DEPARTMENT OF TAXATION
2023 Fiscal Impact Statement

1. **Patron** Joseph P. McNamara

2. **Bill Number** HB 1456

   House of Origin:
   _____ **Introduced**
   _____ **Substitute**
   _____ **Engrossed**

   Second House:
   X **In Committee**
   _____ **Substitute**
   _____ **Enrolled**

3. **Committee** Senate Finance and Appropriations

4. **Title** Pass-through Entity Tax Changes

5. **Summary/Purpose:**

This bill would make the following changes to the elective pass-through entities tax ("PTET"):

- Remove the requirement that a pass-through entity ("PTE") be 100 percent owner by natural persons or persons eligible to be shareholders of an S corporation in order to make the PTET election;
- Define "eligible owner" as a direct owner of a pass-through entity who is a natural person or an estate or trust; and
- State that only the pro rata or distributive share of income, gain, loss, or deduction attributable to eligible owners would be subject to the PTET.

These changes would be effective for taxable years beginning on and after January 1, 2021. If enacted during the 2023 regular session of the General Assembly, this bill would become effective July 1, 2023.

6. **Budget amendment necessary:** Yes.
   Items: 274 and 276, Department of Taxation

7. **Fiscal Impact Estimates are:** Unknown. (See Line 8.)
   7a. Expenditure Impact:

Fiscal Year	***Dollars***	***Positions***	***Fund***
2022-23	$5,280	0	GF
2023-24	$405,750	0	GF

8. **Fiscal implications:**

Administrative Costs

This bill would result in administrative costs to the Department of Taxation ("the Department") of $5,280 in Fiscal Year 2023 and $405,750 in Fiscal Year 2024. These costs would be incurred for purposes of updating the Department's systems and expanded electronic filing functionality for return submissions. The Department's current processes would need to be updated to accommodate the anticipated increase in the number of taxpayers eligible to make the PTET election under this bill. In addition, since this bill is retroactive, software vendors may not make significant changes to the returns already being filed for Taxable Year 2022. Accordingly, the Department would need to develop new electronic filing functionality to allow entities to file their returns and make the election. This new functionality may not be available until later in the year.

Revenue Impact

This bill would have a minimal General Fund revenue impact. The PTET shifts the tax burden rather than increase or decrease it. While this bill would increase the number of pass-through entities that are eligible for the PTET and thus generate additional revenue from electing PTEs, any such revenue would generally be offset by the refundable credits 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: 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 itemized deduction 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.

Virginia's Pass-Through Entity Tax

During the 2022 Session, the General Assembly enacted legislation to permit a qualifying PTE to make an annual election to pay an elective income tax at a rate of 5.75 percent at the entity level. A qualifying PTE is one whose owners are all natural persons or, in the case of PTEs that are S corporations, certain estates and trusts that are permitted to own S corporation shares. The 2022 legislation also allows a corresponding refundable income tax credit to certain PTE owners for income paid by a PTE if such PTE makes the election and pays the elective income tax imposed at the entity level. The effect of PTET and corresponding refundable credit is to offer taxpayers a workaround to the $10,000 cap on the federal deduction for state and local taxes paid.

The legislation allows an individual to claim a credit for taxes paid to other states under laws that are substantially similar to Virginia's PTET.

Proposed Legislation

This bill would make the following changes to the elective pass-through entities tax ("PTET"):

- Remove the requirement that a pass-through entity be 100 percent owner by natural persons or persons eligible to be shareholders of an S corporation in order to make the PTET election;
- Define "eligible owner" as a direct owner of a pass-through entity who is a natural person or an estate or trust; and
- State that only the pro rata or distributive share of income, gain, loss, or deduction attributable to eligible owners would be subject to the PTET.

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Similar Legislation

Senate Bill 1476 is identical to this bill.

cc : Secretary of Finance

Date: 2/7/2023 JLOF
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