SALTrends: Exploring the Benefits of Elective Pass-Through Entity Taxes

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Speakers

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Note

1. This presentation is intended to make participants aware of tax issues that may apply to this audience.

2. Information presented herein is not intended to be tax advice.

3. Please consult with a qualified practitioner for tax advice related to specific transactions.

Background

The federal Tax Cuts and Jobs Act of 2017 made numerous changes to the individual income tax, e.g.,

- Reduced marginal tax rates
- Increased the standard deduction
- Capped the itemized deduction for state and local taxes at $10,000 ("SALT Cap")

The SALT Cap sunsets at the end of 2025.

NY, NJ, CT, MD sued the Treasury Department, arguing the SALT Cap is unconstitutional.

- Federal district court dismissed
- Second Circuit Court of Appeals affirmed
- U.S. Supreme Court denied certiorari (4/18/2022)

Background

IRS Notice 2020-75: The IRS intends to issue regulations clarifying that state and local income taxes paid by a partnership or S corporation to satisfy its liability for taxes imposed on the partnership or S corporation, are deductible in computing non-separately stated income or loss.

Regardless of whether the income tax is the result of an election.

Regardless of whether the partners or shareholders receive a state deduction or credit based on their share of the tax paid by the partnership or S corporation.

Any such payments are not considered in applying the SALT Cap to an individual partner.

Pass-Through Entity Tax Elections

Simple example:

Partnership has two 50/50 individual partners.

Each partner resides in State A.

Partnership's business is 100% State A.

Partnership's ordinary income = $2,000,000

Without a PTET, each partner has

- FTI of $1,000,000
- Federal tax of $370,000 (assume 37% rate), and
- State A tax of $50,000 (assume 5% rate)
- Total Federal + State A tax is $420,000.

Pass-Through Entity Tax Elections

<u>If Partnership makes a PTET election</u> in State A,

- Partnership has
  - PTET of $100,000 (2,000,000 x 5%)
  - Ord. income of $1,900,000 (2,000,000 – PTET)
- Each partner has
  - FTI of $950,000,
  - Federal tax of $351,500 (950,000 x 37%)
  - State A income tax of $50,000 (assume addback of PTET)
  - State A credit for PTET
- Total Federal + State A cash tax is $401,500.

So federal tax savings for each partner is $18,500 (37% x $50,000).

Which States Allow an Election?

- Alabama
- Arizona
- Arkansas
- California
- Colorado
- Connecticut (mandatory)
- Georgia
- Idaho
- Illinois
- Kansas
- Louisiana
- Maryland
- Massachusetts
- Michigan
- Minnesota
- Mississippi
- New Jersey
- New Mexico
- New York (+NYC)
- North Carolina
- Oklahoma
- Oregon
- Rhode Island
- South Carolina
- Utah
- Virginia
- Wisconsin

Pass-Through Entity Tax Elections

What do all the PTET regimes have in common? Not much.

- Provide federal tax savings
- State tax-neutral – no savings, no cost

How do they differ?

- Election – timing, form, revocability, binding for future
- Eligible PTEs, eligible owners
- Calculations (e.g., addback of PTET v. reduced credit v. exclusion of PTET income)
- Tax base (residents' full distributive share or only apportioned share)
- Owners – all in/out or pick and choose?

California

Election: Made on the original return, but the PTE must make a payment by June 15th of the taxable year

Who is included? Any partner, shareholder, or member subject to CA personal income tax who consents, including a disregarded entity owned by an individual.

What is included? A resident's entire distributive share. A nonresident's California-sourced distributive share.

Nonresident withholding (7%) is not affected by an election.

The income tax credit is nonrefundable, five-year carryforward.

New York

Election: Made online, no later than March 15 of the tax year. The 2022 deadline passed, but NY only extended this to September 15 for 2022.

Who is included? All partners, shareholders, or members who are subject to NY individual income tax (including those who hold their interest through a DRE).

What is included? A resident's distributive share. A nonresident's NY-sourced distributive share. But see special rules for S corporations.

Nonresident estimates (withholding) are not required for these owners.

The income tax credit is refundable.

Michigan

Election: Made by submitting a payment online by the 15th day of the third month of the PTE's tax year, e.g., March 15. Binding for the two successive years.

Who is included? Individuals, fiduciaries, and other PTEs.

What is included? Michigan-sourced income.

Michigan does not have nonresident withholding.

The credit is refundable.

Pass-Through Entity Tax Elections

When does the simple example become complex?

- Apportionment
- Owners' states of residence
  - Credit for "substantially similar" taxes paid to other states?
  - Conflicting interests among owners
- Owners that are not individuals – included, not included, eligibility
- Compliance – tracking – owner consent
- Cash flows – (non)refundable credit?
- ASC 740
- Unintended federal tax implications

Outside of the simple example, the aggregate benefit/detriment of a PTET is very fact-specific.

Ohio Credit for PTET in Other States

No credit is allowed to a resident for income tax paid or accrued to another state if the resident has deducted the tax when computing federal adjusted gross income. See, R.C. 5747.05(B)(4)(a).

Ohio Legislation

Senate Bill 246

Passed by a vote of 30-0 on March 16, 2022

Introduced in the House on March 21st, had 1st hearing with Ways and Means Committee on April 5th, 2nd hearing on May 17th

Ohio Legislation

S.B. 246 Key Features

Election: On a form to be prescribed by the Commissioner by the due date of the return. Irrevocable. Annual election. All partners are in – no picking and choosing.

Estimates and annual return: Due on the same schedule as nonresident withholding. Withholding tax estimates can be applied to the PTET. But see underpayment penalties.

Tax base: The PTE's business income, including guaranteed payments and compensation to >20% of owners, is apportioned to Ohio. Nonbusiness income is allocated to Ohio.

Rate: For 2022, 5%. Thereafter, the business income rate (3%).

Ohio Legislation

Nonresident withholding: Not applicable to an electing PTE.

Nonresident owner: No Ohio income tax return due if no other Ohio income.

Credit mechanics: The owner adds back to income his proportionate share of the PTET paid by the electing PTE. The owner gets a refundable income tax credit for the same.

Credit for PTET paid to another state: None allowed.

Tiered PTEs? The Commissioner shall adopt rules to address how the PTET and the credit apply to indirect owners of PTEs based on various ownership structures.

How do the PTET and credit apply when an owner is not subject to income tax? Unclear. Commissioner's rules?

What is Next?

- Watch for new legislation in Ohio and other states
- Monitor updates in your relevant states – things are changing fast!
- Assess your business – are you simple or do you have complicating factors?
- Changes to SALT cap? Seems to have lost steam.

Thank You!

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