

State PTE Tax Update

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Agenda

- Federal SALT cap and state counterattacks
- State PTE taxes
 - Pace of enactment
 - Features
 - Differences
- Problems for multistate PTE owners with the Other State Tax Credit in resident states

The “Hissing Goose”?



- **Jean Baptiste Colbert**, finance minister to King Louis XIV, the Sun King, who reigned as the absolute monarch of France for over 72 years:

“The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing.”¹

- Tax policy is an art ...

1. The original French – “L’art de l’imposition consiste à plumer l’oie pour obtenir le plus possible de plumes avec le moins possible de cris.” (available on the internet at <https://citations.ouest-france.fr/citation-jean-baptiste-colbert/art-imposition-consiste-plumer-oie-45684.html> (last accessed Oct. 13, 2020)).

SALT cap: background

- Prior to the Tax Cuts and Jobs Act (P.L. 115-97) (**TCJA**), itemizing individual taxpayers could generally deduct state and local taxes (**SALT**).
- U.S. Supreme Court: intergovernmental immunity doctrine:
 - *McCulloch v. Maryland* (1819)
 - States can't tax Feds.
 - *Pollock v. Farmers' Loan & Trust Co.* (1895)
 - Feds can't tax states.
 - **Overruled** by *South Carolina v. Baker* (1988)
 - This ruling limits intergovernmental immunity doctrine simply to direct **federal** tax on states.
- TCJA added Internal Revenue Code § 164(b)(6)
 - This limits the SALT deduction to not more than \$10,000 each year (\$5,000 if married filing separately), for taxable years 2018 through 2025 (the **SALT cap**).
 - But, "trade or business" deductions for SALT taxes are still unlimited (and that is the **key** to this analysis).
- State and local taxes remain nondeductible for alternative minimum tax computation.

1861 Civil War Income Tax

THIRTY-SEVENTH CONGRESS. Sess. I. Ch. 45. 1861. 309

SECTION. 1. THE TAX HEREIN PROVIDED SHALL BE ASSESSED UPON THE ANNUAL INCOME OF THE PERSONS HEREINAFTER NAMED FOR THE YEAR NEXT PRECEDING THE TIME FOR ASSESSING SAID TAX, TO WIT, THE YEAR NEXT PRECEDING THE FIRST OF JANUARY, EIGHTEEN HUNDRED AND SIXTY-TWO; AND THE SAID TAXES, WHEN SO ASSESSED AND MADE PUBLIC, SHALL BECOME A LIEN ON THE PROPERTY OR OTHER SOURCES OF SAID INCOME FOR THE AMOUNT OF THE SAME, WITH THE INTEREST AND OTHER EXPENSES OF COLLECTION UNTIL PAID: PROVIDED, THAT, IN ESTIMATING SAID INCOME, ALL NATIONAL, STATE, OR LOCAL TAXES ASSESSED UPON THE PROPERTY, FROM WHICH THE INCOME IS DERIVED, SHALL BE FIRST DEDUCTED.

SEC. 40. AND BE IT FURTHER ENACTED, THAT IT SHALL BE THE DUTY OF THE PRESIDENT OF THE UNITED STATES, AND HE IS HEREBY AUTHORIZED, BY AND WITH THE ADVICE AND CONSENT OF THE SENATE TO EXECUTE AND COLLECT SAID TAXES.

Of what date to be assessed.
Lien.

Income, how to be estimated.

Made of assessing and collecting income tax.

1913 Internal Revenue Code

SIXTY-THIRD CONGRESS. Sess. I. Ch. 16. 1913. 167

as income.

That in computing net income for the purpose of the normal tax there shall be allowed as deductions: First, the necessary expenses actually paid in carrying on any business, not including personal, living, or family expenses; second, all interest paid within the year by a taxable person on indebtedness; third, all national, State, county, school, and municipal taxes paid within the year, not including those assessed against local benefits; fourth, losses actually sustained during the year, incurred in trade or arising from fire, storms, or shipwreck, and not compensated for by insurance or otherwise; fifth, dues due

Deductible from business expenses, interest on debt, loss, etc.

States attempt to repulse attack

- SALT cap is perceived to impact some “high-tax” states.
 - NY, NJ, CT and MD sued the federal government on this very issue - U.S. Supreme Court refused states’ appeal just ten days ago.
 - *New York v. Mnuchin* (now known as *New York v. Yellen*), 408 F. Supp. 3d 399 (S.D.N.Y. 2019) (dismissed September 30, 2019) *aff’g* 15 F.4th 569 (2nd Cir. October 5, 2021) *cert. den.*, [No. 21-966](#) (US S.Ct. April 18, 2022)
 - State Democratic Congressional delegations call for outright repeal of SALT cap, even threatening progress of President Biden’s legislative agenda if SALT cap is not addressed.
 - House: increase SALT cap from \$10k to \$80k
 - Senate: eliminate SALT cap for taxpayers below a certain income threshold (e.g., between \$440k and \$550k)
- State self-help
 - States disguise governmental services as “charitable contributions” (NY, NJ and CT).
 - New state payroll taxes on employees (NY)
 - Employer gets tax deduction.
 - Employee gets tax credit for state taxes paid by the employer against state personal income tax liability.
 - Last but not least, states enacted pass-through entity taxes (**PTE tax**).

State PTE taxes

- Pass-through entity (PTE): a partnership, an S corporation or an LLC treated as either a partnership or an S corporation
- PTE tax: tax imposed on income of the PTE directly with an offsetting credit or deduction for its owners against their own direct state tax liabilities
 - Why does a PTE tax work?
 - Arguably a tax on income of the “trade or business” “should” not be subject to the SALT cap
- Connecticut was the first state to enact a PTE tax in 2018.
- Twenty-seven states (and New York City) have followed (with five already adopted and four proposed for 2022).



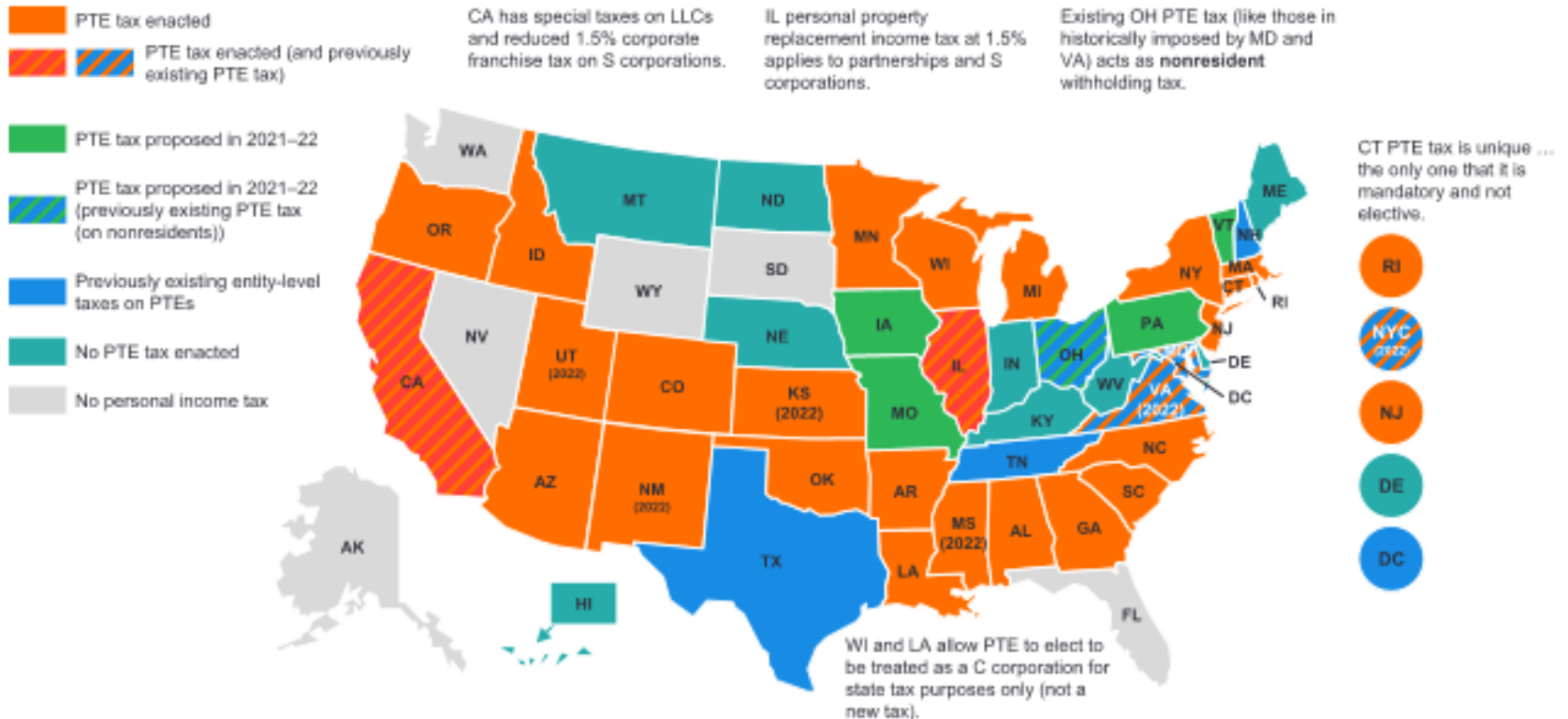
Notice 2020-75 – IRS blesses State PTE Tax exception from SALT cap

- The IRS remained silent on the issue for almost three years!
- Then, (a surprise to me), on **Nov. 9, 2020** (a few days after the 2020 Presidential election), in [Notice 2020-75](#), IRS says it will issue Proposed Regulations clarifying that a partnership or S corporation (collectively, a pass-through entity or “PTE” (and including an LLC)) may deduct state and local taxes imposed on the net income of the PTE.
- Key provisions of Notice 2020-75
 - The term Specified Income Tax Payment means “any amount paid by a [PTE] to a State, a political subdivision of a State, or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the [PTE].”
 - Specifically, treat the PTE taxes as a “non-separately stated” item that is an “above-the-line:” deductible item in computing the PTE income of the owner.
 - Further, taxpayers can rely on the notice and apply it to a PTE’s tax payments made after December 31, 2017.

Notice 2020-75 – IRS blesses State PTE Tax exception from SALT cap (cont.)

- Notice 2020-75 didn't mention any state(s) and/or its tax computation mechanics
- **The common view:** State PTE taxes work around the SALT cap
- **Issues?**
 - How does this apply to an *investment partnership* that is not engaged in a “trade or business” (or any PTE with investment income)?
 - Is the IRS really going to issue regulations?
 - To date, the IRS has not yet issued these proposed regulations
 - Regulatory projects proposed by the Trump Administration were put on hold by the Biden Administration
 - IRS doesn't have unlimited resources – either financially or with people – Lee Sheppard with *Tax Analysts* observed that IRS is not going to commit resources to draft regulations for a “temporary” tax provision (and one that a significant number of members of Congress want to repeal!)
 - So ... how do we muddle through?

Which states have enacted a PTE tax?



Source: Ernst & Young LLP analysis of state laws as of May 5, 2022.

State PTE taxes: features

- Direct entity-level tax on the PTE –
 - A state tax on the “trade or business” for federal tax purposes
- To preserve a single layer of tax on PTEs and their owners, provide proportionate relief from direct state income taxes on PTE owners
 - PTE tax credit
 - Exclusion of PTE taxed income from direct income tax liability
 - For nonresidents, could be excepted from filing state income tax return entirely
- Elective, but one state’s PTE tax is mandatory (CT)
- Rates generally fixed and tied to the state’s personal income tax rates
 - States with progressive rates usually apply one rate – State’s highest (or a high) marginal rate
 - Progressive PTE schedule based on PTE’s taxable income, not the PTE owners’
 - Causes lower bracketed taxpayer/ PTE owners to pay estimated taxes at higher rates



State PTE taxes: features

- PTE credit usually fully refundable in year paid
 - CA and ID examples of **nonrefundable credit**: five-year carryforward
- PTE tax base
 - PTE's aggregate income
 - **New** PTE tax base: aggregate of distributive shares to owners subject to state's personal income tax
 - Corporate and tax-exempt owner shares excluded from PTE tax base
 - 100% of resident partners' distributive shares
 - Nonresidents: limited to state PTE source income (apportioned/allocated)
 - Special rule for S corporation **residents**: only S corporation source income
 - Presumably to avoid "second class of stock" problem for federal income tax purposes
- Estimated payments required
 - Most states require quarterly payments consistent with PTE's fiscal year quarters
 - Notable exceptions:
 - NY: fixed calendar year quarterly schedule (March, June, September and December 15)
 - CA: two annual payments (June 15 and end of year) — but, if June payment **not** made, PTE election invalid

State PTE taxes: features

Elections

- Variety of approaches to approval of PTE tax election
 - Majority of ownership interests of the PTE
 - Managing partner or otherwise authorized person of the PTE
- May have to be made online
- Nearly all irrevocable once made
- Most only effective for the current year
 - But some may extend beyond one year with ability to revoke

State PTE tax law effective only as long as federal SALT cap is in effect

- Some laws expressly tie effectiveness of state PTE tax to the continued existence of the federal SALT cap
- Others expire on fixed date consistent with TCJA expiration of SALT cap (e.g., years after December 31, 2025).
 - Strange deviation: CA, December 1, 2026 (why that date?)
- Many are silent ... future state funding source?

State PTE Taxes: The “Other State” tax credit problem

- Most important issue – “Other state” or “resident state” tax credits
 - Not an issue if:
 - PTE and owners are all in the same state
 - Dentist in Poughkeepsie, NY; personal injury lawyer in Atlanta; farmer in California – of course you should make the PTE election.
 - Multistate PTE owners are in a state without a state income tax (e.g., Tennessee resident owners shouldn’t care)
 - For everyone else, if the resident state does not recognize the PTE tax of the other state as a creditable tax, then a PTE owner is trading a \$0.39 federal tax deduction for a \$1.00 for \$1.00 state tax INCREASE in their resident state taxes

State PTE Taxes: The “Other State” tax credit problem (cont.)

- Think I’m kidding? See my article in *Tax Notes State*, Nov. 8, 2021, pg. 613 – “I Told You So: Maine Denies Resident Credit for Other State’s PTE Tax” – Criticizing March 2021 Maine Board of Tax Appeals ruling that a Maine resident was not entitled to a resident credit for his 2018 Connecticut PTE tax
 - Relies on Maine Supreme Judicial Court’s 2018 ruling in *Goggin v. State Tax Assessor* disallowing resident credit for partner share of New Hampshire business taxes
- Indiana, Virginia and District of Columbia issue similar guidance
 - Virginia DOT revises its guidance on April 14, 2022 after enactment of its tax (so does DC)
- New York issues list of “substantially similar” PTE taxes²
 - Includes all the states on my map PLUS Ohio(?)
 - Why not Virginia? Ohio didn’t enact a new PTE tax and its tax is the same as Virginia’s?
 - Moreover: Why aren’t Tennessee’s or Texas’s franchise/excise tax treated as a creditable PTE tax for New York purposes? Why not New Hampshire’s taxes? What about Ohio CAT, Washington B&O? Los Angeles Business Tax – Why should it matter what kind of tax the other state imposes?
- **With sovereignty comes responsibility**
 - If a state can tax 100% of a resident’s income, to respect federalism and to encourage interstate commerce, it should grant relief for double taxation of residents engaged in multistate activities regardless of the form of the other state’s business tax.
- **Bottom line:** We need clarity, certainty and universal reform of resident or other state tax credits.

² N.Y. Dept. of Tax. & Fin., [Pass-through entity tax \(PTET\)](#) (updated Dec. 30, 2021); TSB-M-21(a)C, (1)l, [Pass-Through Entity Tax](#) (Aug. 25, 2021); [states with a tax substantially similar to PTET](#) (updated Dec. 1, 2021).

State PTE taxes: considerations

- Certain types of PTE owners can make a PTE ineligible for a state's PTE tax election
 - CA (remedied by recent legislation): a PTE could not make a PTE tax election if it had a partnership as an owner.
 - AZ (initially proposed): PTE election is not allowed unless all owners were AZ residents.
 - Quickly amended due to concerns that this would be deemed discriminatory against interstate commerce and thus unconstitutional.



State PTE taxes: considerations

- Do states really need all that documentation to make a PTE election?
 - **Oklahoma's** "Simon Sez" game?
 - Tax Commission Approval Letters
 - **Louisiana:** three years of financial statements?
 - Signed approvals of majority of owners (**Arkansas**)?
 - Lists of PTE owners with Employer Identification Numbers
 - That makes sense! (How else could the state taxing authority match up PTE owners with the PTEs for which they claim a state PTE tax credit?)



State PTE taxes: considerations

Guaranteed payments

- Payments made to a partner regardless of their participation or ownership interest in the partnership
- Are they “in” or “out” of the PTE tax base?
 - **California:** Franchise Tax Board (FTB) initially says “out” (because guaranteed payments don’t represent income from conduct of a trade or business).
 - CA legislature overrules FTB by statute introduced during the first week of February and enacted within five days!
 - [Cal. Stat. 2022, ch. 3](#) (Sections 8, 14 and 15) (2022 CA SB 113)
 - A record for time between introduction and enactment of CA tax legislation!
 - **Georgia:** guaranteed payments to **retired partners** are “out” because federal law prohibits taxation of retirement income except by state of residence ([4 U.S.C. 114](#)) ([See Ga. Comp. R. and Regs. r. 560-7-3-.03\(8\)](#)).
 - Someone did their homework!
 - Retired partners may object to PTE tax elections.

Ga. Comp. R. and Regs r. 560-7-3-.03

(8) If an electing pass-through entity has a pension plan where certain qualified retirement income is paid to retired owners (normally as a guaranteed payment) and such income can only, based on Federal law, be taxed by a retiree’s state of residence in the year of payment, such electing pass-through entity shall subtract such guaranteed payment from its Georgia’s income before allocating and apportioning such income pursuant to O.C.G.A. § 48-7-31. The amount subtracted shall then be taxed by the retiree’s state of residence and such retiree shall not be eligible for the subtraction or addition to income for such respective share of the portion of income provided by paragraph (9).

Serious state disconnects from Subchapter K and Subchapter S issues

- Will states apply Subchapter C principles for PTEs?
- Will federal and state tax basis (stock and inside basis of PTE assets) differ?
- PTE owners will be surprised not to have pass-through treatment among affiliated entities (i.e., can you offset income of one PTE by losses in another for state purposes?)
 - Connecticut and New Jersey provide form of PTE tax consolidation for owners
- What happens to these taxes once the SALT limitation goes away after 2025 (or 2031 if northeast Congressmen get their way)? Will it be renewed? Who controls federal tax policy at that time?
- Potential new revenue source for states by simply *reducing* the percentage credit for PTE taxes (just as CT did in 2019 (and MA ...))



My articles on State PTE Taxes

- Steven N.J. Wlodychak, “They’re All Different and That’s the Problem: State PTE”, *Tax Notes State*, Aug. 2, 2021, pg. 455.
- Steven N.J. Wlodychak, “I Told You So: Maine Denies Resident Credit For Other State’s PTE Tax”, *Tax Notes State*, Nov. 8, 2021, pg. 613.
- Steven N.J. Wlodychak, “IRS Just Raised State Taxes for Multistate Passthrough Entity Owners”, *Tax Notes State*, Dec. 14, 2021, pg. 1159.
- Steven N.J. Wlodychak, “State PTE Tax Updates: Agency Guidance and Even More Differences!”, *Tax Notes State*, Feb. 14, 2022, pg. 4.

Questions?

