

DEPARTMENT OF TAXATION

2022 Fiscal Impact Statement

1. **Patron** Vivian E. Watts

3. **Committee** House Finance

4. **Title** Income Taxation; Pass-Through Entity SALT
Cap Workaround

2. **Bill Number** HB 401

House of Origin:

X **Introduced**

 Substitute

 Engrossed

Second House:

 In Committee

 Substitute

 Enrolled

5. **Summary/Purpose:**

This bill would permit a qualifying pass-through entity ("PTE") to make an annual election for Taxable Years 2021 through 2025 to pay an elective income tax at a rate of 5.75 percent at the entity level. The bill would also allow a corresponding individual income tax subtraction for Taxable Years 2021 through 2025 for any amount of income derived from a PTE having Virginia taxable income if such PTE makes the election and pays the elective income tax imposed at the entity level. The effect of such elective income tax and corresponding subtraction would be to allow the PTE to pay income tax rather than its owners and, thereby, enact a Virginia PTE workaround to the \$10,000 cap on the federal deduction for state and local taxes paid.

This bill would be effective for taxable years beginning on and after January 1, 2021, but before January 1, 2026. This sunset date coincides with the currently scheduled expiration date for the \$10,000 cap on the federal deduction for state and local taxes paid.

6. **Budget amendment necessary:** Yes.

Item(s): 274 and 276, Department of Taxation

7. **Fiscal Impact Estimates are:** Preliminary. (See Line 8.)

7a. **Expenditure Impact:**

<i>Fiscal Year</i>	<i>Dollars</i>	<i>Positions</i>	<i>Fund</i>
2022-23	\$487,600	1	GF
2023-24	\$106,223	1	GF
2024-25	\$106,223	1	GF
2025-26	\$106,223	1	GF

8. **Fiscal implications:**

Administrative Costs

In order to implement this bill for Taxable Year 2022 and after, the Department of Taxation ("the Department") would incur costs of \$487,600 in Fiscal Year 2023 and \$106,223 in Fiscal Year 2024, Fiscal Year 2025, and Fiscal Year 2026. These costs would be

associated primarily with hiring one full-time employee, developing and modifying forms for the electing PTE to file a return showing a tax due, and programming the Department's systems to accept and process returns and payments. Individual income tax returns and systems would also be required to be revised to handle the related individual income tax subtraction that PTE owners would be eligible to claim. One full-time employee and related costs would be needed to handle expected errors and questions from the PTEs and their owners.

As introduced, this bill would be effective for Taxable Year 2021, returns for which are currently being filed. Because PTEs are not currently taxed, the systems work is equivalent to that which would be required to implement a new tax. PTEs filing on a calendar year basis would be required to make the election no later than October 17, 2022, which is the extended due date for calendar year filers. It is not feasible for the Department to have the necessary forms and payment processing systems in place by then. These issues could also cause the administrative costs to exceed the estimates provided above. See Line 10 for suggested amendments to resolve this timing issue.

Revenue Impact

This bill would have an unknown, but likely minimal, General Fund revenue impact beginning in Fiscal Year 2023. While the elective entity level tax proposed by this bill would generate additional revenue from electing PTEs, any such revenue would generally be offset by the subtractions claimed by the owners of such PTEs. Therefore, any revenue impact is expected to be minimal.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: Yes.

Several technical and administrative issues currently left unresolved by the bill would need to be addressed before the elective entity-level tax could be properly implemented. These include, but are not limited to, issues relating to how the new elective entity-level tax would interact with Virginia's existing pass-through entity withholding tax, the number of owners who must consent to validly make this election, and the application of apportionment and allocation for interstate PTEs. To allow the Department to provide guidance to address these issues and others that may arise, we suggest a technical amendment that would grant the Department the authority to develop and make publicly available guidelines implementing the provisions of this bill.

In addition, as explained on Line 8, this bill would be effective for Taxable Year 2021, returns for which are currently being filed. Because of the many system changes that would be necessary, the Department would not be able to implement this bill for the Taxable Year 2021 filing season. PTEs filing on a calendar year basis would be required to make the election no later than October 17, 2022, which is the extended due date for calendar year filers. Because the system changes could not be implemented by October 17, 2022, the Department recommends a technical amendment that would make this bill effective beginning with Taxable Year 2022.

11. Other comments:

Cap on the Deduction for State and Local Taxes Paid

The federal Tax Cuts and Jobs Act limited the itemized deduction for state and local taxes paid (“SALT”) to \$10,000 for taxable years beginning after December 31, 2017, and before January 1, 2026. Since then, Maryland and several other states have enacted laws to work around this limitation for owners of PTEs. These laws have become commonly known as “PTE SALT cap workarounds.”

A PTE is generally not taxed on its income. Instead, the PTE’s income is reported by its owners, which then pay federal and state income taxes on their share of such income. However, any state tax paid by individual owners would be subject to the new \$10,000 limitation. Therefore, any individual owners would not be able to deduct their state tax in excess of \$10,000. State PTE SALT workarounds generally:

- Allow a PTE to elect to pay state tax on its income; and
- Offer the individual owners of the PTE either a credit (e.g., Michigan) or a deduction (e.g., Georgia), the effect of which is to exempt such owners from tax on the PTE’s income.

For federal income tax purposes, transferring the state tax burden from the individual owner to the PTE can be beneficial because, unlike its individual owners, the PTE itself is not subject to the \$10,000 limitation and is entitled to deduct an unlimited amount of state tax. Therefore, this tax planning technique allows the individual owners to avoid the \$10,000 limitation on their federal returns.

Originally, the legality of PTE SALT cap workarounds under federal tax law was uncertain. However, on November 9, 2020, the U.S. Department of Treasury and the Internal Revenue Service issued Notice 2020-75, which provided preliminary approval to PTE workaround structures and stated an intent to promulgate federal regulations on this issue in the future. As of January 2022, such regulations have yet to be promulgated.

Ruling on Maryland’s PTE SALT Cap Workaround

On December 29, 2021, the Department issued a ruling, published as P.D. 21-156, holding that a Virginia resident could not claim the credit for tax paid to Maryland by certain PTEs that have elected to use Maryland’s PTE SALT cap workaround. Maryland law expressly provides that when the PTE makes the election, the tax is treated as a tax imposed on the PTE itself. Maryland allows the owners of an electing PTE to claim their share of the tax paid by the PTE as a credit on each owner’s income tax return.

Virginia’s law granting the credit for income tax paid to another state allows it only for taxes paid by the resident. While the law allows the credit to shareholders of an S corporation for taxes paid by the corporation, taxes paid by other types of PTE to other states are not allowed as a credit on their owner’s Virginia return. As introduced, this bill

would not modify the current rules regarding Virginia's credit for income tax paid to another state.

Proposed Legislation

This bill would permit a qualifying PTE to make an annual election for Taxable Years 2021 through 2025 to pay an elective income tax at a rate of 5.75 percent at the entity level. The bill would also allow a corresponding individual income tax subtraction for Taxable Years 2021 through 2025 for any amount of income derived from a PTE having Virginia taxable income if such PTE makes such election and pays the elective income tax imposed at the entity level. The effect of such elective income tax and corresponding subtraction would be to allow the PTE to pay income tax rather than its owners and enact a Virginia PTE SALT cap workaround.

The election would be required to be made on the PTE's timely filed return, which could be as much as six months after the normal due date for returns if the PTE avails itself of the extension for filing returns. As a result, the owners of an electing PTE could be required to wait until the PTE files its Virginia return to learn whether they can claim the subtraction that would be allowed by this bill. This would be similar to what occurs under current law, where owners of a PTE must wait until they receive Form VK-1 from the PTE to learn all of the income and deductions that pass through to them from the PTE.

This bill would be effective for taxable years beginning on and after January 1, 2021, but before January 1, 2026. This sunset date coincides with the currently scheduled expiration date for the \$10,000 cap on the federal deduction for state and local taxes paid.

Similar Legislation

House Bill 1121 and **Senate Bill 692** are identical to this bill.

cc : Secretary of Finance

Date: 2/3/2022 JPJ
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