

Details of Gov. Youngkin's Proposed Conformity

Federal tax changes and how they could impact Virginia's resources

Business tax changes: Many of the most costly federal tax changes benefit businesses and corporations, and their wealthy shareholders. Governor Youngkin proposes to adopt many of these changes at a significant cost to the state budget. Lawmakers should avoid doubling down on the misguided federal changes, and decouple from business tax changes. This could free up significant revenues that will allow us to meet the needs of communities across Virginia.

Business interest deduction: Back in 2017, the Tax Cuts and Jobs Act (TCJA) imposed new limits on the deductibility of expenses related to net business interest. This limit tightened further in 2022 through the expiration of a rule that effectively raised limits for some businesses. Virginia conformed to both changes but allowed businesses to deduct some business interest that was not allowed to be deducted at the federal level, up to 50% starting in 2024.

H.R.1 loosens the rules at the federal level and adds some new exceptions. Gov. Youngkin proposed to conform to these changes on top of recent state actions favoring the deduction of business interest. Especially with the additional state-level deduction, lawmakers do not need to further loosen the cap on business interest deductibility and should maintain current state rules. (-\$30.8 million in the governor's proposed FY27-28 budget (HB30)).

Deductibility of domestic research and experimentation expenses: Changes made in 2017 required businesses to write off their research expenses over five years, rather than immediately, recognizing that the benefits of research and development are not instant. H.R.1 now allows for the immediate write-off of research expenses, and makes the policy retroactive to 2021 for certain businesses. This gives corporations a windfall, rewarding them for investments that have already happened.

While Gov. Youngkin's proposed budget does not adopt the retroactive provisions, it still allows for the immediate write-off of research expenses moving forward. Virginia lawmakers should instead maintain the five-year reporting requirement and not grant companies immediate tax benefits before the economic benefits of their research spending can even be realized. (-\$163.1 million in the governor's proposed FY27-28 budget (HB30)).

Special depreciation allowance: The reconciliation package allows businesses to write off the full cost of certain property in the first year it is placed in service (100% "bonus" depreciation) as well as creates new 100% write-offs for specific industries, rather than writing off the depreciation of these assets over time.

Virginia, like most other states, has not conformed to similar "bonus depreciation" measures in the past. Even so, the governor proposes to break precedent and allow 50% of the "bonus depreciation," giving tens of millions away to corporations despite the state's historical abstention from such tax changes. Virginia should fully decouple from this federal policy choice. (-\$177.6 million in the governor's proposed FY27-28 budget (HB30)).

Section 179 expensing limit: At the federal level, some businesses are allowed to deduct 100% of the cost of a limited amount of tangible personal property, software, and qualified improvement property under Section 179 of the tax code, regardless of the broader availability at any point in time of 100% bonus depreciation. H.R. 1 doubles this limit to \$2.5 million, and sets a higher phase-out for high-cost purchases.

The governor proposes to accept this limit increase for businesses with the ability to make large purchases, at the cost of state revenues that could be invested in community priorities. To avoid additional revenue loss, Virginia should maintain the previous Section 179 expensing limit and decouple from the federal change. (-\$35.4 million in the governor's proposed FY27-28 budget (HB30)).

Changes to charitable and itemized deductions: Charitable and itemized deductions are more often utilized by higher-income filers. While Gov. Youngkin proposes to conform to new floors on charitable deductions that would result in revenue gains, he also proposes to repeal an existing state limit on itemized deductions, delivering a tax break to high-income households. Lawmakers should maintain the charitable deduction floor while keeping the stronger state limit on itemized deductions in order to rein in benefits for high-income filers while protecting state revenues.

Charitable Deduction Floors: Tax changes in the reconciliation package passed in summer 2025 created a new charitable deductions floor for corporations and individuals who itemize deductions rather than take the standard deduction. H.R.1 sets a new floor for the value of charitable deductions excluded from the deduction: 0.5% of federal adjusted gross income (FAGI) for individual filers and 1% of federal taxable income (FTI) for corporate filers. As this excludes some of the value of charitable deductions taken, it will result in a revenue gain.

State-level charitable deductions are known to be an ineffective policy. Adding a floor will, in theory, encourage larger charitable gifts and avoid rewarding filers for modest donations they would make anyway. Virginia should conform to these changes. As high-income filers itemize far more often, conforming will help better orient our tax code towards fairness as well as provide an increase in revenues. The governor's budget proposes to conform to these changes. (+\$99.8 million in the governor's proposed FY27-28 budget (HB30)).

Limit for itemized deductions: Back in 2017, federal legislation suspended a rule that helped limit the amount of itemized deductions for high-income filers. The former limit rules were often called the "Pease" limitation. Virginia lawmakers aptly chose not to conform to the federal repeal of the "Pease" limit, helping to limit the repeal's ability to further benefit high-income filers in Virginia.

H.R.1 implements a new limit on itemized deductions for high-income filers, however, Virginia's "Pease" limit is stronger. While the updated federal policy provides some limits on the benefit of itemized deductions for some high-income filers, the Pease rule still active in Virginia does a better job at this. Despite this, the governor proposes to repeal Pease and adopt the new federal limit for itemizers. Virginia should retain the

stronger Pease limitation to better limit tax breaks for high-income households and protect revenues. (-\$54.0 million in the governor's proposed FY27-28 budget (HB30)).

Further opportunity for detachment: The conformity debate presents lawmakers a greater opportunity to reexamine our relationship with the federal tax code where it gives special treatment to certain types of capital gains. Two programs in particular — Qualified Small Business Stock and Opportunity Zones — offer large benefits to wealthy investors with little evidence of public benefit.

Qualified Small Business Stock (QSBS): Despite its benevolent sounding name and perhaps earlier intention, the Qualified Small Business Stock (QSBS) exemption provides huge windfalls to the richest among us and does little to encourage investment in small businesses. QSBS allows large portions of capital gains on qualifying stock to be excluded from taxation. Stock must be original issuances from C-corporations, excluding the many small businesses that file taxes in other ways, such as a sole proprietorship. Almost all QSBS benefits (94%) go to households with \$1 million or more in income. H.R. 1 expands the exemption and relaxes holding requirements, increasing benefits for wealthy investors.

Virginia currently conforms to QSBS, and the governor's proposed budget conforms to the changes to QSBS, giving those benefiting from this policy an even greater windfall. Virginia should not conform to H.R. 1's increased exemption limit and should instead decouple from QSBS altogether. As with other conformity provisions, there is no guarantee that the investment a filer seeks to exempt from taxation is located in Virginia. Virginia is likely giving tax exemptions on investments made in other states. Decoupling from both the QSBS expansion and the exemption altogether would generate revenue for Virginia, an estimated \$28.4 million in 2026, while advancing greater fairness in our tax code. (Unknown negative revenue impact in the governor's proposed FY27-28 budget (HB30). Decoupling as a whole would result in an estimated \$28.4 million in 2026).

Opportunity Zones (OZs): The 2017 tax law (TCJA) created the opportunity zone program, allowing investors to defer and exclude some capital gains tax if they invested in an 'opportunity zone' fund, which focuses on areas identified as economically distressed. Virginia conforms to this provision. There has been little evidence that opportunity zones have significant impacts on the communities they are designated to help, all the while giving the wealthy more tax break opportunities. The program was originally set to end in 2026. H.R.1 restructured the program and made it permanent.

The governor proposes to conform to these changes. Instead, Virginia lawmakers should not only decouple from updates to the opportunity zones program rules but also from the special treatment of capital gains it allows. This gives Virginia the opportunity to end the special treatment of capital gains invested in opportunity zones. Current conformity allows taxpayers to claim benefits for investments anywhere in the country, rewarding out-of-state investment at Virginia's expense. (-\$4.1 million in the governor's proposed FY27-28 budget (HB30). Decoupling as a whole would result in a positive revenue impact).