

Guidelines for the Retroactive Taxable Year 2021 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 (“PTET”) 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.

During the 2023 Session, the Virginia General Assembly enacted House Bill 1456 (2023 *Acts of Assembly*, Chapter 686) and Senate Bill 1476 (2023 *Acts of Assembly*, Chapter 687), which removed the requirement that a PTE be 100 percent owned by natural persons or persons eligible to be shareholders of an S corporation in order to make the election to pay the PTET. This legislation also defined an “eligible owner” as a direct owner of a pass-through entity who is a natural person or an estate or trust and states that only the pro rata or distributive share of income, gain, loss, or deduction attributable to eligible owners are subject to the PTET. These changes are effective for taxable years beginning on and after January 1, 2021.

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 Va. Code §§ 58.1-332, 58.1-390.1, 58.1-390.2, and 58.1-390.3, as such laws were amended by 2022 *Acts of Assembly*, Chapters 689 and 690 and 2023 *Acts of Assembly*, Chapters 686 and 687, the provisions of such laws, 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 2021, file the Taxable Year 2021 PTET return, and claim a retroactive PTET credit. For information on definitions, eligibility requirements, the computation of pass-through entity tax, and the credit for taxes paid to other states, please refer to the [Guidelines for the Pass-through Entity Tax](#).

Making the Election

For Taxable Year 2021, a PTE has the option to make a retroactive PTET election and pay PTET for the taxable year by:

- Submitting Taxable Year 2021 Form 502PTET, including all owner credit allocation information, using Business Online Services on or before September 16, 2024; and
- Making all payments electronically either prior to or at the time the Taxable Year 2021 Form 502PTET is submitted.

Taxable Year 2021 Form 502PTET will not be accepted after September 16, 2024, or without full payment of the 2021 PTET. Form 502 cannot be used to make the PTET election for Taxable Year 2021.

Each electing pass-through entity decides how to obtain consent from its eligible owners; provided, however, the election is binding on all the eligible owners once the election is made. For S corporations, this includes the choice whether to take advantage of the special option on how to compute their PTET, described in the [Guidelines for the Pass-through Entity Tax](#). An eligible 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.

Filing the Retroactive Taxable Year 2021 PTET Return

Electing PTEs are required to file their retroactive Taxable Year 2021 PTET returns and the accompanying schedules and make any tax payments electronically. Please see the Department's PTET return instructions for more information regarding how to make payments and file returns electronically. No hardship exemptions are available for electronically filing PTET returns.

Electing PTEs are required to pay in full the PTET owed by the time they file their Taxable Year 2021 Form 502PTET and must file their Taxable Year 2021 Form 502PTET by September 16, 2024. No retroactive Taxable Year 2021 PTET returns will be accepted after that date. There are no extensions or late filing options.

An electing PTE must refer to its previously filed Taxable Year 2021 Form 502 to complete its Taxable Year 2021 Form 502PTET. If an electing PTE has not previously filed a Taxable Year 2021 Form 502, it would still be eligible for the retroactive Taxable Year 2021 PTET election; however, if it was required to file a Taxable Year 2021 Form 502 and it has not yet done so, it may be subject to a late filing penalty of up to \$1,200.

An electing PTE must notify its owners (1) that the election has been made and (2) whether or not they are an eligible owner entitled to receive the information and benefits of the election. In addition, an electing PTE must provide a Schedule VK-1 to each of its owners, including its eligible and ineligible owners, with information regarding the pass-through of income and related deductions and credits 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.

In no case may the PTET credit be distributed to ineligible owners. The amount of PTET credit that is distributed to each eligible owner is equal to the amount of PTET paid by the PTE on the income distributed to each of them. Therefore, the credit must be

allocated to nonresident eligible owners based on only their distributive or pro rata share of income attributable to Virginia. If the electing PTE's total PTE taxable income is zero or less, its eligible owners are not entitled to any PTET credits.

Estimated Tax Payments

Because the Taxable Year 2021 PTET election is retroactive, no estimated payments are required. However, full payment must be made on or before the earlier of (1) the date the return is filed or (2) September 16, 2024.

Previously Paid Nonresident Withholding

If nonresident withholding payments on behalf of nonresident eligible owners were made on a PTE return (Form 502), the PTE should claim the withholding payment on Form 502PTET. However, because eligible owners may have already received and claimed credit for any withholding payment made by the PTE, any withholding payments made must be subtracted from the total amount of retroactive PTET credits allocated to eligible owners.

Previously Filed Composite Returns

If a composite return (Form 765) has already been filed by the PTE, such PTE is still eligible to make the retroactive Taxable Year 2021 election, provided that it reports a subtraction on its PTET return for any income for which tax has been paid on a Form 765.

Penalties

Pursuant to *Va. Code* § 58.1-390.3 E, 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.). 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).

Filing a Return by an Eligible Owner

An eligible owner may claim a refundable PTET credit against their Virginia individual income tax or fiduciary income tax. An estate or trust, other than a trust that is disregarded for income tax purposes, that is an eligible owner of an electing PTE 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.

Taxable Year 2021 Form 502PTET must be submitted and the PTET must be paid in full by September 16, 2024 before the Department will allow eligible owners to claim the PTET credit on their income tax returns as a retroactive 2021 PTET credit. Owners are not allowed to amend their Taxable Year 2021 owner returns to claim the retroactive 2021 PTET credit. Instead, as a filing convenience to taxpayers, the retroactive 2021 PTET credit will be reported exclusively on the owners' returns for Taxable Year 2023. While reported on a 2023 owner return and while no interest will generally be paid relating back to 2021, the retroactive 2021 PTET credit is based upon the owner's and the PTE's Taxable Year 2021 taxes, and any refunds issued on a Taxable Year 2023 return as a result of such credit are solely on account of the owner's and PTE's 2021 taxes.

Eligible owners 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 eligible 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. Eligible 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 eligible owner's proportionate share of any deduction for state and local income taxes paid or incurred by the pass-through entity during the same taxable year.

Example

Partnership ABCD is a calendar year, cash-basis taxpayer. It makes the retroactive PTET election for Taxable Year 2021. It has four partners, all of whom are Virginia residents who receive an equal share of the income. Partnership ABCD determines that it owes PTET in the amount \$50,000, of which \$40,000 is paid on December 15, 2023, and \$10,000 is paid when it files its 2021 PTET return in the spring of 2024. The partners would each claim their pro rata share of the \$50,000 retroactive PTET credit on their Taxable Year 2023 returns.

Partnership ABCD would claim the \$40,000 federal deduction on its Taxable Year 2023 federal return and the corresponding addition, also in the amount of \$40,000, on its Taxable Year 2023 Virginia PTET return. The partners would each claim their pro rata share of the \$40,000 federal deduction on their federal returns and the corresponding addition on their Taxable Year 2023 Virginia returns. The remaining federal deduction in the amount of \$10,000 and the associated Virginia addition would be claimed on Partnership ABCD's Taxable Year 2024 returns. In addition, the partners would claim their pro rata share of the remaining \$10,000 federal deduction and make a Virginia addition in the same amount on their Taxable Year 2024 returns.

Credits are claimed on an eligible owner's return in accordance with Public Document 95-240 (September 22, 1995). As a result, the following ordering rules apply:

1. Credits that are structural in nature, and are considered by the Department to be a reduction in tax liability, rather than a credit against the tax. An example is the nonrefundable credit for taxes paid to other states.
2. Credits which do not have a statutory carryforward or refundable feature. Where there are multiple credits of equal priority, taxpayers may claim them in the order in which they receive the maximum benefit.
3. Credit carryforwards to the taxable year, in the order of those carryforwards which are scheduled to expired first. Where there are multiple credits with carryforwards of equal length, taxpayers may claim them in the order in which they receive the maximum benefit.
4. Current year credit, based on the order of those with the shortest carryforward period first. Where there are multiple credits with carryforwards of equal priority taxpayers may claim them in the order in which they receive the maximum benefit.
5. Refundable credits. The net excess over remaining tax liability is refunded. The PTET credit is a refundable credit.

Where a credit is calculated as, or limited to, a percentage of the tax, the "tax" for this purpose is the gross tax, less any structural credits. A double benefit for any credit claimed or to be claimed, in one or more taxable years, is not permitted.

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.

Approved:

A handwritten signature in black ink, appearing to read "Craig M. Burns". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Craig M. Burns
Tax Commissioner