



Taxpayer and Practitioner Considerations for Whether to Elect into a State Pass-Through Entity (PTE) Tax

Background

With the Tax Cuts and Jobs Act of 2017 limiting the amount of state and local taxes individuals can deduct for federal income tax purposes to not more than \$10,000 annually (“SALT cap”), thirty-six states plus New York City have enacted pass-through entity-level tax legislation to offer taxpayers a “workaround” to the SALT cap, and several more state legislatures are considering the proposal. See attached map.

On Nov. 9, 2020, the Internal Revenue Service (IRS) issued [Notice 2020-75](#) to provide guidance and clarify that pass-through entity owners can deduct their share of the taxes paid by the entity, even if electing to be taxed at the entity level and that it would issue proposed regulations to that effect.

The owners of pass-through entities generally may either be allowed a credit for their share of the PTE tax (PTET) or to exclude their share of the pass-through entity’s income from the taxing jurisdiction’s imposition of income tax on the owners. Unfortunately, each state has adopted a different approach for its PTET. The rules vary based on many factors, such as eligibility, election method, frequency (annual or one-time), tax base and rates, how and when to pay, filing forms, allowance of state credit for entity tax paid to another state, interaction with other state tax rules, etc. It is critically important for practitioners and taxpayers to read IRS Notice 2020-75 and the relevant states’ PTET statute and any guidance and forms from the state tax agency prior to making any decisions.

Issues to Be Considered by Taxpayers and Practitioners in Deciding whether to Elect into a State PTET

Various issues should be considered when deciding whether a taxpayer can and should elect into a state PTE tax.

Members of the AICPA’s State and Local Taxation (SALT) Technical Resource Panel members shared their experiences and compiled with review and input of the AICPA SALT Deduction PTET Task Force the following questions that should be carefully reviewed by the taxpayers and fellow practitioners before making decisions on whether to elect into a PTET in any state.

Election Issues:

- Is the PTET statute elective or mandatory? (Connecticut was mandatory 2018 through 2023)
- What percentage of ownership is required to make the election and what is the voting procedure (remember, voting requirements/procedures may vary from state to state)?
- Is the PTE required to make estimated state tax payments?
- When are estimated payments due?

- When is the election due? Has the election or filing been extended, especially when enacted in the first year the election is available?
- What is the effective date of the election? Is the effective date retroactive?
- Is the election binding for just the current year or for multiple years?
- Is the election required to be made annually?
- When can the election be revoked?
- What are the voting requirements/procedures and notification procedures for revocation?
- Is the PTET statute one that automatically sunsets if the SALT cap sunsets on December 31, 2025, or does it expire on 12/31/25 regardless, or is it permanent? (Most, but not all, state elections are independent of the federal)
- Which entities / types of owners are allowed to make the election?
- Can resident and non-resident owners make an election or consent to participate (if that is part of the state's PTET regime)?
- What form(s) needs to be filed?
- What is the entity withholding tax rates?
- What is the PTET rate?
- What is the highest individual tax rate (relates to composite filers)?
- Is there an exclusion of income (e.g., Wisconsin) or a flow-through of income and credit for PTE tax paid (refundable or nonrefundable) (e.g., the majority of the states)?
- What are the benefits to members/partners and what are potential detriments?
- How is the PTET credit used in sequence with other credits for owners?
- Is there is any AMT issue of using a PTET credit?
- Double check the operating or partnership agreement and consider:
 - Does the agreement even permit the PTE to elect to pay a PTET?
 - Are the voting requirements consistent with the PTET statute?
 - Do the allocation provisions properly allocate any PTET to each partner in a way that reflects the partner's share of the economics?
 - Does the agreement allow cash distributions to non-electing/non-consenting/ineligible owners?
 - If there is a cash distribution provision, are distributable earnings reduced by the partner's share of any PTET expense?
 - Are guaranteed payments reduced by the partner's share of any PTET expense?

Federal Issues

- How is excess PTET credit taxed?
- For federal income tax purposes, is the PTET deduction an IRC section 162 or section 212 deduction?
- Has Reg. §1.67-1T(c) been considered?
 - It provides for allocation of expenses related to both a trade or business activity and a production of income activity using a "reasonable basis."
- Does the PTET reduce self-employment tax or net investment income tax?
- Will additional disclosure be necessary for all shareholders to properly treat the PTET deduction under the net investment income tax rules and passive activity rules?
- Can the entity apply a loss carryforward from a prior year?

- Does the state election and payment sequencing create a “deposit” for federal tax purposes, such as where the payment was made in one year, but the entity cannot elect until the subsequent year when the election is can be made?
- Will the IRS allow payment alone to be enough for a federal deduction (ignore deposit issues)?
- Does IRS Notice 2020-75 allow a partnership to specially allocate the PTET to the consenting/eligible owners?
- How will the PTET deduction affect the 199A deduction? Is there a reduction in the section 199A qualified business income deduction?
- What is the timing of payment when deducting for federal tax purposes (some partners will have tax effects depending on the year the distribution is made)?
- Which year does the entity take the federal deduction? The owners should consider the tax law on “deposits” and methods of accounting.
- How does the entity report any refund of the PTET?
- Must a refund be separately reported to the owners in order to determine the tax treatment?
- Are there any complications for S corporations related to:
 - Shareholder agreements
 - Per share, per day allocation of income / expense
 - Disproportionate distributions
 - One class of stock issue

State Issues

- Does the PTET regime exclude the PTE’s income from the owners’ returns?
- What income and deductions will be included in the state taxable income base for the PTET?
 - For example, will charitable contributions reduce the base?
 - Will a sale of the entity structured for tax as an asset sale increase the base?
 - Will a sale of the entity structured for tax as a stock sale be includible in the base?
- Does the PTET include the distributive share of otherwise exempt owners?
- Is there nonbusiness income that will be sourced to a state if the election is made?
- Does the PTE payment deducted for federal tax purposes create a nondeductible item for state taxes that reduces the shareholder basis before losses and deductions?
- Does the PTET regime provide a full or partial credit to owners for taxes paid?
- Are there limits on the shareholders’ ability to use the credit on their state returns?
- Will other states in which the PTE is doing business allow a credit for the PTET at the owner level?
- Is nonresident partner or shareholder withholding still required when the PTE election is made?
- Can the PTE election and payment of PTE tax at the entity level satisfy a nonresident member’s state filing requirement? (i.e. such that a separate filing by the member is not required)
- Can a pass-through entity still elect to file a composite return if a PTE election is made? If yes, how is the PTE credit applied/claimed?
- Can estimated composite, withholding and/or individual estimated payments be transferred to the pass-through entity’s account to cover the PTE tax?

Taxpayers and Tax Practitioner Issues

- What are the compliance costs (including CPA fees)?
- How much risk does the election create for the entity or owners, assuming that the IRS issues no more guidance?
- Does an operating agreement need to be reviewed by legal counsel and/or amended in order to optimize, or otherwise account for an efficient election?
- Are the entity and owners “eligible” as defined under the state’s PTE statute?
- Who determines if qualified taxpayers (owners) consented?
- Who is charged with monitoring new state Department of Revenue (DOR) guidance or changes in the laws of the states in which the PTE election has been made, or might be made if the law or conditions changed?
- How will the election be made and documented and what documentation is needed to prove an owner consented or not to the election?
- Is the election or vote made anonymously to other partners or not? Note that the partnership and its managers (and advisers) ultimately need to know who elected.
- What are the mechanical issues with the state PTET return preparation? For example, if the return must be filed through the state’s website, the tax practitioner may be required to obtain a Power of Attorney (POA) or a specific type of account in order to be able to prepare and release returns for clients. Note that even if that is possible, the practitioner may not want to do that or may need contractual language. For example, if the practitioner’s firm is also the auditor for the taxpayer, perhaps the practitioner may need to be more careful about what information tax preparers would have if they entered into a client account.
- What is the likelihood of interest in the SALT cap workaround, assuming the entity and at least one owner is “qualified”?
- If the SALT cap is raised by Congress, does that change the willingness of qualified taxpayers (owners) to consent to (or continue) the election?
- Do owners have sufficient tax they individually owe on their share of PTE net income so that they are above the SALT cap?
- Which states should an entity with income taxed in multiple states pay the optional state PTE tax?
- How and when to handle amended returns and audits? Like the comprehensive partnership audit rules (CPAR), does the partnership/operating agreement specify who handles these?
- Does the partnership/operating agreement require a distribution to all partners?
- If the PTE deduction is reported on Schedule K in Other Deductions, rather than in nonseparately stated ordinary business income, will an additional disclosure be needed, since the return will not comply with the Notice?
- What will the effect be on distributions to defective grantor trusts that were expected to fund installment sale payments? (For tax practitioners only) Conflict of interest and malpractice risks in advising owners and entities, such as:
 - How to explain unknowns to a client?

- How to advise entity and owners who may have conflicting interests and when the law is not 100% clear?
- How to handle a situation where not all owners consent or are eligible?
- How to deal with issues when not all owners consent or are not all eligible to get a state tax credit as this situation likely causes a violation of an S corporation's one-class-of-stock requirement, and for a partnership, it might violate the partnership agreement and cause other tax and legal issues for the entity and owners.

State Activities

For the information on the state-by-state PTE taxes, please refer to the AICPA [Map of States with Adopted or Proposed Pass-Through Entity \(PTE\) Level Tax.](#)

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