

## CLIENT BULLETIN – NOVEMBER 18, 2022

### **Is it Possible to Reduce 2022 Income Taxes on Income from a Pass-Through Entity?**

The answer to this question is potentially YES.

#### **Background & Benefits of Recent Virginia Legislation**

Prior to the Federal Government enactment of the Tax Cuts and Jobs Act (TCJA) in December 2017, taxpayers who itemized deductions on their federal income tax returns were allowed to deduct state and local income taxes paid, real estate taxes paid, and personal property taxes paid, essentially without limitation. The TCJA placed a \$10,000 limit on the deduction for state and local taxes (SALT). States whose residents received the largest benefit from the SALT deduction were concerned about this fading deduction and sought a workaround of this SALT deduction limitation. Specifically, pass-through entity profits for qualifying entities and their owners will now be able to fully deduct their respective share of tax liability imposed on net taxable Virginia profits from electing pass-through entities, whereby realizing a tax savings benefit not previously provided.

The IRS issued Notice 2020-75 in November 2020, which offered guidance allowing the SALT imposed on and paid by a partnership or an S corporation to be considered a deduction by the entity in computing its federal taxable income. Regulations from the IRS to implement Notice 2020-75 are not yet issued; however, states have adopted statutes following the concepts of Notice 2020-75.

During its 2022 Session, the Virginia General Assembly adopted legislation codified as Section 58.1-390.3 to allow for the payment of elective income tax by pass-through entities. By May 2022, twenty-seven states had adopted some form of pass-through entity tax legislation. On October 31, 2022, the Virginia Department of Taxation issued Draft Guidelines for the implementation of the pass-through entity tax in Virginia.

#### **Key Terms and Definitions**

A "pass-through entity" (PTE) means any entity, including a limited partnership, a limited liability partnership, a general partnership, a limited liability company, a professional limited liability company, a business trust, or a Subchapter S corporation, that is recognized as a separate entity for federal income tax purposes, in which the partners, members, or shareholders report their share of the income, gains, losses, deductions, and credits from the entity on their federal income tax returns or make the election and pay the tax levied pursuant to Virginia Code Section 58.1-390.3. A "qualifying pass-through entity" means a pass-through entity that is 100 percent owned by natural persons or, in the case of a Subchapter S corporation, 100 percent owned by natural persons or other persons eligible to be shareholders in an S corporation. Natural person means a human being as distinguished from a person created by operation of law, such as a corporation or a PTE. Natural persons also include entities disregarded for federal tax purposes, such as grantor trusts and single member limited liability companies, so long as that disregarded entity or grantor trust is 100% owned by a human being. In the case of a Subchapter S corporation only, a pass-through entity can qualify to make the election based upon being 100 percent owned by the natural persons or persons eligible to be shareholders in an S corporation.

## Electing to Pay the Tax

Each qualifying pass-through entity may decide how to obtain consent from its owners on whether to pay the PTE tax. This is an entity-level decision and the decision made by the entity is binding on all owners. The election to pay the PTE tax is an annual election.

The election to pay the tax is made by filing the pass-through entity tax return or by submitting a payment of pass-through entity tax. Timely filing (by April 15 for calendar year entities) is critical to documenting the election to be taxed at the PTE level and minimize underpayment penalties with Virginia.

## PTE Tax Payment

The tax rate paid by a PTE to Virginia is 5.75%. Virginia taxable income is multiplied by this tax rate to determine the tax due by the PTE. The tax due and paid by the PTE is allocated to the owners as a refundable credit to be used on their Virginia income tax returns. Any overpayment of tax by the PTE is refunded to the PTE and not allocated to the owners.

## Estimated Tax Payments

Estimated tax payments are not required by the PTE for tax year 2022. The Virginia tax must be paid in full by the due date of the return to avoid any underpayment penalties. Beginning in tax year 2023, an electing PTE is required to make estimated payments if the tax for the year is reasonably anticipated to exceed \$1,000. Beginning in 2023, quarterly estimated payments will be due on April 15, June 15, September 15, and December 15.

*Key Point:* Regulations expanding on IRS Notice 2020-75 that would clarify the allowable year PTE tax payments to a state are deductible on the federal income tax return are not yet issued. As of the date of this publication, if you wish to receive a federal tax deduction for 2022, we recommend that an estimated Virginia PTE tax payment be paid prior to December 31, 2022. Estimated PTE tax payments are paid by filing Form 502V on the Virginia Department of Taxation website.

## Other Provisions

The PTE tax provisions also apply to nonresident owners of Virginia PTE's. These owners will receive a refundable Virginia tax credit. If the PTE income is a Virginia nonresident's only source of Virginia income, they may file but are not required to file a Virginia income tax return.

There is general reciprocity between Virginia and other states that have a substantially similar PTE tax structure.

If you have any questions about how this pass-through entity tax legislation may affect your current and future tax filings, please contact our office.