



TAX BULLETIN 11-1
Virginia Department of Taxation
February 18, 2011

IMPORTANT INFORMATION REGARDING
2010 VIRGINIA INCOME TAX RETURNS

VIRGINIA INCOME TAX FIXED-DATE CONFORMITY
ADVANCED TO DECEMBER 31, 2010

Under emergency legislation (House Bill 1874; Chapter 2 of the 2011 Acts of Assembly) passed by the 2011 General Assembly and signed by Governor McDonnell, Virginia's fixed-date of conformity to the terms of the Internal Revenue Code will advance from January 22, 2010 to December 31, 2010. This notice is intended to provide taxpayers with directions on how to reconcile this legislation with their 2010 Virginia income tax returns. This legislation extends the temporary increase in the federal earned income tax credit (EITC) benefit to taxable year 2010 and extends the treatment adopted for cancellation of debt transactions occurring in 2009 to transactions completed on or before April 21, 2010.

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 each year. In 2010, a provision was enacted that fixed Virginia's conformity to Internal Revenue Code terminology to the Internal Revenue Code as it existed on January 22, 2010. Because of changes in federal law since that date, some taxpayers would have had to make adjustments to their federal adjusted gross income or federal taxable income through the fixed-date conformity adjustments on the 2010 income tax return. This bulletin informs taxpayers about which fixed-date conformity adjustments are still necessary for their 2010 income tax returns, if applicable.

Impact of Federal Legislation on 2010 Virginia Income Tax Returns

By advancing Virginia's date of conformity to December 31, 2010, Virginia conforms to five significant measures enacted by Congress since January 22, 2010, which affect income taxation in Virginia:

- The Amendment in Nature of a Substitute to the Reconciliation Act (H.R. 4872), in combination with the Patient Protection and Affordable Care Act (H.R. 3590), which expand healthcare coverage and provide several tax-related requirements and incentives;
- The Hiring Incentives to Restore Employment Act (H.R. 2847), which extends the increase in expensing of certain depreciable business assets;
- The Education Jobs and Medicaid Assistance Act (H.R. 1586), which modifies certain affiliation rules;
- The Small Business Jobs and Credit Act of 2010, which improves access to credit for small businesses and reduces the amount subject to capital gains taxes; and
- The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which extends certain tax provisions scheduled to expire in 2010.

Conformity to the Internal Revenue Code for Taxable Year 2010

Effective for taxable years beginning on and after January 1, 2011, Virginia's fixed-date of conformity to the terms of the Internal Revenue Code ("IRC") will advance from January 22, 2010, to December 31, 2010, with limited exceptions. Virginia will continue to disallow any 5-year carry-back of net operating losses ("NOL") allowed for NOLs generated in either taxable year 2008 or 2009.

Bonus Depreciation

Virginia will continue to disallow any bonus depreciation allowed for certain assets under Internal Revenue Code ("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' fixed-date conformity 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 ("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 not conform to this federal tax provision.

Cancellation of Debt Income

Virginia will continue to disallow 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. Under IRC § 108(i), the income realized upon the reacquisition of certain business debt during 2009 and 2010 may be deferred and reported in taxable years 2014 through 2018.

For taxable year 2009 purposes, a partial deferral of some of these exclusions will be allowed for specified debt reacquired in taxable year 2009. Taxpayers that defer cancellation of debt income from transactions in 2009 on their federal returns will continue to be able to elect to report the addition required by conformity in equal amounts over three taxable years: 2009, 2010 and 2011.

For taxable year 2010, Virginia will extend the treatment of deferral of cancellation of debt to transactions completed on or before the adoption of the Appropriations Act on April 21, 2010 (Chapter 874 of the 2010 Acts of Assembly). Because the change to the Virginia treatment of this income was not fully known until the Appropriations Act was passed by the General Assembly at its reconvened session on April 21, 2010, the treatment adopted for transactions occurring in 2009 is extended to transactions completed on or before April 21, 2010. The income from qualifying transactions may elect to report it in equal amounts over three taxable years: 2010, 2011, and 2012.

Domestic Production Deduction

Virginia will continue to partially deconform from the domestic production deduction allowed under IRC § 199 for taxable years 2010 and thereafter. The federal domestic

production deduction is equal to 9% of qualified production activities income of the taxpayer in 2010 and thereafter. Instead of allowing the full amount of this deduction to flow through, Virginia will allow a deduction equal to two-thirds of the federal deduction. This is equivalent to allowing a deduction of 6% of the qualifying income as had been allowed in taxable years 2008 through 2010.

Earned Income Tax Credit

Under House Bill 1874, signed by Governor McDonnell, for purposes of computing the Virginia low-income tax credit, Virginia will conform to the temporary increase in the federal earned income tax credit (EITC) under IRC § 32(b)(3) for taxable year 2010. Although the EITC increase was extended to taxable year 2011 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Virginia law does not presently conform to this change for taxable year 2011. However, the General Assembly will have the opportunity to consider conforming to the extension during the 2012 session.

Instructions for Taxpayers

Individuals and corporations should consult the instructions for the appropriate 2010 Virginia income tax return for information about how to properly add back income related to bonus depreciation, applicable high yield discount obligations, and domestic production expenses that are deducted for federal income tax purposes. In addition, individuals and corporations who have already filed a 2010 Virginia income tax return but need to make a fixed-date conformity adjustment should consult the instructions for the appropriate income tax return for further information about filing an amended return.

Taxpayers with Cancellation of Debt Income

For Virginia income tax purposes, a partial deferral of some of the income tax deductions related to cancellation of debt income realized in connection with a reacquisition of business debt at a discount will continue to be allowed for specified debt reacquired for part of taxable year 2010. This change is not reflected in the form instructions. For taxable year 2010, taxpayers with cancellation of debt income resulting from transactions on or before April 21, 2010, may elect to report the addition required by conformity in equal amounts over three taxable years: 2010, 2011 and 2012. Taxpayers must add back the entire amount of any cancellation of debt income resulting from transactions after April 21, 2010.

Taxpayers that deferred cancellation of debt income for transactions in 2009 on their federal returns are allowed to elect to report the addition required by conformity in equal amounts over three taxable years: 2009, 2010 and 2011. For taxpayers that reported the addition for cancellation of debt income in taxable year 2009, the same addition amount should be reported in taxable years 2010 and 2011.

For individuals, the addition for cancellation of debt income should be entered on Line 2 on the Form 760PY ADJ (for part-year residents), on Line 2 on the Form 763 ADJ (for nonresidents), or as Code 13, on Line 2 of the Schedule ADJ (for residents). For corporations, this addition should be entered as Code 15 on the Schedule 500 ADJ. Finally, this addition should be entered on Line 3 of Schedule 3 of the Form 770 for fiduciaries or as Code 17 on the Schedule 502 ADJ for pass-through entities.

Further Instructions

If you have additional questions, please visit our website at <http://www.tax.virginia.gov>, or contact us at (804) 367-8031 for individual income tax questions or (804) 367-8037 for corporate income tax questions.