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Obscure Federal Tax Provision Could Cost Virginia \$119 Million in FY09-11

RICHMOND – An obscure business tax break in the recent federal economic recovery package threatens to cost Virginia and most other states billions of dollars over the next couple of years, according to a report from the Washington, DC-based Center on Budget and Policy Priorities. But state lawmakers can take simple steps to prevent the loss.

“We have already made difficult cuts to close our budget shortfall, and this unnecessary tax break would just make that shortfall bigger” said Michael Cassidy of the Commonwealth Institute for Fiscal Analysis. “Schools, health care, public safety, and other state-funded services will suffer if Virginia fails to act.”

Since Virginia’s tax code is based on federal law, the cut in federal taxes could reduce Virginia revenues as well as federal revenues. While it is impossible to predict any state’s actual revenue loss, the report estimates that Virginia could lose approximately \$119 million in revenue in fiscal years 2009-2011.

The provision in question is generally referred to as the “cancellation of debt income” (CODI) provision. When a business is able to repurchase its debt on the open market at a discount, it must count the amount of that discount as taxable CODI. The CODI provision allows businesses that buy back their debt at a discount to wait four years before beginning to pay taxes on the income the discount represents.

Revenue losses will be concentrated in the 2010 fiscal year — which in Virginia begins July 1, 2009 and the year after that.

Virginia can easily avoid this significant revenue loss. Lawmakers can amend state tax laws to “decouple” their definition of gross income from the new CODI provision.

Already, other states are beginning to decouple from this provision. Florida, Maryland and Minnesota have enacted legislation to decouple, and other states are considering doing the same. All other states except Nevada, Texas, Washington, and Wyoming could be adversely affected if they fail to decouple.

“Given the enormity of our budget problems, it makes no sense for Virginia to sit back and allow this obscure federal tax provision to eat into our already dramatically declining revenues,” said Cassidy. “Policymakers should take action immediately.”

Breaking the link between a state’s tax code and a federal provision is not unusual. In recent years, more than 30 states, including Virginia, have taken similar action to avoid a revenue loss arising from the “bonus depreciation” tax provision of previous federal recovery bills.

State revenue loss resulting from the CODI provision would come at the worst possible time. Policymakers already made significant spending cuts this past General Assembly session and are poised to make more as revenues continue to come in below expectations.

About The Commonwealth Institute

The Commonwealth Institute for Fiscal Analysis provides credible, independent and accessible information and analyses of state fiscal issues with particular attention to the impacts on low- and moderate-income persons. Our products inform state fiscal and budget policy debates and contribute to sound decisions that improve the well-being of individuals, communities and Virginia as a whole. The Commonwealth Institute is a program of the Virginia Interfaith Center for Public Policy.

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