

DEPARTMENT OF TAXATION

2004 Fiscal Impact Statement

1. **Patron** David B. Albo

2. **Bill Number** HB 149

3. **Committee** House Finance

House of Origin:

 X **Introduced**

 Substitute

 Engrossed

4. **Title** Income Tax; Filing of Information Returns
By Pass-through Entities

Second House:

 In Committee

 Substitute

 Enrolled

5. **Summary/Purpose:**

This bill would require business entities that are not subject to federal and state income taxes at the entity level, such as partnerships, limited liability companies and Subchapter S Corporations, to file annual informational returns with the Department of Taxation setting forth their income and a list of their owners.

The provisions of this bill would be effective for taxable years beginning on or after January 1, 2004

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

6a. **Expenditure Impact:**

<i>Fiscal Year</i>	<i>Dollars</i>	<i>Positions</i>	<i>Fund</i>
2003-04	\$0	0	GF
2004-05	\$1.3 million	9	GF
2005-06	\$0.7 million	12	GF
2006-07	\$0.5 million	12	GF
2007-08	\$0.5 million	12	GF
2008-09	\$0.5 million	12	GF

6b. **Revenue Impact:**

<i>Fiscal Year</i>	<i>Dollars</i>	<i>Fund</i>
2003-04	\$0	GF
2004-05	\$2.0 million	GF
2005-06	\$6.0 million	GF
2006-07	\$7.9 million	GF
2007-08	\$7.9 million	GF
2008-09	\$7.9 million	GF
2009-10	\$7.9 million	GF

7. **Budget amendment necessary:** No.

8. Fiscal implications:

Administrative Costs

The Department would incur administrative costs of \$1.3 million in FY 2005, \$654,852 in FY 2006, \$526,626 in FY 2007, \$518,346 in FY 2008 and \$527,732 in FY 2009. Included in these administrative costs are costs for additional full time employees to be used in customer service, compliance, and systems functions. Other costs are for forms and systems development. The Governor's tax reform plan contains identical provisions to require the filing of informational returns by pass-through entities. The Governor's tax reform plan contains provisions for the filing of informational returns by pass-through entities that are identical to this bill. Therefore, the administrative costs of this bill are identical to the costs assumed in the Executive Budget.

Revenue Impact

Compared to current law, this bill is estimated to increase General Fund revenues by \$2 million in FY 2005, \$6 million in FY 2006 and \$7.9 million in FY 2007 and each fiscal year thereafter. As this bill is identical to the pass-through entity filing provisions in the Governor's tax reform proposal, the increased General Fund revenues generated by this bill are assumed in the Executive Budget.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Background on Pass-through Entities

Pass-through entities are business entities, such as partnerships, limited liability companies and Subchapter S corporations, that are not subject to federal and state income taxes at the entity level. The partners, members or shareholders (the "owners") of the pass-through entity report their share of the income from the entity on their own income tax returns.

Under current law, the owners of pass-through entities are liable for Virginia income taxes on Virginia source income. However, the Department does not have an effective way of identifying these owners and verifying that they have properly paid tax on Virginia income. The revenue loss attributable to noncompliance on the part of the owners of pass-through entities has grown with the increased popularity of pass-through entities.

Pass-through entities are currently required to file informational returns with the IRS and most other states. Virginia formerly required partnerships to file such returns, but repealed the practice in 1988. New technology will enable the Department to effectively

utilize the proposed informational returns to ensure that the owners of pass-through entities properly report and pay tax on Virginia income.

Proposal

This proposal would require every pass-through entity doing business in Virginia or having income from Virginia sources to file an annual informational return with the Department listing its income and owners.

This proposal would authorize the Department to establish an income threshold for the filing requirement. Pass-through entities with income below this threshold would not be required to file returns. This proposal would also allow pass-through entities to apply to the Department to file a single composite return for all nonresident shareholders. These provisions would help reduce the compliance burden on affected taxpayers.

Under this proposal, entities would be required to file returns using an electronic medium prescribed by the Department. However, the Department would be authorized to waive this requirement for businesses with small numbers of owners.

This proposal would impose a penalty for failure by the pass-through entity to file the return. The penalty would be \$200 for each month or fraction thereof during which such failure to file continues, not exceeding six months in the aggregate. In no case would the penalty be less than \$200. In the event that the entity's failure to file the return exceeds six months, the penalty would be six percent of the total amount of Virginia taxable income derived by its owners from the pass-through entity for the taxable year. The six percent penalty would be reduced by the amount of the \$200 monthly penalty and any tax paid by the owners on their share of the income from the pass through entity for the taxable year.

Officers or owners who make fraudulent returns or statements with the intent of assisting or facilitating the evasion of the payment of the taxes would face a civil penalty of not more than \$1,000 and a Class 6 felony. Officers or owners who willfully fail or refuse to make a return would face a Class 1 misdemeanor.

This proposal would be effective for taxable years beginning on or after January 1, 2004.

Other Legislation

House Bill 1081 and **Senate Bill 467** contain provisions identical to this bill.

Senate Bill 530, **Senate Bill 635** and **Senate Bill 589** would require pass-through entities to file annual informational returns with the Department of Taxation setting forth their income and a list of their owners.

cc : Secretary of Finance

Date: 1/31/2004 JEM