



Tax Planning Opportunity for Owners of Pass-Through Entities: Virginia Enacts Workaround to \$10,000 Federal Income Tax Limitation on State and Local Taxes

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Virginia recently passed legislation that provides an opportunity for the owners of a qualified pass-through entity (PTE) to reduce their federal income tax liability if the PTE makes an election to pay Virginia taxes at the entity level. The opportunity is Virginia's workaround to the \$10,000 federal limitation for individuals to deduct state and local taxes.

This election will be useful to all PTEs with Virginia business income between 2021 and 2025. The potential savings will be amplified if the PTE sells its business during those tax years. As discussed in the "Planning Points" below, if the PTE has such a transaction and intends to make the election, it will likely need to hold in reserve, or make a call capital, in the amount of cash needed to pay the Virginia tax. If a capital call is made, keep in mind the "single class of stock" rule for subchapter S entities.

Additional detail about the election and an example of the potential tax savings are summarized below. The Virginia Department of Taxation (VATAX) is developing additional guidelines that will be issued later this year. We will continue to monitor the election and send out updates as they become available.

Tax Planning Opportunity

- During its 2022 session, the Virginia General Assembly passed legislation permitting a qualifying PTE to make an annual election for Tax Years 2021 through 2025 to pay an elective income tax at a rate of 5.75% at the entity level.
- The bill also allows a corresponding refundable Virginia income tax credit to the owners of the PTE for any amount of income tax paid by a PTE that made the election and paid the elective income taxes.

- The effect of the elective income tax and corresponding refundable credit is to allow the PTE to pay income tax rather than its owners and, thereby, to provide a Virginia PTE workaround for the \$10,000 cap on the federal deduction for state and local taxes paid.

Example: LLC is a Virginia limited liability company that is a partnership for federal and state income tax purposes. The Owners of LLC have agreed to sell their membership interest in LLC for \$100 million in 2022. If LLC makes an election and pays the PTE tax at 5.75%, the result is a federal income tax deduction of \$5.75 million. Assuming the highest federal rate of 37% at the owner-level, the Owners have collectively saved an estimated \$2,127,500 in federal income taxes.

Key Terms:

- "Pass-through entity" generally 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." It does not include any entity that is a disregarded entity for federal or state income tax purpose or any entity that has made a check-the-box election to be treated as a corporation.
- "Qualifying pass-through entity" means "a pass-through entity that is 100 percent owned by natural persons [which we understand means human beings] 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.?"

Procedure

- The Department has not released the procedures and forms necessary to make the election. For tax year 2021, the statute requires the Department to delay the election for at least 12 months after the extended due date for filing the PTE return (October 2022). Interest will not accrue on underpayments or overpayments solely attributable to the delayed election.
- For tax years beginning in 2022, the statute requires the PTE to make the election on or before the due date for filing the PTE return, including any extensions that have been granted. Payments are due with the return.

Open Issues

- Ownership by LLCs and Trusts: The plain language of the statute provides that the PTE must be owned by natural persons or, with respect to S corporations, eligible Subchapter S shareholders. It is silent on whether qualifying PTEs can be owned by other PTEs (e.g., LLCs) or trusts, including

grantor trusts, which are disregarded entities for federal and state income tax purposes. We anticipate that VATAX will address these issues when it issues guidance later this year.

- Fiduciary Issues: A PTE election may cause significant issues for a non-Virginia resident if his or her state does not treat the tax as one in which such individual may receive a direct credit against such individual's home state income tax. As a result, certain owners of PTEs may end up paying the tax twice. Please see our Planning Points below for additional guidance.

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As more states are beginning to enact similar SALT Cap Workarounds, it is important to check with the Williams Mullen Tax Team when dealing with a PTE in any state.

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