

DEPARTMENT OF TAXATION

2022 Fiscal Impact Statement

1. **Patron** J. Chapman Petersen

2. **Bill Number** SB 692

3. **Committee** Passed House and Senate

House of Origin:

 Introduced

 Substitute

 Engrossed

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

Second House:

 In Committee

 Substitute

 X **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 refundable income tax credit for Taxable Years 2021 through 2025 for any amount of income tax paid by 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 refundable credit 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. Because the filing season for Taxable Year 2021 is already under way, this bill would require the Department of Taxation to delay the election for at least 12 months, and prevent interest from accruing on underpayments or overpayments solely attributable to the delayed election. This bill would also allow an individual to claim a credit for similar taxes paid to other states for Taxable Years 2021 through 2025.

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	\$793,390	2	GF
2023-24	\$179,123	2	GF
2024-25	\$179,123	2	GF
2025-26	\$179,123	2	GF

8. Fiscal implications:

Administrative Costs

In order to implement this bill for Taxable Year 2021 and after, the Department of Taxation ("the Department") would incur costs of \$793,390 in Fiscal Year 2023 and \$179,123 in Fiscal Year 2024, Fiscal Year 2025, and Fiscal Year 2026. These costs would be associated primarily with 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 from PTE. Individual and fiduciary income tax returns and systems would also be required to be revised to handle the related refundable credit that PTE owners would be eligible to claim. Ongoing costs in Fiscal Years 2024, 2025, and 2026 include hiring two full-time employees and related costs to handle anticipated errors and questions from the PTEs and their owners.

Revenue Impact

This bill would have an unknown, but likely minimal, General Fund revenue impact beginning as early as 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 refundable credits claimed by the owners of such PTEs and the credits for similar taxes paid to other states. Therefore, any revenue impact is expected to be minimal.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

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. Notice 2020-75 did not specifically address PTE workaround structures that would apply on a retroactive basis. 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. A qualifying PTE would be one whose owners are all natural persons or, in the case of PTE that are S corporations, certain estates and trusts that are permitted to own S corporation shares. The bill would also allow a corresponding refundable individual or fiduciary income tax credit for Taxable Years 2021 through 2025 for any amount of income tax paid by 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 refundable credit 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 annually 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. However, due to the timing of the legislation, the bill would require the Department to allow PTEs to file their 2021 return by the normal due date without making an election and delay making the election for at least 12 months after the extended due date for the PTE's 2021 return. This would effectively delay the election due date for Taxable Year 2021 until at least October 15, 2023. As a result, the owners of an electing PTE would be required to wait until the PTE files an amended Virginia return making the election to learn whether they can claim the credit 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 tax attributes that pass through to them from the PTE.

Because of the delay in electing this treatment for Taxable Year 2021, the bill would prohibit the accrual of interest on underpayments by the PTE and overpayments by the owners that are solely attributable to the election authorized by this bill. This bill would not otherwise prevent the accrual of interest on underpayments under current law and, therefore, pass-through entities and their owners would need to file their Taxable Year 2021 returns and make all required payments under existing law as if no such election existed. If the election is later made, electing pass-through entities and their owners would need to file amended returns and would be entitled to claim a refund to the extent that they are eligible for the credit for taxes paid by the PTE.

Penalties similar to corporate income tax penalties would be imposed on PTE that make the election but fail to pay the tax.

In addition, this bill would allow taxpayers to claim a credit on their individual income tax return for similar taxes paid to other states for Taxable Years 2021 through 2025. This provision would overrule Public Document 21-156 (December 29, 2021), which denied a credit for a similar tax paid to Maryland due to the application of current law.

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 is identical to this bill.

cc: Secretary of Finance

Date: 03/23/2022 JPJ
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