DEPARTMENT OF TAXATION
2024 Fiscal Impact Statement

1. **Patron** Carrie E. Coyner

2. **Bill Number** HB 1447

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

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

3. **Committee** House Finance

4. **Title** Pass-through Entity Tax; Penalty Waiver

5. **Summary/Purpose:**

This bill would require the Department of Taxation ("the Department") to waive penalties imposed on any pass-through entity ("PTE") paying the pass-through entity tax ("PTET") for Taxable Years 2021 through 2023. The waiver would not apply to any penalty imposed due to false or fraudulent action by the taxpayer with the intention of avoiding taxes.

This bill would be effective for taxable years beginning on and after January 1, 2021, but before January 1, 2024.

6. **Budget amendment necessary:** No.

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

8. **Fiscal implications:**

<u>Administrative Costs</u>

As it is unclear under this bill whether the waiver process must be automated or manual, the Department of Taxation's ("the Department") costs are unknown. If the intent of this bill is to mandate an automated waiver process, the Department estimates that this bill would result in administrative costs of $154,044 in FY 2024, $112,320 in FY 2025, and $74,800 in FY 2026 and 2027. These costs would be incurred for purposes of hiring one full time employee and the expenses associated with updating technology, and systems to implement the penalty waiver.

<u>Revenue Impact</u>

This bill would have an unknown negative General Fund revenue impact beginning in Fiscal Year 2024. Because this bill would eliminate penalties for making late payments of pass-through entity tax for Taxable Years 2021 through 2023, it would decrease the incentive for taxpayers to make timely payments. Late payments of pass-through entity tax could have the effect of shifting tax revenues to later fiscal years. The extent to which this would occur as a result of this bill is unknown. In addition, it is unknown the extent to which penalties would be waived under this bill that are not currently being waived under the Department's existing penalty waiver process described on Line 11.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

<u>Cap on the Deduction for State and Local Taxes Paid</u>

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, several states, including Virginia 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 or a deduction, 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.

<u>Virginia's Pass-through Entity Tax</u>

During the 2022 Session, the General Assembly enacted legislation to permit a certain PTEs to make an annual election to pay an elective income tax at a rate of 5.75 percent at the entity level. The 2022 legislation also allowed 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. During the 2023 Session, the General Assembly enacted legislation that expanded the number of PTEs that were eligible to make this election.

Electing PTEs are required to file this pass-through entity tax return electronically. Because certain software vendors were not supporting the filing of the pass-through entity return, the General Assembly approved funding in September to allow the Department to establish a free online filing option. However, this option did not become available until December 2023, which is after the Taxable Year 2022 extended due date for many electing PTEs.

As a result, the Department issued Tax Bulletin 23-8, which offered an automatic waiver of penalties for certain PTEs if full payment of an electing PTE's tax liability was made by the original due date. If full payment of an electing PTE's tax liability was not made by the original due date, a PTE requesting a waiver of the failure to file penalty or any other penalties could do so by completing and submit an offer in compromise request.

The Department has worked to streamline the offer-in-compromise process for PTET waiver requests. This includes adopting a triage process to identify and group PTET waiver requests together to expedite review and processing, as well as adopting a process by which tax preparers can provide a list of clients requesting a PTET penalty waiver, eliminating the need for practitioners to submit individual applications for each client. These enhancements have allowed the Department to reduce the processing time to less than 30 days. Through December, the Department has received 289 penalty waiver requests and approved more than 98 percent of such requests.

Proposed Legislation

This bill would require the Department to waive penalties imposed on any pass-through entity paying the pass-through entity tax for Taxable Years 2021 through 2023. The waiver would not apply to any penalty imposed due to false or fraudulent action by the taxpayer with the intention of avoiding taxes.

This bill would be effective for taxable years beginning on and after January 1, 2021, but before January 1, 2024.

cc : Secretary of Finance

Date: 2/4/2024 JLOF
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