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State PTE Elections: Pitfalls & Opportunities

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Presenters

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Evan Meltzer
Director

317.383.4252
evan.meltzer@forvis.com



Jim Pierzchalski
Director

816.489.4323
jim.pierzchalski@forvis.com

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Agenda

- History
- What Is a State PTE?
- IRS Treatment
- State PTE Compliance Considerations
 - Making the Election
 - Eligibility
 - PTE Tax Payments
 - Income Tax Base
 - Individual Return Filing Requirement
 - Credit for Taxes Paid, Income Exclusion, or Neither
- Questions

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History

- The 2017 Tax Cuts & Jobs Act (“TCJA”) created a limit (“SALT Cap”) on the State & Local Tax itemized deduction of \$10,000 (married filing jointly) & \$5,000 (married filing separately) for tax years beginning after 12/31/17 & before 1/1/2026
- This limit has a severe impact on individuals from states with high income tax rates, such as California, New Jersey, & New York
- There has been debate on Capitol Hill about raising the limit, but at this time no such legislation has been passed

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History

- Since the passage of TCJA, high tax rate states have been attempting legislation to provide benefit to residents of their states impacted by the SALT Cap
- The IRS previously rejected state efforts to provide additional deductions by recharacterizing state tax payments as charitable contributions to the states
- The IRS did approve the deduction of entity-level taxes of pass-through entities

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What Is a State PTE?

- A state PTE tax treats the tax paid at the PTE level as a deduction at the pass-through entity rather than an itemized deduction at the individual partner level, which would be subject to the SALT Cap
- A state PTE is not subject to the TCJA's SALT Cap
- The PTE tax paid by the pass-through entity will reduce the entity's ordinary income

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What Is a State PTE?

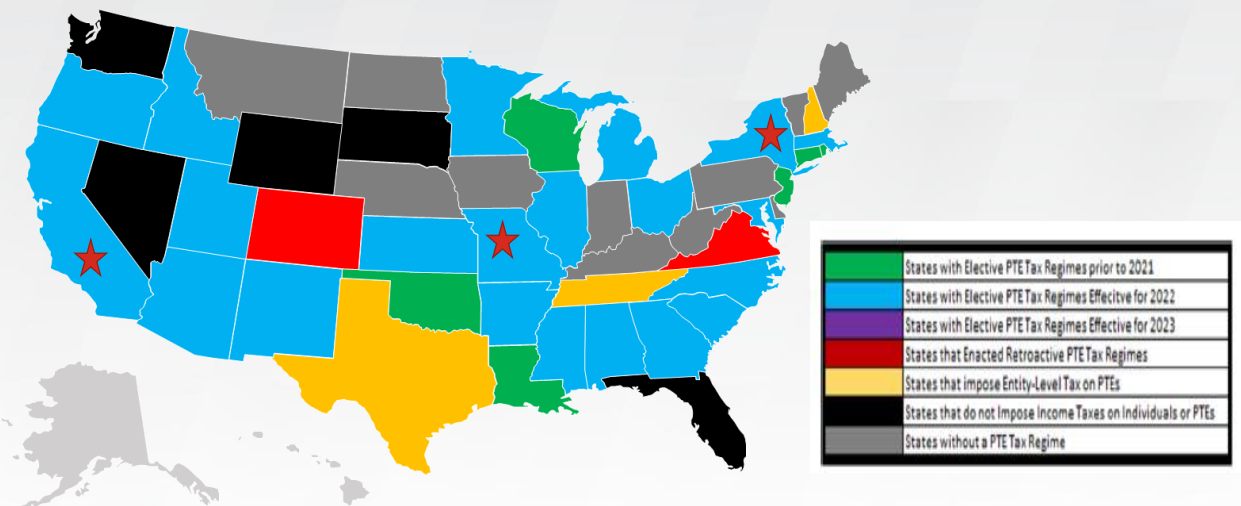
States with a PTE Election (effective tax year beginning on or after)

- Alabama (1/1/21)
- Arizona (12/31/21)
- Arkansas (1/1/22)
- California (1/1/21)
- Colorado (1/1/22)
- Connecticut (1/1/18)
- Georgia (1/1/22)
- Idaho (1/1/21)
- Illinois (12/31/21)
- Kansas (1/1/22)
- Louisiana (1/1/19)
- Maryland (12/31/19)
- Massachusetts (1/1/21)
- Michigan (1/1/21)
- Minnesota (12/31/20)
- Mississippi (1/1/22)
- Missouri (12/31/22)
- New Jersey (1/1/20)
- New Mexico (1/1/22)
- New York (1/1/21)
- New York City (1/1/23)
- North Carolina (1/1/22)
- Ohio (1/1/22)
- Oklahoma (1/1/19)
- Oregon (1/1/22)
- Rhode Island (1/1/19)
- South Carolina (1/1/21)
- Utah (1/1/22)
- Virginia (1/1/21)
- Wisconsin (S-Corps 1/1/18; Other PTEs 1/1/19)

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State Map of PTE Elections for 2022



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IRS Treatment

- Business taxpayers are not subject to the SALT Cap
- According to IRS Notice 2020-75, PTE tax payments are deducted on a cash basis regardless of the accounting method of the taxpayer
 - “(2) Deductibility of Specified Income Tax Payments. If a partnership or an S corporation makes a Specified Income Tax Payment during a taxable year, the partnership or S corporation is allowed a deduction for the Specified Income Tax Payment in computing its taxable income for the taxable year in which the payment is made”

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Compliance Considerations

Making the Election

- When is the election effective?
- What is the deadline to make the election?
- Is it annual, revocable, irrevocable, etc.?
- What is the compliance burden of the election?
- What entity types are eligible?
- Who is an eligible owner participant?
- How are tiered structures treated?

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Compliance Considerations

Making the Election

- Must all owners participate?
- How are estimated tax payments treated, especially for the first year?
- Do the owners still file a personal return in the state?
- How are net operating losses treated?
- How is the income of a resident owner calculated?
- What adjustments are made in the calculation of income, *e.g.*, separately stated items of income/deduction?
- Can the PTE file a composite return & claim a credit?

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Compliance Considerations

Making the Election

- Deadlines vary among the states
- Deadlines also might vary year-to-year within the same state, *i.e.*, deadline for first year the PTE option was available versus subsequent years
- In some states, the election must be made by the due date of the return, including extensions (Ex: Colorado, Georgia, Illinois)
- In other states, the election must be made before March 15th of the year the election will take effect (Ex: Michigan, New York)
- New York is an example of a state that provided alternate deadlines in the first & second year (9/15 for tax year 2022)

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Compliance Considerations

Making the Election

- Election periods vary state by state
- Most states require an annual election (Ex: Arizona, California, Colorado)
- Others are effective until revoked or binding for a period of time
- Effective until revoked (Ex: Alabama, Oklahoma)
- Binding for three years (Ex: Michigan)
- Annual election but binding for that tax year once made (Ex: Colorado, Georgia)
- Some states have revocable elections (Ex: New Jersey – must be revoked before original due date of return)

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Compliance Considerations

Eligibility

- Typically, entities that have pass-through treatment for federal & state purposes are eligible
- This would normally include partnerships, LLCs taxed as partnerships, as well as S Corporations
- Disregarded entities would not typically be eligible like single member LLCs (SMLLCs), Qsubs, etc.

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Compliance Considerations

Eligibility

- Typically, individuals, trusts, & estates are eligible owners of an electing PTE
- In some states, a PTE could be an eligible owner of another PTE provided its ultimate owners are individuals, trusts, & estates

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Tiered PTE Structures

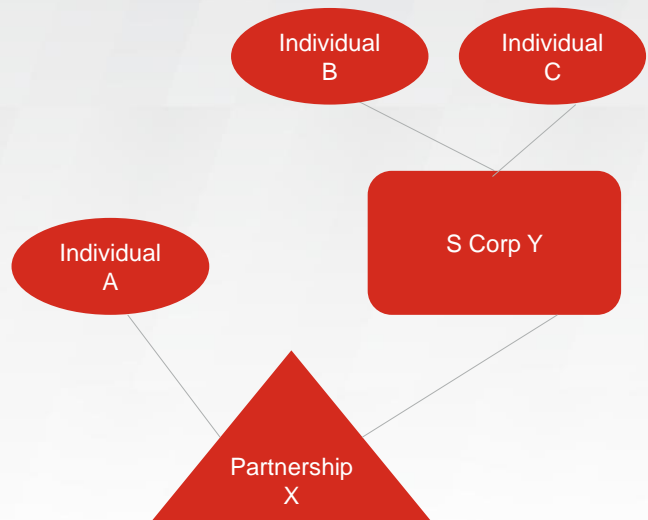
Individuals B & C: Eligible, so long as S Corp Y makes the PTE election

Individual A: Ineligible under the current structure since Partnership X is not permitted to make the PTE election

An eligible entity must be 100% directly owned & controlled by parties eligible as S corporation shareholders under the IRC

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Georgia



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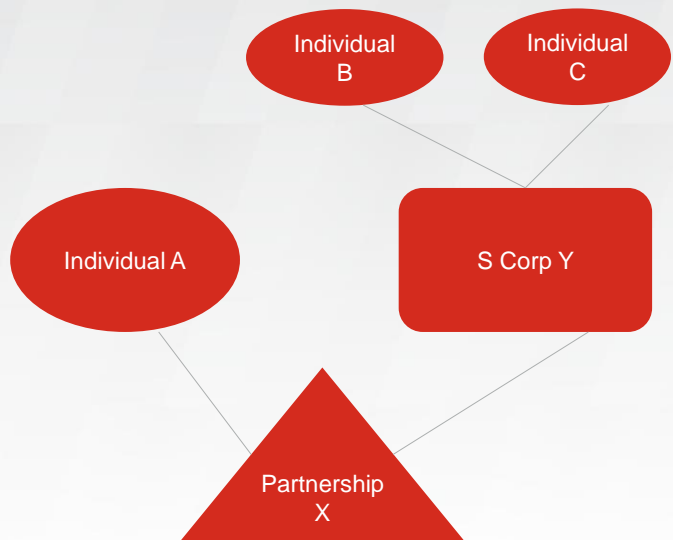
Tiered PTE Structures

Individuals B & C:
Eligible, but only if S Corp Y makes the NC PTE election.
Partnership X is ineligible

An eligible entity must be 100% owned by individuals, estates, trusts, & certain tax-exempt organizations to make the election

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Compliance Considerations

- **PTE Tax Payments**
 - Some states offer first-year Estimated Tax Payment penalty waivers
 - A few states will allow an individual or composite account to transfer payments made to a PTE (Ex: Minnesota)
 - Some states do not allow for the transfer of an individual payment to the PTE, but those payments are taken into account in the calculation of the underpayment penalty (Ex: New Jersey)
 - There are some states with mechanisms to transfer PTE payments to the owners or to be refunded if the election is made & subsequently revoked

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Compliance Considerations

▪ Income Tax Base

- States' approaches to the income tax base are generally calculated based on the following two options
 - Option 1
 - Income from residents & apportioned income from non-residents (Ex: California, Kansas)
 - Key consideration is applicability of the payments made on behalf of resident partners

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Compliance Considerations

▪ Income Tax Base (cont.)

- States' approaches to the income tax base are generally calculated based on the following two options
 - Option 2
 - Income is based on the apportioned share sourced to each partner (Ex: Missouri)
 - This calculation is typical of what would be derived in a state composite tax return

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Compliance Considerations

▪ Individual Income Tax Return Filing Requirement

- States vary on rules related to the filing requirements of individual partners included in pass-through entities making a PTE election
- Most states will not require a nonresident to file an individual income tax return if the partner has no additional state sourced income to report for the tax year (Ex: Illinois)
- This treatment is similar to state composite income tax returns
- However, there are states that require a return to be filed even if there is no other state sourced income to report (Ex: California, New York)

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Compliance Considerations

▪ Individual Income Tax Return Filing Requirement (cont.)

- These states require the individual to file a nonresident return & report the applicable state sourced income & corresponding PTE credit attributed
- It is too early to know how aggressively the states will enforce this requirement if the nonresident partner does not file a return

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Compliance Considerations

▪ Credit for Taxes Paid

- In addition to the federal income tax deduction at the pass-through entity, the other key provision is whether states will allow a resident to claim a credit for taxes paid on their individual income tax returns
- In most states the answer is yes
- However, there are some complexities in terms of which states are allowed & the calculation of the credit
- Review state guidance to determine if there is a “substantially similar” component to the definition of which state PTE credits are allowed

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Compliance Considerations

▪ Income Exclusion

- There are a handful of states which do not allow a credit for taxes paid but do allow an income exclusion from the individual’s tax base
- In these states the individual can subtract from their resident income the amount of income that has been subject to a state PTE tax in their nonresident states
- While this is not as beneficial as the credit for taxes paid, it is still a benefit to the individual

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Compliance Considerations

▪ Neither

- Finally, there are a few states which do not allow a credit for taxes paid or an income exclusion from the individual's tax base
- Generally, these are states which do not currently have a PTE option in place (Ex: Indiana)
- This adds an extra layer of complexity when a pass-through entity has partners from states which do allow a credit for taxes paid or income exclusion & states which allow neither

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Compliance Considerations

▪ Example

Federal Taxable Income		\$	1,000,000		
Missouri Source Income		\$	500,000		
Missouri PTE Tax Rate			5.30%		
Missouri PTE Tax		\$	26,500		
Owner Resident State	Ownership %	Share of MO PTE Tax	Federal Tax Rate	Federal Tax Benefit	
Missouri	25%	6,625	37%	2,451	
Illinois	25%	6,625	37%	2,451	
Texas	25%	6,625	37%	2,451	
Indiana	25%	6,625	37%	2,451	
Indiana Resident - Tax					
Federal AGI		\$	250,000		
Indiana Tax Rate			3.23%		
Indiana Income Tax		\$	8,075		
Indiana Resident - Credit for Taxes Paid					
Income x Indiana Tax Rate (3.23%)		\$	4,038		
Lost Credit		\$	(4,038)		
Net Benefit/(Loss)		\$	(1,586)		

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