DEPARTMENT OF TAXATION
2026 Fiscal Impact Statement

1. **Patron** Vivian E. Watts

2. **Bill Number** HB 977
   House of Origin:
   _____ **Introduced**
   X **Substitute**
   _____ **Engrossed**

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

3. **Committee** House Finance

4. **Title** Income Tax; Conformity

5. **Summary/Purpose:**

The Department of Taxation ("the Department") understands that the Patron intends to introduce a substitute. This Fiscal Impact Statement is based upon the substitute.

Conformity

This bill would update Virginia's date of conformity to the Internal Revenue Code ("IRC") to December 31, 2025, and restart Virginia's rolling conformity, with certain exceptions, to the Internal Revenue Code ("IRC"). This would allow Virginia to conform to the changes made to federal tax law by 2025 H.R. 1 (P.L. 119-21) with the following exceptions:

- The provisions relating to the special depreciation of real property used in domestic qualified production;
- The provisions relating to the new limitation on itemized deductions;
- The provisions relating domestic research and experimental expenditures, including the full expensing, transitional, and catch-up deduction provisions; and
- The provisions relating to the increased dollar limitations for expensing of certain depreciable business assets.

Other Provisions

This bill would reduce the Virginia disallowed business interest deduction, from 50 to 40 percent of the business interest disallowed on the federal return. This bill would also permanently reinstate the Virginia eligible educator expenses deduction, extend the sunset date for the elective pass-through entity tax ("PTET") permanently—including the applicable provisions of the out-of-state tax credit, and make other technical corrections.

This bill contains an emergency clause that provides that it would be effective from its passage.

6. **Budget amendment necessary:** Yes.
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7. **Fiscal Impact Estimates are:** Preliminary. (See Line 8.)

8. **Fiscal implications:**

Administrative Costs

The Department of Taxation ("the Department") considers this bill as routine and does not require additional funding.

Because of the implementation and release schedule for the Integrated Revenue Management System ("IRMS") replacement project, this legislation will not be impacted by such project if enacted during the 2026 Regular Session of the General Assembly. For more information on the new system implementation releases, see the 2025 Status Report on the Replacement of the Integrated Revenue Management System (IRMS).

Revenue Impact

This bill would have a net positive General Fund revenue impact as shown below:

2025 H.R. 1 Provisions	FY 2026	FY 2027	FY 2028	FY 2029	FY 2030	FY 2031	FY 2032
*Business Interest Limit	($0.6)	$13.5	$14.4	$15.3	$15.5	$15.1	$15.0
Opportunity Zones Program	$10.9	$22.9	($27.0)	($12.2)	($12.4)	($12.6)	($12.9)
1% Floor on Corp Charitable Contributions	$4.3	$7.7	$9.2	$8.9	$8.3	$8.0	$8.1
0.5% Floor on Indiv Charitable Contributions	$15.8	$40.4	$42.5	$44.7	$49.7	$56.7	$60.2
**All Other Provisions	$3.0	$12.7	$20.7	$28.6	$28.9	$19.3	$16.0
Total	**$33.4**	**$97.2**	**$59.8**	**$85.3**	**$90.0**	**$86.5**	**$86.4**

*This is the net effect of conforming to the new higher federal limit on the amount of business interest that may be deducted on the federal return and decreasing the Virginia deduction for business interest disallowed by this limit on the federal return.

**Nearly 30 other miscellaneous flow through provisions that individually have a relatively small impact on Virginia revenues and, collectively, largely "net-out" to have only a small total impact. This includes provisions such as the treatment of ABLE accounts, disaster casualty losses, and the discharge of student loan debt.

Because the Introduced Executive Budget assumes substantial conformity with HR 1 and includes a reduction in revenues attributable to the provisions of HR 1 of $101.6 million in FY 2026, $148.6 million in FY 2027, and $183.2 million in FY 2028, this bill would result in additional General Fund revenues available for appropriation of $135.0 million in FY 2026, $245.8 million in FY 2027, and $243.0 million in FY 2028. Such increase in revenues is primarily attributable to full deconformity from the research and experimental expenses deduction, the new limitation on itemized deductions, and the increased dollar limitations for expensing of certain depreciable business assets.

However, if compared to all the HR 1 tax provisions in the Introduced Executive Budget—including both conformity provisions and tax policy provisions relating to tips, overtime and car loan interest deductions, this bill would result in additional General Fund revenues available for appropriation of $135.0 million in FY 2026, $339.7 million in FY 2027, and $450.0 million in FY 2028.

The portion of this bill relating to extending expiring Virginia tax provisions would have no revenue impact because their extension is assumed in the Official General Fund Revenue Forecast.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Virginia's History with Rolling and Fixed Date Conformity

Prior to 1971, the Virginia Constitution did not allow provisions incorporated into Virginia law if they could be subsequently revised without approval of the General Assembly. The new constitution adopted in 1971 included a provision allowing incorporation of the IRC "as those laws may be or become effective." From 1972 until 2002, Virginia relied on the new constitutional provision to automatically conform to any Congressional changes in the definition of income. As a result, Virginia was a rolling conformity state during that period.

The Job Creation and Worker Assistance Act of 2002 ("JCWAA") substantially reduced Virginia taxable income of businesses by creating a new depreciation deduction and modifying the carryback period for net operating loss deductions. The 2002 Appropriation Act included a provision temporarily fixing the date of conformity to the IRC as of December 31, 2001. In 2003, the General Assembly adopted fixed date conformity by adopting the IRC as it existed on December 31, 2002 and specifically excepting the depreciation/NOL provisions modified by JCWAA. From 2002 to 2023, Virginia has been a fixed date conformity state. Annual conformity bills have generally advanced the date of fixed conformity and revised the list of exceptions as needed.

In 2023, the General Assembly adopted rolling conformity by automatically conforming Virginia to amendments to the IRC enacted after January 1, 2023, except:

- Any amendments that would increase or decrease General Fund revenues by more than $15 million in the fiscal year in which the amendment was enacted or any of the succeeding four fiscal years, or
- All amendments occurring between adjournment sine die of the previous regular session of the General Assembly and the first day of the subsequent regular session of the General Assembly if the cumulative impact of such amendments would increase or decrease General Fund revenues by more than $75 million in the fiscal year in which the amendments were enacted or any of the succeeding four fiscal years.

- Generally, the same exceptions that were in place during fixed date conformity.

In 2025, the General Assembly temporarily paused rolling conformity by providing that Virginia would not automatically conform to any federal tax changes enacted on or after January 1, 2025, but before January 1, 2027, with a projected revenue impact that would increase or decrease General Fund revenues by any amount in the fiscal year in which the amendment was enacted or any of the succeeding four fiscal years. However, Virginia continues to conform to any federal tax changes that the General Assembly subsequently adopts and to any federal tax extenders.

Virginia's Current Conformity to Federal Income Tax Law

Beginning on January 1, 2025, Virginia no longer automatically conforms to the IRC on a rolling basis. Virginia law currently deconforms from the following provisions:

- Bonus depreciation allowed for certain assets under federal income taxation.
- The five-year carry-back of net operating losses ("NOLs") generated in certain taxable years.
- Tax exclusions related to cancellation of debt income.
- Tax deductions related to the application of the applicable high yield debt obligation rules.
- Suspension of the federal overall limitation on itemized deductions.
- The reduction in the medical expense deduction floor.
- Certain business provisions of the federal CARES Act.
- The deduction of business expenses through certain COVID-related small business assistance programs.
- On or after January 1, 2025, but before January 1, 2027—any amendment to the IRC enacted with a projected impact on general fund revenues.
- On or after January 1, 2027—any amendment to the IRC with a projected impact on general fund revenues of more than $15 million, AND all amendments to the IRC enacted after a projected cumulative impact on general fund revenues exceeding $75 million. These threshold amounts apply to the year an amendment was enacted or any of the succeeding four fiscal years, and do not apply to amendments to the IRC adopted by the General Assembly and federal tax extenders. The dollar amounts are indexed for inflation.

The Secretary of Finance is required to provide an annual report on the fiscal impact of amendments to the IRC occurring since the adjournment sine die of the prior year's regular session of the General Assembly to the Chairmen of the Senate Committee on Finance and Appropriations and the House Committees on Appropriations and Finance.

2025 H.R. 1 (P.L. 119-21)

2025 H.R. made significant changes to several individual and corporate income tax provisions and made many of the temporary provisions of the 2017 Tax Cuts and Jobs Act ("TCJA") permanent. Most of the changes made to corporate income tax provisions are effective for Taxable Years 2025 and thereafter, while the changes to the individual income tax provisions are generally effective for Taxable Years 2026 and thereafter. Such changes include the following provision from which Virginia would deconform under this bill:

- **The new special depreciation deduction, under IRC § 168(n), for real property used in domestic qualified production activities.** Virginia has historically deconformed from similar special depreciation provision under IRC Sections 168(k), 168(l), and 168(m).
- **The new limits on itemized deductions, which reduces the value of itemized deductions for taxpayers in the 37% tax bracket and eliminates the prior "Pease" limit on itemized deductions.** Virginia would maintain the Pease limit on itemized deduction on the state income tax return.
- **The new transitional rules for domestic research and experimental ("R&E") expenditures retroactive and catch-up deductions, and the return to full expensing of domestic R&E expenditures.** From 2022 to 2024 domestic R&E expenditures were required to be amortized over a 5-year period, and Virginia would require such expenditures to continue to be amortized over a 5-year period.
- **The increased dollar limitations for expensing of certain depreciable business assets from $1 to $2.5 million, and its phaseout threshold was raised from $2.5 to $4 million of total qualifying purchases.** Virginia would require business taxpayers to continue to use the lower amounts.

2025 H.R. 1 also increased the amount of business interest taxpayers can deduct by allowing a more generous definition of adjusted taxable income ("ATI") which is used in the calculation of the limitation on the amount of interest that may be deduction for federal income tax purposes. Virginia would conform to this federal change, but would reduce the Virginia specific deduction from 50 to 40% of the interest disallowed by the federal limitation on business interest.

Virginia income tax returns start with federal adjusted gross income ("FAGI") for individuals and federal taxable income ("FTI") for corporations. 2025 H.R. 1 contained several provisions that do not change how taxpayers calculate FAGI and FTI, and as a result these provisions do not impact Virginia income tax returns. These provisions include the federal No Tax on Tips, No Tax on Overtime and No Tax on Car Loan interest provisions.

Eligible Educator Expenses Deduction

The eligible educator expenses deduction is an individual income tax deduction of up to $500 for qualifying expenses paid or incurred by an eligible educator. The eligible educator expenses deduction expired on January 1, 2025.

Virginia's Pass-through Entity Tax

During the 2022 Session, the General Assembly enacted legislation to permit certain PTEs to make an annual election to pay an elective income tax at a rate of 5.75 percent at the entity level. The 2022 legislation also allowed a corresponding refundable income tax credit to certain PTE owners for income paid by a PTE if such PTE makes the election and pays the elective income tax imposed at the entity level. The effect of PTET and corresponding refundable credit is to offer taxpayers a workaround to the $10,000 cap on the federal deduction for state and local taxes paid. During the 2023 Session, the General Assembly enacted legislation that expanded the number of PTEs that were eligible to make this election.

Virginia allowed taxpayers to claim Virginia's nonrefundable credit for taxes paid to other states ("out-of-state credit") on their individual income tax return for certain taxes paid by a PTE under another state's substantially similar PTE tax structure. During the 2025 Session of the General Assembly, the sunset date for the PTET and PTET credit were extended to January 1, 2027, but the sunset date for the PTET out-of-state credit was not and it expired on January 1, 2026.

Proposal

Conformity

This bill would update Virginia's date of conformity to the Internal Revenue Code ("IRC") to December 31, 2025, and restart Virginia's rolling conformity, with certain exceptions, to the Internal Revenue Code ("IRC"). This would allow Virginia to conform to the changes made to federal tax law by 2025 H.R. 1 (P.L. 119-21) with the following exceptions:

- The provisions relating to the special depreciation of real property used in domestic qualified production;
- The provisions relating to the new limitation on itemized deductions;
- The provisions relating to transitional rules for domestic research and experimental expenditures retroactive and catch-up deductions, and the full expensing of domestic research or experimental expenditures; and
- The provisions relating to the increased dollar limitations for expensing of certain depreciable business assets.

Virginia would conform to the following flow through provisions of H.R. 1:

- The New Opportunity Zones program, which allows taxpayers to defer and exclude eligible gains from investments in economically distressed communities. This makes the old temporary program permanent and restructured the program to offer rolling tax benefits using a more targeted definition of Opportunity Zones;
- The new higher federal limit on the amount of business interest that may be deducted on the federal return. This bill also includes an offsetting decrease to the Virginia deduction for business interest disallowed by the limit on the federal return (see "Other Provisions" below).
- The new floor on individual taxpayers' charitable contributions which allows an itemized deduction for only the portion of their charitable contributions that exceed 0.5 percent of their FAGI;
- The new floor on corporate taxpayers' charitable contributions which allows a deduction for only the portion of their charitable contributions that exceed 1 percent of their FTI; and
- Nearly 30 other miscellaneous provisions that individually have a relatively small impact on Virginia revenues and, collectively, largely "net-out" to have only a small

total impact. This includes provisions such as the treatment of ABLE accounts, disaster casualty losses, and the discharge of student loan debt.

Other Provisions

This bill would reduce the Virginia disallowed business interest deduction, from 50 to 40 percent of the business interest disallowed on the federal return. This bill would also permanently reinstate the Virginia eligible educator expenses deduction, extend the sunset date for the elective pass-through entity tax ("PTET") permanently—including the applicable provisions of the out-of-state tax credit, and make other technical corrections.

This bill contains an emergency clause that provides that it would be effective from its passage.

Similar Bills

SB 664 would conform Virginia to the IRC as it existed January 1, 2026, with certain exceptions. Rolling conformity would be retained but would remain paused with limited exceptions for extenders.

cc : Secretary of Finance

Date: 01/26/2026 JLOF
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