Passthrough Entity Taxes and Resident Credits: Avoiding Double Taxation

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Introduction

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I. AN OVERVIEW OF THE SALT DEDUCTION AND PTE TAXES

Why the need for a PTE Tax?

- TCJA – SALT Cap
  - SALT deduction for individuals temporarily limited to an aggregate deduction of $10,000 ($5,000 for a married taxpayer filing a separate return).
  - Applies to tax years beginning after December 31, 2017 and before January 1, 2026.

Relevant Exceptions to the SALT Cap

- Code section 164(b)(6): State, local, and foreign real property taxes paid or accrued in carrying on a trade or business or an activity described in Code section 212 (relating to expenses for the production of income) are not subject to the SALT Cap.

- JCT Explanation: "Additionally, taxes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner's or S corporation shareholder's distributive or pro-rata share of income or loss on a Schedule K-1 (or similar form), will continue to reduce such partner's or shareholder's distributive or pro-rata share of income as under prior law."

State Taxation of Pass-through Entities Pre-TCJA

- Before passage of the Tax Cuts and Jobs Act ("TCJA"), P. L. 115 – 07, most states conformed to the federal pass-through tax treatment of pass-through entities, with certain outliers:

  - Previously existing or "legacy" entity level taxes: New York City, District of Columbia, Illinois, New Hampshire, Tennessee, Texas
  - Previously existing pass-through entity taxes on nonresidents: Ohio
  - Gross receipts, annual fees or flat taxes, composite returns

State Taxation of Pass-Through Entities – Post-TCJA

- Since the passage of TCJA, at least 16 states have enacted various forms of Pass-Through Entity Taxes (“PTET”). Other states (MI, PA, NC) considering enactment.
- Concept: Instead of passing income through to PTE owners, the law requires a PTE to pay tax on its income at the entity level, similar to a tax on a C corporation.
  - Shift the tax on PTE income from the owner to the PTE to allow the PTE to deduct the entity’s state and local income taxes as a tax on the business at the federal level, followed by a deduction for the PTE tax in the distributive share of the PTE owner’s income.
  - At the state level, owner claims a credit on the owner’s state income tax return for the amount of the owner’s distributive share of the taxes paid by the PTE.

Considerations

- A state PTET may not apply to all owners equally
- A state PTET may increase overall tax liability
- A state PTET may have an adverse impact on nonresident individual owners whose own state law will not provide an offset for the taxes deductible at the individual level
- How to handle differing tax results for owners
- Simplified nexus and administrative burdens
- Impact of PTET election on composite returns

How much benefit?

- How much benefit PTETs will yield in federal tax benefits depends on:
  - The states in which the PTE does business
  - Composition of its owners (individuals, corporate)
  - Tax rates
  - Impact of a credit for taxes paid by the entity against the state personal income tax of the state in which the PTE tax is levied and the state of residence of the owner

→ All of these issues must be considered in determining whether to make a PTET election BUT the issue of resident credits might be the most critical

II. *THE VARIOUS FLAVORS OF PTETS*

The Mandatory PTET: Connecticut

- On May, 31, 2018, CT became one of the first states to enact a PTE regime directly in response to the SALT deduction cap
- CT PE tax is applicable beginning in the 2018 tax year and is mandatory (with an elective alternative base)
- Applicable to every PE that does business in Connecticut and has income derived from or connected with Connecticut sources
- Tax rate is 6.99% (highest PIT rate)
- PEs can file a combined return if they meet the ownership test (80% voting control directly or indirectly owned by common owner(s))
- Nonresidents who have no other CT source income other than the income from the PE are not required to file a return
- CT uses customer-based sourcing for all entity types

Calculating the CT PE Tax

Two Tax Bases:

1. Standard Base (default) = CT Source Income of PE - CT Source Income from Subsidiary PEs
2. Alternative Base (elective) = Modified CT Source Income + Resident Portion of Unsourced Income

- 2019 legislation clarified that guaranteed payments are included in the calculation of both tax bases

CT PE Tax: Calculating the Credit

- Original legislation provided a tax credit to partners/shareholders of 93.01%
- 2019 legislation reduced that percentage to 87.5%
- Corporate partners eligible for credit subject to corporate tax rules

CT PE TAX – ALTERNATIVE BASE EXAMPLE

- PE has $100,000 of total income. The PE is owned by (1) a resident individual, (2) a nonresident individual, (3) a corporation subject to the corporation business tax, and (4) a tax-exempt entity. Each of these four partners receive distributive shares equal to 25% of PE's income. PE has nexus with Connecticut, Massachusetts, and Rhode Island. Under Connecticut sourcing rules, PE has $10,000 of Connecticut source income, $20,000 of Massachusetts source income, and $30,000 of Rhode Island Source Income.
- PE has a ***Standard Base of $10,000***.
- 50% of the PE's income is distributed to partners subject to tax under chapter 229 (the resident and nonresident individuals). Therefore, the PE's ***Modified Connecticut Source Income is $5,000*** ($10,000 * 50%).
- PE has $40,000 of unsourced income ($100,000 - $60,000). A resident individual receives 25% of the PE's distributive shares of income. Therefore, the ***Resident Portion of Unsourced Income is $10,000*** ($40,000 * 25%).
- PE is subject to tax on $15,000 (its $5,000 of Modified Connecticut Source Income plus $10,000 of Resident Portion of Unsourced Income).
- PE Tax liability of $1,049 ($15,000 * 6.99%).

THE ELECTIVE PTET: NEW JERSEY BUSINESS ALTERNATIVE INCOME TAX (“BAIT”)

- NJ BAIT effective for tax years beginning on or after January 1, 2020.
- Allows pass-through entities to *elect* to pay tax on owners’ share of “distributive proceeds.”
  - Requires annual election.
- Owners’ receive a credit against gross income tax equal to the member’s tax on the share of distributive proceeds paid by the pass-through entity.
- Not available to SMLLCs or sole proprietorships.

CALCULATING THE BAIT

- Tax is calculated on the sum of each member's distributive proceeds of income sourced to NJ

- "Distributive proceeds" = net income, dividends, royalties, interest, rents, guaranteed payments, and gains derived from or connected with New Jersey sources.
  - Uses federal ordinary income as starting point

- NJ source income determined based on the gross income rules

- Includes corporate partners' distributive proceeds

- Combined BAIT returns permissible

CALCULATING THE BAIT CREDIT

- Partners/shareholders get a credit for the tax on their share of distributable proceeds

- Corporate partners can take the credit but cannot reduce their tax below the minimum tax due

- Partnership can still file composite returns for nonresident partners and apply the BAIT credit against the taxes due

ELECTIVE PTET WITH AN OWNER-LEVEL ELECTION: CALIFORNIA

- Passed on July 16, 2021

- Available 2021 – 2025

- Available to “qualified entities” and their owners who are “qualified taxpayers
  - A **qualified entity** is an entity treated as a tax-partnership or an S corporation, and whose owners are corporations or individuals but <u>not partnerships</u> (*i.e.* a qualified entity can be a partnership, but can’t have an owner that is a partnership).
  - Also excluded: Publicly-traded partnerships, members of a California corporate combined reporting group, disregarded entities

- Automatic repeal if full SALT deduction is reinstated

- PTET is in addition to the 1.5% S corporation tax

CALIFORNIA PTET

- California (cont.)
  - The election is made by filing a return and by satisfying a tax-payment requirement
    - For 2021: The tax-payment requirement is satisfied by paying the tax on or before the original due date of the return (w/o extensions)
    - For 2022 – 2025: The tax payment requirement is satisfied by paying the greater of 50% of the tax paid by the entity in the prior year or $1000 (and the balance on or before the original due date of the return)
  - Election is irrevocable
  - Tax rate is 9.3% and base is the amount of income (for resident owners) and California-source income (for non-resident owners) attributable to consenting owners who are individuals, fiduciaries, trusts or estates.
  - Owners must individually consent to have their shares of income included in the PTET base (total income for residents, sourced income for nonresidents, apportioned income for corporations)
  - Consenting owners get a nonrefundable credit (with a 5-year carry-over) equal to their pro rata share of the taxes paid
    - Is this a bad deal for non-residents and corporations because they will experience a diminishment of their capital accounts?

ELECTIVE PTET WITH OWNER PIT INCOME EXCLUSION: LOUISIANA

- Louisiana
  - Effective for years after 2018
  - Rates are graduated with 6% being the highest rate
  - Elective
  - Election may be made by majority vote of members (by capital account for partnerships and ownership percentages for S corporations)
  - Applicable to any electing tax-partnership and electing S corporations
  - Election results in the entity being taxed as a C corporation (so the base will be apportioned)
  - Owners (but not corporate owners!) get an exclusion for items of income and loss taken into account at the entity level

LEGACY PTET: Washington D.C.

- District of Columbia
  - DC's unincorporated business tax has been around for a while
  - Rate is 8.25%
  - Mandatory
  - Applicable to tax-partnerships only
  - Tax base must be apportioned
  - No credit or exemption to owners
  - Legacy tax

LEGACY PTET: NYC UBT & GCT

- NYC has taxed pass-through entities for decades (UBT established in 1966).
- Partnerships, LLCs, DREs, and sole proprietorships doing business in NYC taxed subject to Unincorporated Business Tax.
  - Rate is 4%
  - Single factor, receipts only allocation
- Federal S corporations subject to General Corporation Tax.
  - NYC does not recognize the federal S election
- UBT and GCT not “tied” to NYS tax regime for partnerships and federal S corporations. Very distinct regimes.

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III. RESIDENT CREDIT STATUTES

TAXATION OF RESIDENTS VS. NONRESIDENTS

- Taxable Income:
  - Residents – Everything
  - Nonresidents – Income from in-state sources is taxable
- What qualifies as “income from in-state sources”?
  - Wages for services performed in-state
  - Income/loss from real property
  - Income/loss from in-state business
- Not all income has a source
  - Think “unearned income” or income from investments/intangibles
  - Generally not taxable for nonresidents
  - Double-taxation possible for dual-residents

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RESIDENT TAX CREDITS

- States generally allow their residents a credit for taxes paid to other states
- Credit cannot exceed the tax due in home state
- Two general approaches:
  - Most common – Credit allowed for tax paid to other state on income sourced to that state, typically based on the home state's allocation rules (i.e. if we would tax a nonresident on the income, we will give the resident credit on taxes paid to the other state on that income)
    - E.g., New York, Rhode Island
  - Less common – Credit allowed for tax paid to other state on income not sourced to the home state (intangible income)
    - E.g., New Jersey

Resident Tax Credit Statutes: *Limited to tax paid on income sourced to the taxing state*

- New York's statute:

  "A resident shall be allowed a credit against the tax otherwise due . . . for any income tax imposed on such individual for the taxable year by another state of the United States, a political subdivision of such state, the District of Columbia or a province of Canada, ***upon income both derived therefrom*** and subject to tax under this article." [N.Y. Tax Law § 620(a) (emphasis added)].

- Connecticut's statute:

  "Any resident . . . of this state shall be allowed a credit against the tax otherwise due under this chapter in the amount of any income tax imposed on such resident . . . for the taxable year by another state of the United States or a political subdivision thereof or the District of Columbia ***on income derived from sources therein*** and which is also subject to tax under this chapter." [Conn. Gen. Stat. § 12-704(a)(1) (emphasis added)].

- California's statute:

  "The credit shall be allowed only for taxes paid to the other state . . . ***on income derived from sources within that state*** which is taxable under its laws irrespective of the residence or domicile of the recipient." [Cal. Rev. and Tax Code § 18001(a)(1) (emphasis added)].

Resident Credit Challenges for Income Derived from Other Jurisdictions

- What constitutes "income derived from" sources in other states typically depends on how sourcing is determined in the state offering the credit NOT the state where the tax is paid.

- States differ over many sourcing questions, including:
  - Apportionment methodologies of pass-through entities
  - Convenience Rule
  - Sourcing of deferred compensation (grant to vest vs. grant to exercise)
  - Concepts and definitions of business vs. nonbusiness income

Resident Tax Credit Statutes: *For tax paid to other state on income not sourced to home state*

- New Jersey:
  - The resident credit is only limited to the extent that (*i*) the income is not from New Jersey sources and (*ii*) the income is actually taxed by the other jurisdiction
  - Result: NJ allows a resident credit for tax paid to another jurisdiction on intangible income
  - NJ also allows a resident credit for local taxes (e.g. NYC tax paid by a dual resident)
- Michigan, Montana and Oregon offer similarly structured resident credits

Resident Tax Credit Challenges With Broader Statutes

- Beware of what that state might consider income sourced to the resident state (e.g. NJ rules for S corporations)

- Differences in tax rates

- Differences in year tax is paid

A BRIEF NOTE ON RECIPROCAL AGREEMENTS

- The idea:
  - *If an employee works in State A but lives in State B, a reciprocal tax agreement between States A and B may provide that the employer need only withhold for, and the employee need only file in, State B*
- However, reciprocal tax agreements typically exist only between neighboring states, and not all neighboring states have them
- Not applicable to local taxing jurisdictions
- Not applicable to income earned in a 3rd state that is not party to the agreement
- Only applies to wage income
- Most common among Midwestern states

PTE TAXES AND RESIDENT CREDITS

- PTE taxes result in a difference between the payor of the tax in the other jurisdiction and the taxpayer claiming the resident credit
- Generally, states with more limited resident credit statutes (i.e. income must be derived from sources in the other state) may be less likely to allow a credit for PTET paid to another state UNLESS there is a specific statutory provision permitting a credit for PTET
- Most, if not all, states that passed a PTET in response to the SALT deduction cap have explicit statutory provisions allowing the resident credit

RESIDENT CREDIT FOR "SUBSTANTIALLY SIMILAR" TAXES: CONNECTICUT

"Each person that is subject to the tax imposed under chapter 229 as a resident or a part-year resident of this state and is a member of an affected business entity shall also be entitled to a credit against the tax imposed under said chapter…for such person's direct and indirect share of taxes paid to another state of the United States or the District of Columbia, on income of any affected business entity of which such person is a member that is derived therefrom, provided the taxes paid to another state of the United States or the District of Columbia results from a tax that the commissioner determines is **substantially similar** to the tax imposed under this section. Any such credit shall be calculated in the manner prescribed by the commissioner, which shall be consistent with the provisions of section 12-704." **Conn. Gen. Stat. § 12-699(g)(1)(B).**

RESIDENT CREDITS ALLOWED PRIOR TO STATE PTET: CALIFORNIA

Cal. Rev. & Tax. Cd. § 18006:

For purposes of determining a credit under Section 18001 (relating to residents) or Section 18002 (relating to nonresidents), both of the following shall apply:

(a) A member of a partnership is allowed to treat his, her or its pro rata share of net income taxes paid to another state by the partnership as if those taxes had been paid directly by the partner.

(b) (1) A shareholder of a corporation that is an S corporation… is allowed to treat his or her pro rata share of net income taxes paid to another state by the S corporation as if those taxes had been paid by the shareholder.

(2) This subdivision applies only if either of the following requirements is met:

(A) The state imposing the tax does not allow corporations to elect to be treated as an S corporation.

(B) The state imposes a tax on S corporations and the corporation referred to in paragraph (1) has elected to be treated as an S corporation in the other state.

NO RESIDENT CREDIT FOR PTET: MAINE

- **§ 5217-A -- Income tax paid to other taxing jurisdiction.**
- A resident individual is allowed a credit against the tax otherwise due under this Part…for the amount of income tax imposed on that individual for the taxable year by another state of the United States, a political subdivision of any such state, the District of Columbia or any political subdivision of a foreign country that is analogous to a state of the United States with respect to income subject to tax under this Part that is derived from sources in that taxing jurisdiction. In determining whether income is derived from sources in another jurisdiction, the assessor may not employ the law of the other jurisdiction but shall instead assume that a statute equivalent to section 5142 applies in that jurisdiction….

MAINE DENIES RESIDENT CREDIT FOR PTET

- Maine Board of Tax Appeals No. BTA-2020-1
- ME resident is denied credit for PTET paid by his S corporation to Connecticut.
- S corp paid tax to CT under its mandatory PTET.
- BTA concludes that the ME credit scheme limits a resident credit to taxes imposed and paid by the taxpayer claiming the credit.
- Taxpayer alternatively claimed that CT imposed tax on him individually (prior to the credit for PTET) and that should be allowed a credit in ME since ME taxes the same income. BTA concluded that the ME statute provides for a credit for income taxes imposed by the other jurisdiction on income *after credits.*
- BTA basically said, tough luck (including penalties)!

IV. A CLOSER LOOK AT NEW YORK'S PTET AND RESIDENT CREDIT PROVISIONS

New York Pass-Through Entity Tax (PTE)

- Passed as part of the 2021-2022 budget legislation in April, 2021, applicable to the 2021 tax year
- Elective regime applicable to any pass-through entity other than single-member LLCs/DREs
- Election is irrevocable for the year it is made
  - For 2021, Oct. 15 election date
  - For 2022 forward, March 15 election date
- Different regime for partnerships/LLCs and for S corporations
- No combined returns (even for multi-tier partnerships)
- Tax rate mirrors PIT rates

CALCULATING THE NY PTE TAX

- Partnerships calculate tax on the NY-source distributive share of income of nonresident individual partners (including trusts) + the distributive share of all income received by resident individual partners
  - The distributive share of income received by corporate partners is not subject to PTE tax

- S corporations calculate tax only on the NY-source income of individual partners

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CALCULATING THE NY PTE CREDIT

- Partners and shareholders get a dollar-for-dollar credit for their share of PTE taxes on their NY personal income tax return

- Must addback amount of the credit into income
  - No “double addback”

- Beginning in 2021, NY residents are able to take a credit for PTE taxes paid on “substantially similar” PTE taxes

RECENT NYS PTET GUIDANCE

- TSB-M-21(1)C, (1)I issued Aug. 25, 2021 along with FAQs
- Key updates/clarifications:
  - Only authorized person for entity (<u>not</u> a tax preparer) can make the election.
  - Election for 2021 (due 10/15) can <u>only</u> be made through an online account.
  - PTET tax payments may be made before 12/31/21 <u>online.</u>
  - An electing partnership must classify its partners as resident or nonresident before computing taxable income. Partners cannot be classified as part-year residents. Instead, if they are resident for at least half the year, they must be classified as full-year resident.
- Guidance emphasizes that for 2021, individuals must pay estimated taxes as if the PTE did not elect into the PTET regime, regardless of whether the PTE makes a payment in 2021.

NYS's "Substantially Similar" Guidance

- NY recently published a list of states that qualify as those with substantially similar PTET regimes to NY so that a NY resident can claim a PIT credit for PTET taxes paid
- Includes all states that enacted PTET regimes in response to the TCJA as of Sept. 24, 2021
- Does not include "legacy" PTET (e.g. Washington D.C.)
- Note that this only applies to tax years beginning in 2021
- No requirement that the entity have also elected into NY's PTET

V. TO ELECT OR NOT TO ELECT?

How to Make the Decision

- Potential Federal Benefit
  - How much of a deduction?
  - Are there concerns about the availability of the federal deduction?
- Difficulty of Election/Transaction Costs
  - How easy is it to elect?
  - Is it annual?
  - Who must make the election?
- Partnership concerns
  - Will I need a special allocation of the federal deduction?
- Resident credits
  - Will all partners/shareholders be made whole at the individual state tax level?
- Potential sourcing issues

A WORD ON SOURCING ISSUES

- States differ as to how income is apportioned by a pass-through entity
  - NY's 3-factor formula for partnerships vs. market-based sourcing for S corporations
  - CT, CA and many others use market-based sourcing for all entities

- Resident credits that require the income be derived from sources in the other state may have limits on the amount of credit available whether tax paid to the other jurisdiction by the PTE or the individual

- But beware in NJ – S corporations use gross income rules (i.e. 3 factor formula used by partnerships) for BAIT but not if tax is paid by individual nonresident!

Scenario #1

- A partnership owns a dozen whiskey bars throughout NYS. As a hedge against the variability of the business, the partnership also has a number of passive investments. Its partners include 3 NY resident partners. Should it make the PTE election?
  - What if it has a 50% partner who is a resident of California?
  - What if that 50% partner is a resident of Maine?
  - What if it has 3 resident individual partners and 1 corporate partner?

Scenario #2

- A NJ S corporation sells software to customers around the United States. It is owned by 50 shareholders who are residents of a variety of states. Should it elect into the BAIT?
  - What if 50% of the corporation was owned by a NJ resident?
  - What if in addition to the 50% shareholder, 75% of the company's revenues were derived from NY customers? Should it elect into the NY and/or the NJ PTET regime?

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