusted Gross Income (“FAGI”)</i>
+Federal Adjustments	+Virginia Additions (only if not included in FAGI)
-Federal Adjustments	-Virginia Subtractions (only if not excluded from FAGI)
= <i>Federal Adjusted Gross Income (“FAGI”)</i>	= <i>Virginia Adjusted Gross Income (“VAGI”)</i>
-Federal Standard Deduction or Itemized Deductions	-Virginia Standard Deduction or Federal Itemized Deductions (depends on federal election)
-QBI Deduction	-Deduction for Virginia Exemptions
	-Virginia Deductions (regardless of federal treatment)
= <i>Federal Taxable Income</i>	= <i>Virginia Taxable Income</i>

Because this bill would establish a new Virginia deduction, the amount allowed under this bill could be taken whether the taxpayer chooses to take the Virginia standard deduction or itemized their deductions.

Background

The Internal Revenue Service (“IRS”) has published guidance regarding whether a worker should be classified as an independent contractor. The IRS guidelines follow the common law rules, which generally focus on the extent to which the person for whom services are performed has the right to control and direct the individual who performs the services. For many years, the IRS looked at 20 factors when making independent contractor determinations, but today focuses on three categories of factors: behavioral, financial, and type of relationship.

On January 9, 2024, the U.S. Department of Labor (“DOL”) adopted a regulation changing the criteria it would use in classification cases. Instead of focusing on control like the IRS, the DOL would focus on the economic reality and how dependent the worker is on a

purported employer. The DOL and IRS share information on their enforcement of employee classification.

Worker classification affects taxation of both the business and worker, as well as whether the worker should be entitled to the rights and benefits available to employees. States and the federal government have considered legislation to change the classification of certain workers to employees instead of independent contractors. Another approach has been to give certain rights and benefits to independent contractors that would be analogous to what is available to employees. One of those analogous benefits is a portable benefit account. Although the details vary, the goal is to give independent contractors access to tax-favored benefits equivalent to those available to employees.

Proposed Legislation

General

This bill would permit an individual to open and contribute to a portable benefit account if the individual has worked, been hired, or contracted as an independent contractor during the taxable year. A portable benefit account must be offered through and administered by a bank, credit union or other depository institution. Distributions from a portable benefit account would be permitted to be used for the benefit of the individual, the individual's spouse, and any dependents in the household, but would be limited to the payment of:

- Health insurance premiums, copays, deductibles, coinsurance, or other costs related to maintaining health insurance coverage;
- Coverage for or the direct purchase of prescription drugs;
- Fees or costs related to a health care sharing ministry arrangement;
- Fees or costs related to a direct primary care agreement; or
- Other health care costs related to insurance coverage, alternative care, or direct-pay or cash-pay services.

Once opened, the individual may contribute to, and take distributions from, the portable benefit account regardless of whether the individual continues to be classified as an independent contractor. There is no penalty or other mechanism to enforce the limitation on distributions from the account. In order to open a portable benefit account under this bill, the individual would be required to be classified as an independent contractor pursuant to the guidelines published by the IRS.

Taxation

A deduction would be allowed for 100% of the amount contributed to a portable benefit account if the individual has worked, been hired, or contracted as an independent contractor during the taxable year. However, in the event that taxpayers request deductions that would result in more than \$5 million in revenue loss, the Department would prorate all requested deductions so the maximum revenue loss would not exceed \$5 million.

However, the Department will not know if proration of deductions would be necessary, and if so, to what extent, until the end of individual income tax filing season—after all returns claiming such deduction have been filed. Because deductions are taken before calculating Virginia taxable income, any proration will increase taxpayers' taxable income, and consequently the amount such taxpayers owe in income tax will also increase. As a result of this change in income tax liability taxpayers who take a deduction that is later prorated would have to file amended returns to correct their Virginia individual income tax liability, or the Department would have to send out an assessment to each such taxpayer for underpayment of income tax.

As the portable benefit account would not qualify for special treatment under the Internal Revenue Code, there would be no federal deduction for contributions to the account. Any interest, dividend or other income earned by funds in the account would be taxable income to the account owner for federal and Virginia purposes. There would be no tax liability for funds distributed from the account; however, some of the expenses paid with distributions could qualify for an itemized or other deduction on the federal or Virginia returns, or both.

The provisions of this bill establishing the deduction would be effective for taxable years beginning on and after January 1, 2025, and before January 1, 2027. The remaining provisions of this bill, if enacted during the regular session of the 2025 General Assembly, would become effective July 1, 2025.

Similar Legislation

House Bill 2443 would also allow the creation of portable benefit accounts, but in addition to contributions by an independent contractor, would allow contributions to be made by an internet or application-based company.

cc : Secretary of Finance

Date: 01/20/2025 JPJ
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