

DEPARTMENT OF TAXATION

2007 Fiscal Impact Statement

1. **Patron** Mark D. Obenshain

2. **Bill Number** SB 1238

3. **Committee** Senate Finance

House of Origin:

 X **Introduced**

 Substitute

 Engrossed

4. **Title** Withholding Tax for Pass-through Entities

Second House:

 In Committee

 Substitute

 Enrolled

5. **Summary/Purpose:**

This bill would require pass-through entities doing business in the Commonwealth and having taxable income derived from Virginia sources to pay a withholding tax equal to four percent of the Virginia taxable income allocable to nonresident owners. Each nonresident owner would be allowed a credit for that owner's share of the tax withheld by the pass-through entity.

This bill would be effective for taxable years beginning on or after January 1, 2007.

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

6a. **Expenditure Impact:**

<i>Fiscal Year</i>	<i>Dollars</i>	<i>Positions</i>	<i>Fund</i>
2006-07	\$0	0	GF
2007-08	\$220,506	2	GF
2008-09	\$425,617	2	GF
2009-10	\$207,426	2	GF
2010-11	\$203,926	2	GF
2011-12	\$201,216	2	GF
2012-13	\$199,227	2	GF

6b. **Revenue Impact:**

<i>Fiscal Year</i>	<i>Dollars</i>	<i>Fund</i>
2006-07	\$0	GF
2007-08	\$0	GF
2008-09	\$8.5 million	GF
2009-10	\$8.5 million	GF
2010-11	\$8.5 million	GF
2011-12	\$8.5 million	GF
2012-13	\$8.5 million	GF

7. **Budget amendment necessary:** Yes.

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8. Fiscal implications:

Administrative Costs

The Department would incur administrative costs of \$220,506 for FY 2008, \$425,617 for FY 2009, \$207,426 for FY 2010, \$203,926 for FY 2011, \$201,216 for FY 2012, and \$199,227 for FY 2013. These costs represent the amount needed for systems modifications, forms development, data capture, and compensation for the two additional full-time employees that would be required to effectively administer this new tax.

Please note that these administrative costs assume an effective date of January 1, 2008.

Revenue Impact

Pass-Through Entities ("PTE's") are required to file an information return that includes a schedule listing every owner and the income, deductions, credits, etc. allocated to that owner. TAX used this data from the 2004 tax year and restricted the population to exclude resident owners and all nonresident owners who currently comply with Virginia law by filing their own returns or by being included in a unified nonresident return.

For the non-resident, non-compliant owners, the taxable income was estimated from the data reported by PTE's and adjusted based on TAX's data from nonresident returns. The 4% withholding rate was then applied to the estimated taxable income for each non-resident, non-compliant individual and corporate owner. The total withholding generated was then reduced for revenue normally obtained through TAX's audit and collection efforts, data and filing errors, and non-compliance.

Net new revenue, taking into account the offsetting revenue losses from refunds for nonresident owners for whom withholding would cause an overpayment, would be approximately \$8.5 million per year.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: Yes.

The effective date of this bill must be changed to taxable years beginning on or after January 1, 2008, in order to allow time for TAX to issue guidelines (due by September 1, 2007 under the bill) and for pass-through entities to implement withholding changes. Some pass-through entities may already be making estimated payments for 2007 if they have elected to file unified nonresident returns, and would need to coordinate the change to a withholding system. Therefore, the following technical amendment is suggested:

Page 2, Line 101, after 1,
Strike: 2007
Insert: 2008

The amount to which the specified 4% withholding rate is applied must also be changed. The term "Virginia taxable income" is defined in Va. Code § 58.1-322 as federal adjusted gross income with all of the additions, subtractions and deductions specified in that section, which includes the personal exemption and itemized deductions. The PTE is unlikely to have information on each owner's itemized deductions; it will only know about the income it generated. The use of a 4% withholding rate, which is less than the highest income tax rate (5.75% for individuals and 6% for corporations), recognizes that many owners will have itemized and other deductions. In addition, over half of the twenty-five states that impose a withholding requirement on some or all types of PTE's state that the withholding applies to the owner's share of PTE income from state sources. These states include Arkansas, Colorado and Pennsylvania.

Page 1, Line 28, after the

Strike: Virginia taxable income

Insert: nonresident owner's share of income from Virginia sources

11. Other comments:

Current Law

The 2004 tax reform (House Bill 5018, Chapter 3, 2004 Acts of Special Session I) created a new requirement for pass-through entities. For taxable years beginning on or after January 1, 2004, these entities are now required to file an annual information return with TAX setting forth their income and a list of their owners. Pass-through entities can apply to the Department to file a single composite return for all nonresident shareholders.

Pass-through entities are required to file returns using electronic medium prescribed by the TAX. The Department, however, is authorized to waive this requirement for businesses with small numbers of owners. If a pass-through entity fails to file a return, a penalty is imposed in the amount of \$200 for each month or fraction thereof during which such failure to file continues, not exceeding six months in aggregate.

Other States

Based on information obtained from the 2006 Multistate Corporate Tax Guide, there are twenty-five states that require that some or all of the types of pass-through entities withhold taxes on distributions or distributive shares of income. The majority of these states, including Arkansas, Colorado and Pennsylvania, base this tax on income from state sources. Others, such as Maryland and Kansas, calculate the tax using taxable income and multiply this amount either by the highest marginal income tax rate or by a specified percentage (typically 5%).

Proposal

This bill would require pass-through entities doing business in the Commonwealth and having taxable income derived from or connected with Virginia sources to pay a withholding tax equal to four percent of the Virginia taxable income of all nonresident owners that may be lawfully taxed by the Commonwealth and that is allocable to a nonresident owner. This tax would be required to be paid when the pass-through entity's

annual information return is required to be filed. The Tax Commissioner could, however, require any pass-through entity to pay over to TAX the tax deducted and withheld at any earlier time or times if she believed it necessary for the protection of trust fund moneys due the Commonwealth.

When determining the amount of withholding tax due, the pass-through entity would be allowed to apply any tax credits allowable under the Code of Virginia to the pass-through entity that pass through to nonresident owners; provided that the application of any credit or credits could not reduce the tax liability of any nonresident owner to less than zero.

Withholding would not be required for any nonresident corporation that was exempt from the Virginia income tax. The pass-through entity would be allowed to rely on a written statement from the nonresident owner claiming to be exempt from the tax if the pass-through entity disclosed the name and federal taxpayer identification number for all such owners in its return for the taxable year.

In addition, withholding would not be required when it would cause undue hardship to the pass-through entity. The Tax Commissioner, in her discretion, would have to approve in writing the pass-through entity's written petition for exemption from the withholding requirements under this exception. The standards for undue hardship would be required to take into account the ability of a pass-through entity to comply at reasonable cost with the withholding requirements and the cost to the Commonwealth of collecting the tax directly from a nonresident owner who does not voluntarily file a return and pay the amount of tax due with respect to his allocable Virginia taxable income.

Every pass-through entity required to deduct and withhold tax would be required to furnish to each nonresident owner a written statement, as prescribed by the Tax Commissioner, showing the amount deducted and withheld as tax. TAX anticipates adding this information to the information returns that PTE's are required to file under existing law.

Each nonresident owner would be allowed a credit against the owner's Virginia income tax liability for that owner's share of the tax withheld and paid by the pass-through entity.

The Tax Commissioner would be required to develop and publish guidelines for purposes of implementing this bill. These guidelines would have to be made publicly available by September 1, 2007. The development of the guidelines would be exempt from the provisions of the Administrative Process Act.

cc : Secretary of Finance

Date: 1/22/2007 AMS
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