



State Elective Pass-Through Entity Taxes (PTETs): Assessing and Utilizing These Elections

2023 Financial Services Tax Conference

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Shaping the future:
convergence
& collaboration
2023 Financial Services Tax Conference

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TCJA and Multistate Update

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PTET background and current status

TCJA and Multistate Update

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I.R.C. Section 164(b)(6)

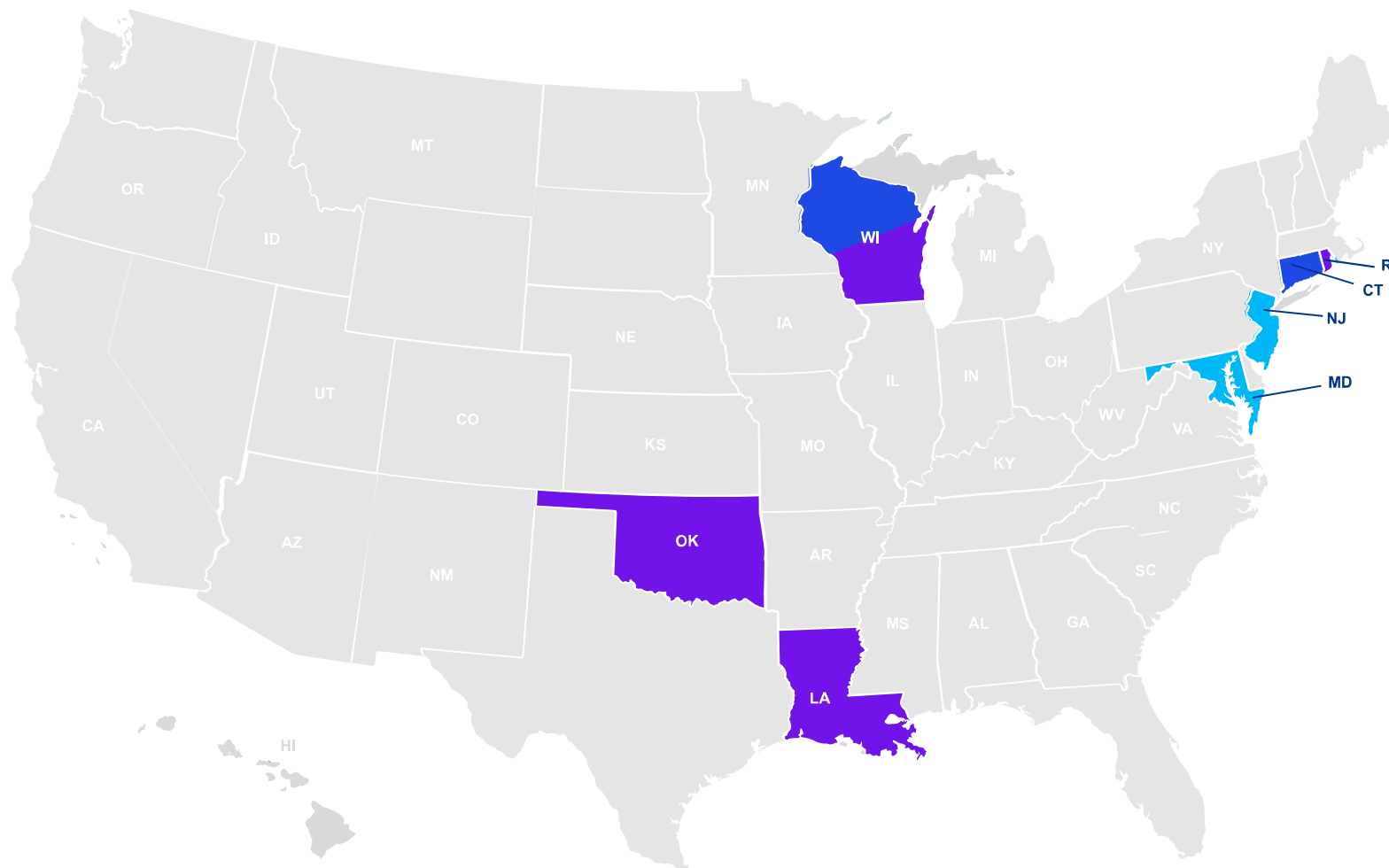
What is the individual income tax limitation (the “SALT Cap”)?

- I.R.C. Section 164
 - History and tax form usage
- Tax Cuts and Jobs Act: I.R.C. Section 164(b)(6)
 - Deductibility follows present law. H.R. Conf. Rep. No. 115-466, n. 172 (December 15, 2017)
- IRS/Treasury Notice 2020-75
 - Provides that regulation shall give guidance on aspects of a Specified Income Tax Payment
 - No draft or final regulations have been issued yet
 - AICPA letters have requested guidance on specific aspects of how PTET interacts with other IRC provisions
- “Specified Income Tax Payment”
 - Means any amount paid by a domestic partnership or an S corporation to a Domestic Jurisdiction pursuant to a direct imposition of income tax by the Domestic Jurisdiction,
 - Is deductible by the partnership or S corporation in computing its taxable income,
 - Deduction does not constitute an item of deduction that a partner or shareholder takes into account separately under sections 702 or 1366 and that the Specified Income Tax Payment will be reflected in the “distributive or pro-rata share of non-separately stated income or loss reported on a Schedule K-1,” and
 - Will not be taken into account in applying the SALT Cap to any partner or shareholder.

Post-TCJA Elective PTETs

Before IRS/Treasury Notice 2020-75

- TY 2018**
 CT (mandatory to TY2023, elective starting TY2024), WI (S corporations)
- TY 2019**
 OK, LA, RI, WI (partnerships)
- TY 2020**
 NJ, MD



Post-TCJA Elective PTETs

After IRS/Treasury Notice 2020-75

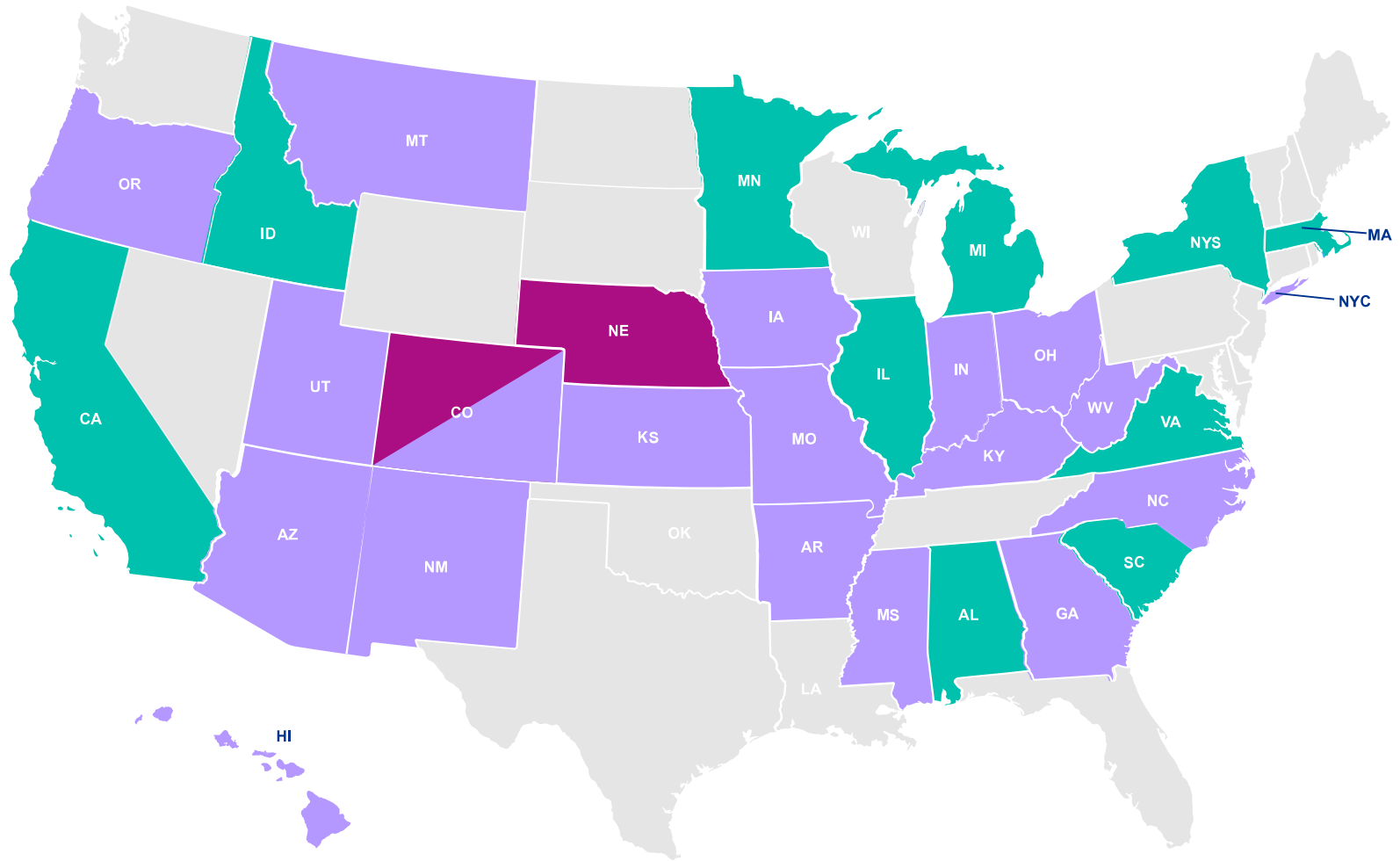
TY2018 (retroactive)
CO
NE*

TY2021
AL, CA, IL, ID, MA, MI, MN,
NYS, SC, VA

TY2022 and after
AR, AZ, CO, GA, HI**, IN*, IA*, KS,
KY*, MS, MO, MT**, NM, NYC, NC,
OH, OR (TY22/23 only), UT, WV*

* PTET states for TY2022 based on
2023 legislation

** PTET states for TY2023



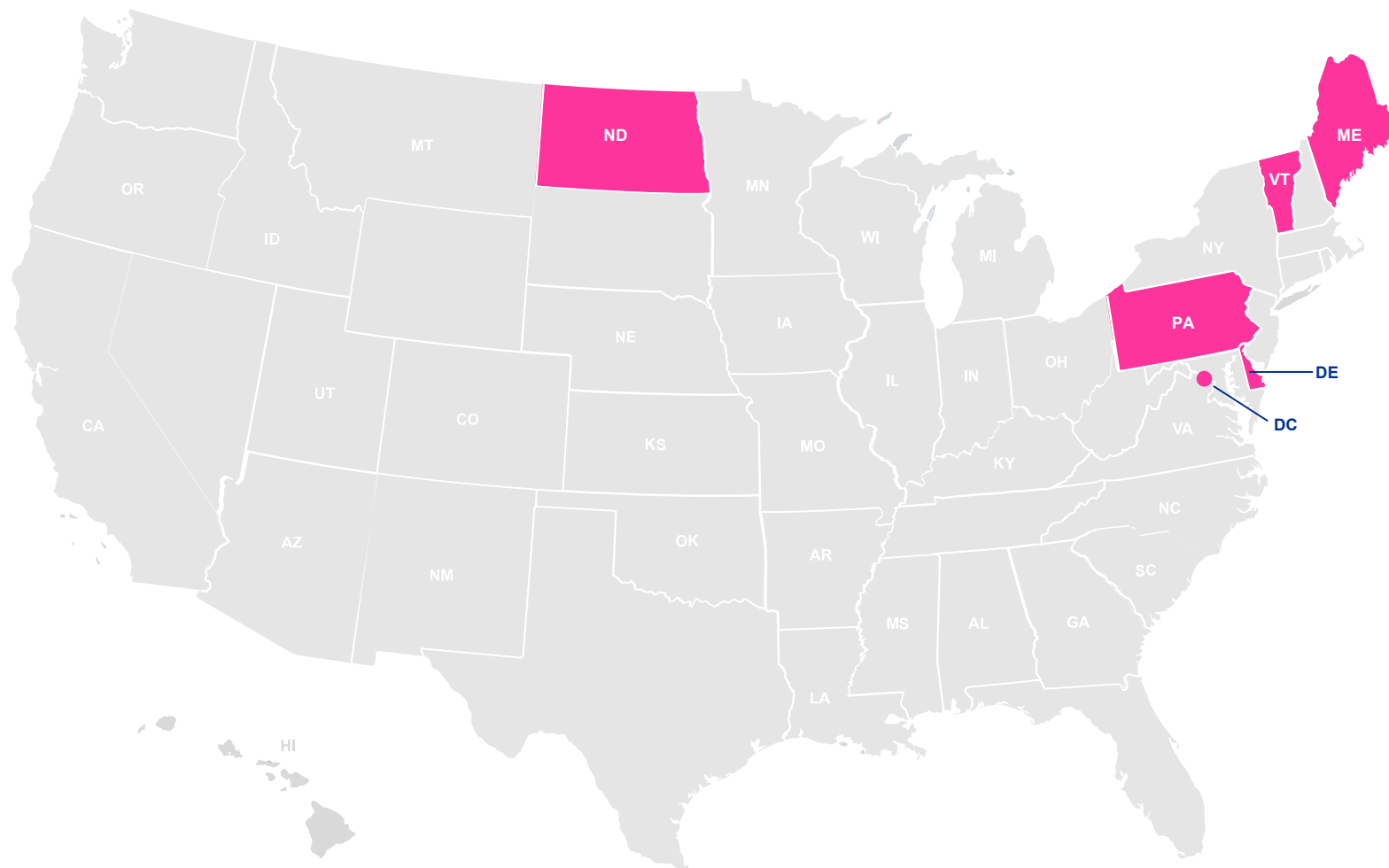
States with No PTET

No PTET enacted (yet)
and have a state
personal income tax



DE, DC*, ME, ND, PA, VT

* No income tax on nonresidents



Retroactive PTET and Changes in Approach

Retroactive to start of TCJA limitation in TY2018

- Colorado
- Nebraska

Changed limitation on which entities could elect

- Prospective (e.g., MN TY2023)
- Retroactive (e.g., VA TY2021)

Retroactive to prior year

- Legislation passed in year effective (e.g., IL)
- Immediately prior year (e.g., VA)

Moved from “income backout” approach to “PTET Credit” approach

- E.g., NM for TY2023

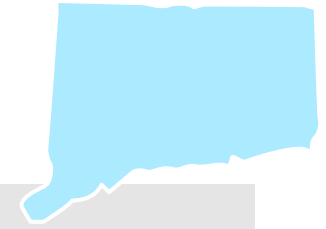
Connecticut changes



No longer mandatory starting TY 2024

- Mandatory composite and nonresident owners
- Elective PTET with nonelective tax base
- Tax base components
 - MCSI = modified Connecticut source income
 - RPUI = Connecticut resident portion of unsourced income
 - UI = Unsourced income
- Tax base computation
 - MCSI + RPUI

Connecticut changes



Nonelective tax base components

- MCSI =
 - IRC 702(a) separately/nonseparately computed items (including guaranteed payments, minus itemized deductions) +/- related modifications, multiplied by
 - % derived from or connected with CT sources, multiplied by
 - % held by individuals, trusts, etc.
- RPUI = UI multiplied by percentage ownership directly held by CT resident individuals
- UI
 - IRC 702(a) separately/nonseparately computed items (including guaranteed payments, minus itemized deductions) +/- related modifications, minus
 - IRC 702(a) separately/nonseparately computed items (including guaranteed payments, minus itemized deductions) +/- related modifications *multiplied by* % derived from or connected with CT sources, minus
 - IRC 702(a) separately/nonseparately computed items (including guaranteed payments, minus itemized deductions) +/- related modifications *multiplied by* % derived from or connected with sources in another state (if subject to tax in other state)

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PTET variations and computations

State Approaches and Variations

PTET Income Backout Approach Example

- Dan and Brad formed a partnership during 2022, with business operations only in South Carolina
- Dan is a DC resident (DC CFTP impact?) and holds a 2/3 interest; Brad is an SC resident and holds a 1/3 interest

South Carolina Elective Passthrough Entity Tax (SC PTET)	Dan (DC resident / SC nonresident)	Brad (SC resident)	Total
PTE SC tax base income (100% SC apportionment)	2,000,000	1,000,000	3,000,000
SC PTET Rate			<u>X 3%</u>
SC PTET Due			90,000
Partner share of SC Active Trade or Business Income from PTE making SC PTET election	2,000,000	1,000,000	
Partner SC personal income tax	Partner SC income 2,000,000 Minus Exclusion <u>(2,000,000)</u> SC income tax due -0-	Partner SC income 1,000,000 Minus Exclusion <u>(1,000,000)</u> SC income tax due -0-	
Potential federal tax deduction	\$60,000	30,000	Total Benefit tax- effected = <u>33,300</u>
Federal tax before SC PTET	2,000,000 x 37% = 740,000	1,000,000 x 37% = 370,000	
Federal tax after SC PTET	1,940,000 x 37% = 717,800	970,000 x 37% = 358,900	

PTET Credit Approach Example – Part 1 (IL PTET)

- Scott and Brad formed an S corporation during 2022, with apportionment 50% to Illinois and 50% to Virginia
- Scott is a VA resident and holds a 2/3 interest, while Brad is an IL resident and holds a 1/3 interest
- IL and VA credit for taxes paid (CFTP) treatment – “substantially similar” test and IL DOR list (Publ. 129)

Illinois Elective Passthrough Entity Tax (IL PTET)	Scott (VA resident/IL nonresident)	Brad (IL resident)	Total
PTE federal income	4,000,000	2,000,000	6,000,000
IL Apportionment			X 50%
IL PTET Rate			X 4.95%
IL PTET Due			148,500
Shareholder's share of IL PTET = Shareholder's Credit for IL PTET	99,000	49,500	
Shareholder IL personal income tax	$4,000,000 \times 50\% \times 4.95\% = 99,000$ Minus credit <u>(99,000)</u> Income tax due -0-	$2,000,000 \times 4.95\%$ Minus credit <u>(49,500)</u> Income tax due* <u>49,500</u> <i>*before IL CFTP</i>	
Federal tax deduction IL PTET	99,000	49,500	Total Benefit (tax-effected) = <u>54,945</u>
Federal tax before IL PTET	$4,000,000 \times 37\% = 1,480,000$	$2,000,000 \times 37\% = 740,000$	
Federal tax after IL PTET	$3,901,000 \times 37\% = 1,443,370$	$1,950,500 \times 37\% = 721,685$	

PTET Credit Approach Example – Part 2 (VA PTET)

- Same facts for S corporation and its shareholders
- Question: Does the S corporation continue to have a **valid S election**?

Virginia Elective Passthrough Entity Tax (VA PTET)	Scott (VA resident)	Brad (IL resident/VA nonresident)	Total
PTE federal income	4,000,000	2,000,000	6,000,000
VA Apportionment		X 50%	
VA PTET base income	4,000,000	1,000,000	5,000,000
VA PTET Rate			X 5.75%
VA PTET Due			287,500
Shareholder's share of VA PTET = Shareholder's Credit for VA PTET	230,000	57,500	
Shareholder VA personal income tax	4,000,000 x Grad. Rates = 229,743 Minus credit <u>(230,000)</u> Income tax due* (257) <i>*before VA CFTP</i>	2,000,000 x 50% x Grad. Rates 57,243 Minus credit <u>(57,500)</u> Income tax due* (257) <i>*Refund = Income (per tax benefit rule)</i>	
Federal tax deduction VA PTET See next slide for description of issue	230,000	57,500	Total Benefit (tax-effected) = <u>106,375</u>
Federal tax before VA PTET	4,000,000 x 37% = 1,480,000	2,000,000 x 37% = 740,000	
Federal tax after VA PTET	3,770,000 x 37% = 1,394,900	1,942,500 x 37% = 718,725	

S corporation qualification criteria

Criteria to maintain S corporation status

- Second Class of Stock
 - S corporations may only have one class of stock
 - Special allocations are not permitted (pro rata allocation requirement)
- Accumulated Adjustments Account
 - All of the corporation's stock must be entitled to the same distribution and liquidation rights
 - Special cash distributions to true-up for PTET not permitted
- Certain states have not focused on the federal rules
 - State rules may have not been designed to avoid the federal pitfall
 - State response may be – don't elect if it would result in federal disadvantage

New York State PTET



Aspects of a state PTET plan

- PTET tax base
 - The passthrough entity pays the PTET only with respect to the distributive share of its income attributable to NYS Article 22 personal income tax filers; NYS PTET is not paid on income shares of filers such as corporations or other partnerships
 - For New York State resident partners, the PTET is paid by the entity on the entire (i.e., unapportioned) income, but for nonresident partners the PTET is paid by the entity on the “New York source” income
 - For both resident and nonresident shareholders of an “electing standard S corporation,” the PTET is paid by the entity on the “New York source” amounts determined using the Article 9A sourcing rules
 - If all of the S corporation’s shareholders are New York residents, then the entity can instead be an “electing resident S corporation” that uses a base of its entire (i.e., unapportioned) income
- PTET tax rate
 - Tax range brackets, with the initial PTET bracket set at 6.85% for PTET taxable income of less than \$2 million, to as high as 10.90% on PTET taxable income exceeding \$25 million

New York State PTET-continued



Aspects of a state PTET plan

- PTET owner tax credit
 - Resident and nonresident taxpayers are entitled to a credit, against their New York State personal income tax liability, for their share of the PTET that was paid on their distributive or prorata share of income included in the PTET base
 - An individual claiming the credit must add back to income an amount equal to the amount of the credit
 - If the PTET credit for an individual exceeds the New York State personal income tax due, the excess is available as an overpayment carryforward or as a refund (without interest)
- PTET owner liability
 - Per NY Tax Law 866(c)(3), owners with joint and several liability for the NYS PTET include “the individual that made the election on behalf of the electing partnership or electing S corporation”
- Partner special allocations
 - The rules that govern the allocation of the federal deduction apply - consider IRC 704, the partnership agreement, and TSB-M-21(1)C,(1)I
- Composite for nonresident owners
 - PTE tax credit is not permitted to be claimed on a composite/group return filing in New York State

Elective PTET Variations

Structure of a particular state's PTET plan can impact the potential benefit

- Income backout versus PTET Credit approach
 - Consider other sources of income/loss and refundability of PTET Credit
- Types of passthrough entities that can elect and limitations based on tax classification of owners
 - Which owners have distributable or prorata share included in the tax base?
 - How much of an owner's distributable or prorata share is included in the tax base?
 - Guaranteed payments
- Tax years for which pass-through entity tax election is available
- Impact of I.R.C. Section 164(b)(6) repeal
- Impact on owner filings
 - Composites
 - Credit for taxes paid
- Payments: timing and nonresident withholding
- New PTET forms and pass-through entity state returns

03

Common questions and practical experiences

Factors Impacting Potential Benefit

Top 10 PTET Hot Topics

- 1 If PTE missed election or payment deadlines, is electing PTET still possible?
- 2 Will my trust owners (and the trust beneficiaries) benefit from PTET?
- 3 Does each owner get to decide whether to participate in the PTET?
- 4 Could a PTET election impact my qualification as an S corporation?
- 5 How could PTET impact my decision on selling an S corporation or its assets?
- 6 If a PTE elected last year, is it true there is no need for modeling this year?
- 7 Does the ability to have special allocations matter?
- 8 One of the PTE owners says we should elect PTET - is there any reason why we would not want to elect PTET?
- 9 What is your view on the deductibility of PTET paid on investment income?
- 10 Do the states where our PTE has its activities or states with resident owners have an elective PTET yet?

PTET Uncertain Issues

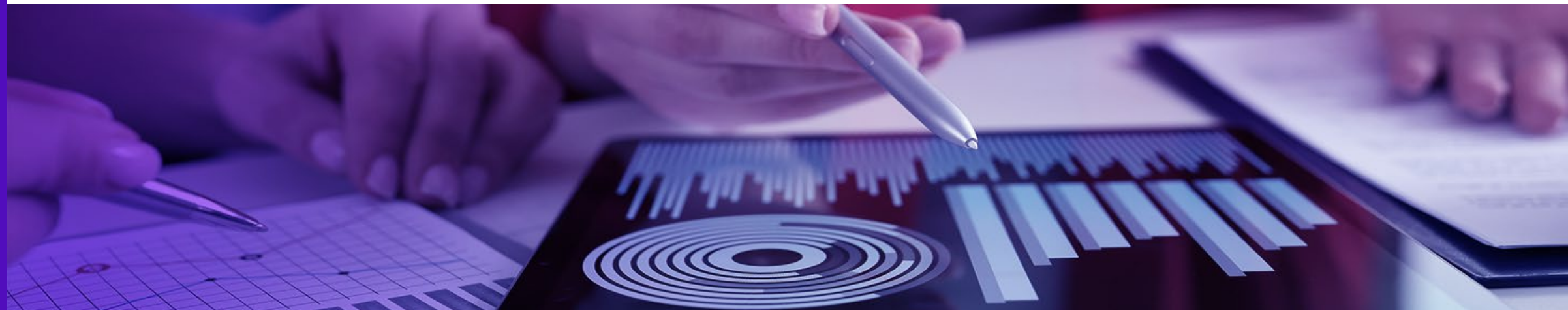
What are the parameters for federal deductibility and avoiding a state detriment?

- Federal deduction for state taxes
 - History and tax form usage
- Federal income tax impacts on owner
 - *Maines v. Commissioner*, 144 T.C. No. 8 (2015)
- Federal deduction timing
 - Connection to state elections and state payments
- State tax impacts on owner
 - Credit for taxes paid
- Accounting for income taxes
 - Treatment as partner capital adjustment or as income tax?

PTET Scenarios and Review

What impact does changes in activities or owners have on the PTET benefit?

- Need for annual review
 - Various factors could impact the PTET benefit
- Potential changes that impact PTET benefit
 - Level of income (e.g., state graduated tax rates)
 - Changes in types of owners (e.g., transfer from individual to trusts)
 - Owner residency (e.g., impact of partner moving from NY to FL)
 - Composite returns and nonresident individual returns – compliance cost impact
 - Other sources of income and deductions for owner (e.g., charitable plans)
 - Extraordinary income / loss items (e.g., disposal gain)



PTET and Transactions

Transaction Considerations and Potential Pitfalls

- Logistical considerations (e.g., election timing and who has authority to make election)
- Transaction form: F reorganization, sale of a disregarded entity, IRC 338(h)(10)
 - Disposal by the owners, that are not reported by the PTE itself, result in gain for the owner and not the PTE, which means the gain would not be in the PTET tax base
- Consider PTET in gross-up calculation? Impact?
- Due diligence: is there exposure for the buyer resulting from seller's PTET-related actions?
- Did transaction result in tax year that ends or not?
- New entities formed after PTET election date (e.g., NY has a first quarter election date)
- State sourcing, treatment of gain related to goodwill asset, and deductibility
- Cash for payments of PTET and which party gets a federal deduction
- Impact of current or future PTET elections on the terms to include in deal documents

PTET Interaction with Other Developments

Potential for PTET benefit can be connected to other state positions

- Illinois changes for “Investment Partnerships”
- California Office of Tax Appeals cases on sourcing of passthrough disposals
 - *Matter of the Appeal of Buehler*
- Has partner residency actually changed?
 - NY Division of Tax Appeals: *Mr. Garg and Ms. Nigalayev vs. NY DTF*
- State Partnership Audit Rules



Q&A

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Thank you!

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