

DRAFT Guidelines for the Pass-through Entity Tax

During the 2022 Session, the Virginia General Assembly enacted House Bill 1121 (2022 *Acts of Assembly*, Chapter 690) and Senate Bill 692 (2022 *Acts of Assembly*, Chapter 689), which permit a qualifying pass-through entity (“PTE”) to make an annual election to pay an elective income tax at a rate of 5.75 percent at the entity level. The legislation also allows a corresponding refundable income tax credit to certain PTE owners for income tax paid by a PTE if such PTE makes the election and pays the elective income tax imposed at the entity level.

The legislation allows an individual to claim a credit for taxes paid to other states under laws that are substantially similar to the pass-through entity income tax. Effective for taxable years beginning on and after January 1, 2021, but before January 1, 2026, this overrules Public Document 21-156 (December 29, 2021), which generally denied a credit for a tax paid to Maryland under that state’s elective pass-through entity income tax. This provision only applies to taxes paid by a PTE under the law of another state that is substantially similar to *Va. Code* § 58.1-390.3. Therefore, it does not apply to any other entity-level taxes, such as any franchise, privilege, business, license, or occupation taxes described in *Va. Code* § 58.1-332.2.

These guidelines are published by the Department of Taxation (“the Department”) to provide guidance to taxpayers regarding the elective income tax and corresponding refundable credit as required by *Va. Code* § 58.1-390.3 (F). These guidelines are not rules or regulations subject to the provisions of the Administrative Process Act (*Va. Code* § 2.2-4000 et seq.) and are being published in accordance with the Tax Commissioner’s general authority to supervise the administration of the tax laws of the Commonwealth pursuant to *Va. Code* § 58.1-202. As necessary, additional information regarding these procedures will be published and posted on the Department’s website, www.tax.virginia.gov.

These guidelines complement the Department’s existing General Provisions Applicable to All Taxes Administered by the Department of Taxation Regulation (23 Virginia Administrative Code (“VAC”) 23 VAC 10-20-10 et seq.), Individual Income Tax Regulation (23 VAC 10-110-20 et seq.), and Corporation Income Tax Regulation (23 VAC 10-120-10 et seq.). To the extent that there is a conflict between the Department’s existing guidance and 2022 *Acts of Assembly*, Chapters 689 and 690, the provisions of that law, as interpreted by these guidelines, supersede existing guidance.

These guidelines represent the Department’s interpretation of the relevant laws. They do not constitute formal rulemaking and hence do not have the force and effect of law or regulation. In the event that the final determination of any court holds that any provision of these guidelines is contrary to law, taxpayers who follow these guidelines will be

treated as relying on erroneous written advice for purposes of waiving penalty and interest under *Va. Code* §§ 58.1-105, 58.1-1835, and 58.1-1845.

These guidelines address how to make the pass-through entity tax election for Taxable Year 2022 and after. Please note that the ability to make the pass-through entity tax election is currently set to sunset after Taxable Year 2025. Please also note that these guidelines do not address Taxable Year 2021. As a result, those seeking to make the election for Taxable Year 2021 should continue to follow [Tax Bulletin 22-6](#). Subsequent guidance will be published by the Department regarding how to make the election for Taxable Year 2021.

Definitions

As used in these guidelines, unless the context requires otherwise:

“Credit for taxes paid other states” or “out-of-state credit” means the nonrefundable individual income tax credit allowed by *Va. Code* § 58.1-332.

“Electing pass-through entity” or “electing PTE” means a qualifying pass-through entity that has made the election allowed by *Va. Code* § 58.1-390.3.

“Owner” means any individual or entity who is treated as a partner, member, or shareholder of a pass-through entity for federal income tax purposes.

“Pass-through entity” or “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 *Va. Code* § 58.1-390.3.

“Pass-through entity tax” or “PTET” means the elective income tax imposed by *Va. Code* § 58.1-390.3.

“Pass-through entity tax credit” or “PTET credit” means the refundable individual and fiduciary income tax credit allowed by subsection D of *Va. Code* § 58.1-390.3.

“Qualifying pass-through entity” or “qualifying PTE” 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.

Making the Election

A qualifying PTE has the option to make the election to pay PTET for the taxable year. Such election can be made by:

- During Taxable Year 2022, filing Form 502V and submitting a payment of PTET with such form,
- During Taxable Years 2023 and after, making an estimated payment of PTET for the taxable year,
- Making an extension payment of PTET for the taxable year,
- Filing a PTET return (“Form 502PTET”) on or before the extended due date for the taxable year.

If a Form 502PTET has not been filed for the taxable year, the PTET election can be revoked by filing the Form 502. Once Form 502PTET is filed, the election is binding for that taxable year.

Each electing pass-through entity decides how to obtain consent from its owners; provided, however, the election is binding on all the owners once the election is made. An owner does not have the option to “opt out” of an entity’s election with the Department. An owner, officer, or employee of the PTE who is authorized to act on behalf of the PTE in tax matters must sign the PTET return. By signing the return, the signer is declaring that they are the authorized representative of the PTE. Because the PTET return must be filed electronically, the return must be signed using the electronic signature procedures established by the Department. Please see the Department’s website for more information.

Which PTEs Qualify to Make the Election

Generally, a PTE qualifies to make the election only if it is 100 percent owned by natural persons. Natural person means a human being as distinguished from a person created by operation of law, such as a corporation or a PTE. For this purpose, natural person also includes 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 percent 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 natural persons or persons eligible to be shareholders in an S corporation. Please consult federal tax law and Internal Revenue Service guidance regarding which persons are eligible to be S corporation shareholders. If a PTE (the “upper-tier entity”) owns another PTE (the “lower-tier entity”), the lower-tier entity cannot

make the election. Rather, an upper-tier entity may make the election for itself if it is itself qualified to make the election.

Pass-through Entity Taxable Income and Tax

Allocation and Apportionment

The first step in computing the PTET is determining the allocation and apportionment of the PTE's income. Please see the Form 502 Instructions for information regarding how to determine the PTE's allocation and apportionment.

Classifying Owners

The second step is determining whether each owner should be classified as a resident or nonresident of Virginia.

With respect to individual owners, they are residents if they meet the definition of "resident" in *Va. Code* § 58.1-302, for the taxable year. All other individual owners should be treated as nonresidents. For the purposes of the PTET computation, owners may not be classified as part-year residents. An individual owner should be treated as a resident if they are a resident of Virginia for Virginia individual income tax purposes for at least half of the year.

With respect to estate or trust owners, they are residents if they meet the definition of "resident estate or trust" in *Va. Code* § 58.1-302, for the taxable year. Any estate or trust partner that does not meet this definition is a nonresident owner.

With respect to owners that are disregarded entities, the classification should be based upon the individual, estate, or trust that owns the disregarded entity.

Effect of Classification on Allocation and Apportionment

Once that classification is made, the Virginia taxable income of an electing PTE is determined by adding the following:

- Each resident owner's share of the electing PTE's income or loss, subject to the modifications to the PTE's income as described in *Va. Code* §§ 58.1-322.01, 58.1-322.02, 58.1-322.03, and 58.1-322.04. This is because Virginia residents are taxable on all of their PTE income regardless of the PTE's allocation and apportionment.

- Each nonresident owner's share of the PTE's income or loss, subject to the modifications to the PTE's income as described in *Va. Code* §§ 58.1-322.01, 58.1-322.02, 58.1-322.03, and 58.1-322.04, that is attributable to Virginia.

In determining the share of such income or loss that is attributable to Virginia, the electing PTE adds:

- Each nonresident owner's share of such income or loss other than dividend income ("apportionable income") multiplied by the PTE's apportionment percentage; and
- Each nonresident owner's share of dividend income ("allocable income") if the PTE is commercially domiciled in Virginia.

An electing PTE's calculation of its PTE taxable income must include all items of income, gain, loss, or deduction, to the extent they would flow through and be included in the income of owners that are taxable under *Va. Code* §§ 58.1-320 and 58.1-360, as applicable, including guaranteed payments. However, the electing PTE can exclude income from the calculation of PTE taxable income to the extent that the PTE can establish that the amount is properly allocable to an owner who is not subject to tax on such amount under *Va. Code* §§ 58.1-320 and 58.1-360, as applicable. Two examples are (1) income that is not U.S. sourced and is allocable to nonresident alien partners and, therefore, not included in federal adjusted gross income under the Internal Revenue Code, and (2) retirement income of former partners that is exempt from nonresident state taxation under 4 U.S.C § 114.

Separately stated items of deduction are generally included when calculating each owner's share of the PTE's taxable income. However, any deduction that is subject to a federal limitation, such as the deduction for charitable contributions and the Section 179 deduction, will be limited to what is allowed under federal law for a C corporation.

Electing PTEs must make an addition for any state and local income taxes to the extent that the electing entity deducted such taxes in determining its federal taxable income.

Computing the Tax

An electing PTE calculates its Virginia income tax by multiplying its Virginia taxable income by 5.75 percent. Credits are generally passed through to the owners and are not applied against the PTET. However, the following may be used to reduce the amount due with the PTET return or, if applicable, generate a refund to the electing PTE:

- Any payments that have formerly been made for the taxable year, including estimated and extension payments, and

- Any credit that permits the PTE to elect to receive and claim the credit at the entity level rather than passing through the credit to the owner, such as the Research and Development Expenses Tax Credit and the Motion Picture Production Tax Credit, but only if the PTE so elects to receive and claim the credit at the entity level.

This PTET is in addition to any other taxes imposed on the entity, including sales and use taxes, withholding taxes with respect to employees, and minimum taxes in lieu of income taxes.

Filing the Annual PTET Return

PTEs are required to file their returns and the accompanying schedules, and make any tax payments electronically. The Department will provide more information regarding how to make payments and file returns electronically in its forthcoming instructions.

PTET returns (“Form 502PTET”) are due by the 15th day of the 4th month following the close of the taxable year. For calendar year filers, that means April 15. Virginia allows an automatic 6-month filing extension for PTEs. No application for extension is required. For calendar year filers, that means that they have until October 15 to file their return on extension. However, this six-month extension is only for filing the return and does not extend the due date for payment of taxes. As a result, an electing PTE must pay at least 90 percent of its PTET due by the original due date for filing the return. If Form 502PTET is filed within the automatic extension period, but less than 90 percent of the tax liability was paid by the original due date, an extension penalty will apply. The extension penalty is imposed at the rate of 2 percent per month or part of a month from the original due date through the date of full payment, the date the return is filed, or the extended due date, whichever is earlier. The maximum penalty is 12 percent of the tax due with the return.

When an electing PTE files an annual Virginia income tax return reflecting an overpayment, the Department will refund the overpayment of PTET to the electing PTE. Only the electing PTE is entitled to request a refund of an overpayment of PTET; the individual owners cannot request a refund.

An electing PTE must notify its owners that the election has been made and provide a Schedule VK-1 to each of its owners with information regarding the income and related deductions and credits passed through to the owner so that the owners can complete their own Virginia tax returns.

On its return, an electing entity must report its total PTET. The total amount of PTET credits reported by an electing entity shall not exceed the total PTET paid by the electing PTE.

The electing PTE must provide sufficient information on the Schedule VK-1s in its return to identify all PTET credit-eligible taxpayers and their credit amounts. If such identifying information is not provided, the otherwise eligible owners will not be entitled to utilize the PTET credit on their Virginia income tax returns.

The PTET credit is distributed in proportion to the owner's distributive or pro rata shares of income. If the electing PTE's total PTE taxable income is zero or less, its owners are not entitled to any PTET credits. Instead, the electing PTE may file Form 502PTET to request a refund of any PTET estimated tax payments it made.

Estimated Tax Payments

For Taxable Year 2022, an electing PTE is not required to make estimated payments of PTET and will not be subject to an addition to tax charge for not making estimated payments. If a PTE wishes to make a payment during Taxable Year 2022, it may do so by filing an electronic Form 502V and making a payment of PTET with that form. However, such payment is not required, and taxpayers may wait to make payments until the original due date of the return, when they should either make a return payment or, if filing on extension, an extension payment.

For taxable years after Taxable Year 2022, an electing PTE is required to make estimated payments if its PTET for the taxable year can reasonably be expected to exceed \$1,000. Estimated payments for electing PTEs will be based upon the rules set forth in Article 20 (*Va. Code* § 58.1-500 et seq.). As a result, for calendar year filers required to make four quarterly installments, estimated payments must be made to the Department as follows: 25 percent by April 15, 25 percent by June 15, 25 percent by September 15, and 25 percent by December 15. For non-calendar year filers required to make four quarterly installments, the electing PTE is required to pay 25 percent of the amount due to the Department by the 15th day of the 4th month following the beginning of its fiscal year. Subsequent installments are payable by the 15th day of the 6th month, the 15th day of the 9th month, and the 15th day of the 12th month following the beginning of its fiscal year. In case of any underpayment of estimated tax payments by a PTE, an addition to tax will apply at the established interest rate for underpayments unless one of the exceptions in *Va. Code* § 58.1-504 applies.

Nonresident Withholding Payments and Composite Payments

Electing PTEs should not make nonresident withholding payments or payments associated with composite returns ("composite payments"). If nonresident withholding

payments were made before the PTE made the PTET election, the PTE should claim the withholding payment on Form PTET. If composite payments were made before the PTE made the PTET election, the PTE should request a refund of any such payments made. Please see the Department's website for guidance on this. If the PTE would prefer to request reallocation of composite payments to its PTET return, it may do so by submitting a written request to the Virginia Department of Taxation, Customer Services, P.O. Box 1115, Richmond, VA 23218-1115. The request should be made as far in advance of filing the PTET return as possible.

Filing Requirements for Nonresident Owners of an Electing PTE

An electing PTE may not file a composite return on behalf of its nonresident owners. If a nonresident owner's only Virginia-source income is through an electing PTE that fully pays the PTET, such nonresident owner is permitted, but not required, to file a Virginia nonresident return.

Penalties

Pursuant to 2022 *Acts of Assembly*, Chapters 689 and 690, the penalties for electing PTEs are based upon the corporate penalties in Article 14 (*Va. Code* § 58.1-450 et seq.) instead of the penalties in Article 9 (*Va. Code* § 58.1-390.1 et seq.).

If the PTET return is filed within the 6-month extension, but the electing PTE failed to pay 90 percent of the tax due by the original due date, then the PTE is subject to an extension penalty of 2 percent per month or fraction of a month thereof from the original due date through the date of filing of the return, the date of full payment, or the extended due date, whichever is earlier. The maximum extension penalty is 12 percent of the tax due. If the full amount is not paid when the return is filed, the late payment penalty will be assessed at the rate of 6 percent per month up to a maximum of 30 percent of the tax due:

- In the case of a Form 502PTET filed within the extension period, from the date of filing through the date of payment, or
- In the case of a Form 502PTET filed on or before the original due date of the return, from the date of the original return due date through the date of payment.

If the PTET return is filed after the extended due date or is not filed at all, the extension provisions do not apply and the PTE is subject to the late filing penalty (*Va. Code* § 58.1-455) equal to 30 percent of the tax due. In no case will the penalty for failure to file timely be less than \$100, and this minimum \$100 penalty applies whether or not tax is due for the period covered by the return. The late payment penalty does not apply to the extent that the taxpayer is already subject to the late filing penalty.

Civil and criminal penalties may be imposed for filing a fraudulent return. The criminal penalty for filing a fraudulent return is a Class 6 felony (*Va. Code* §§ 58.1-451 and 58.1-452). Interest on the unpaid balance of any tax and penalty is charged at the underpayment rate established by IRC § 6621, plus 2 percent, from the due date until paid.

Filing a Return by an Owner

An owner may claim a refundable PTET credit against their Virginia individual income tax or fiduciary income tax. A trust, other than a trust that is disregarded for income tax purposes, that is an owner of an electing Subchapter S corporation is allowed to claim the full PTET credit that it receives on its fiduciary income tax return, but it is not permitted to distribute any portion of the credit to its beneficiaries.

Eligible taxpayers must wait until the electing PTE issues the Schedule VK-1 before claiming the PTET credit. If the electing PTE does not issue the Schedule VK-1 until after the due date for the owner's return, the owner may (1) make any necessary extension payments and file the return during the extension period or (2) file the original return without claiming the credit and then file an amended tax return once the Schedule VK-1 showing a PTET credit is received. Owners of an electing PTE who claim the PTET credit on their individual or fiduciary income tax return must make an addition equal to the amount of PTET credit claimed.

Credits are claimed on an owner's return in accordance with Public Document 95-240 (September 22, 1995). As a result, credits that are structural in nature, such as the nonrefundable credit for taxes paid to other states (discussed below), should be claimed first, whereas refundable credits such as the refundable PTET credit should be claimed last.

Credit for Taxes Paid to Other States

For Taxable Years 2021 through Taxable Year 2025, taxpayers may claim Virginia's nonrefundable credit for taxes paid to other states ("out-of-state credit") on their individual income tax return for certain taxes paid by a PTE under another state's substantially similar PTE tax structure. As explained in [Tax Bulletin 22-6](#), this provision of the legislation overrules Public Document 21-156 (December 29, 2021), which generally denied a credit for a tax paid to Maryland under that state's elective PTET. This provision only applies to taxes paid by a PTE under the law of another state that is substantially similar to *Va. Code* § 58.1-390.3. Therefore, it does not apply to any other entity taxes, such as any non-elective franchise, privilege, business, license, occupation, excise, or unincorporated business taxes described in *Va. Code* §§ 58.1-332 and 58.1-332.2. The credit also does not apply to PTET imposed by any city,

county, regional, or other local taxing jurisdiction, regardless of the fact that such local PTET may be collected by a state. The other state's PTET should be distributed in proportion to each owner's distributive or pro rata share of the PTE's income.

However, even if PTET is allocated by the PTE to its owners, the owners cannot necessarily claim full out-of-state credits for the allocated PTET. Instead, the credit for PTET may not exceed the limitation specified in *Va. Code* §§ 58.1-332(A)(3), which is based upon a ratio comparing the income upon which the other state's tax was computed with the Virginia taxable income upon which the Virginia individual income tax was computed. Generally, the income upon which the other state's tax was computed will be the amount of income reported on the nonresident individual income tax return, after sourcing and apportionment. However, in the case of a state using a subtraction or deduction-based PTET rather than a credit-based PTET, the income upon which the other state's tax was computed will be the sum of (1) the amount of taxable income reported on the nonresident individual income tax return, after sourcing and apportionment and (2) the amount of taxable income on which the PTE paid PTET to the other state on the individual's behalf, after sourcing and apportionment, which will typically equal the amount of subtraction or deduction that they are receiving from the PTE.

The out-of-state credit may also be claimed on fiduciary income tax returns pursuant to *Va. Code* § 58.1-371. Except as noted below regarding reverse credit states, the out-of-state credit is limited to Virginia resident returns only.

Reverse Credit States

When a state practices reciprocity with Virginia pursuant to *Va. Code* § 58.1-332(B), a Virginia resident receiving income from that state may typically claim an out-of-state credit on that state's nonresident income tax return and is prohibited from claiming a credit on his or her Virginia resident income tax return. Similarly, a resident of one of these states receiving income from Virginia may typically claim an out-of-state credit on Virginia's nonresident income tax return but not on the other state's resident income tax return. States that practice this kind of reciprocity are referred to as "reverse credit states" because they reverse the normal rule that out-of-state credits are claimed only on resident returns.

Currently, there are three reverse credit states with a substantially similar PTET: Arizona, California, and Oregon. Virginia is required to follow subsection B of *Va. Code* § 58.1-332 with respect to its PTET and the PTET of these reverse credit states. As a result, a Virginia resident may not claim an out-of-state credit for PTET paid to one of these reverse credit states on the Virginia return, and should instead claim a credit on the other states' nonresident income tax return for PTET paid to Virginia. However, if a reverse credit state does not allow an out-of-state credit for PTET paid to Virginia,

Virginia residents may then claim a credit on the Virginia return, provided that documentation is attached to the Virginia return to verify that the other state disallows the out-of-state credit to Virginia residents. Similarly, a resident of a reverse credit state may claim an out-of-state credit for PTET paid to such reverse credit state on his or her Virginia return, provided that no out-of-state credit has been claimed on his or her return filed with the other state.

The credit may not exceed the limitation specified in *Va. Code* §§ 58.1-332(B), which is based upon a ratio comparing the income subject to Virginia individual income tax to the entire income upon which the other state's tax was imposed. Generally, the income upon which the other state's tax was computed will be the amount of income reported on the resident individual income tax return. However, in the case of a state using a subtraction or deduction-based PTET rather than a credit-based PTET, the income upon which the other state's tax was computed will be the sum of (1) the amount of taxable income reported on the resident individual income tax return and (2) the amount of taxable income on which the PTE paid PTET to the other state on the individual's behalf, which will generally equal the amount of subtraction or deduction that they are receiving from the PTE.

Additional Information

These guidelines are available online in the Laws, Rules & Decisions section of the Department's website, located at www.tax.virginia.gov. For additional information, please contact the Department at (804) 367-8037.