

Massachusetts Society of CPAs

Pass-through Entity Taxes

December 21, 2021

Tom Chappell, Massachusetts Department of Revenue

David Nagle, Sullivan and Worcester LLP

Alexis Morrison-Howe, Deloitte Tax LLP

Overview of Pass-through Entity Taxes

Polling Question

How familiar are you Passthrough Entity Taxes?

- A. Very familiar
- B. Somewhat familiar
- C. Not familiar



State and Local Tax (“SALT”) Deduction Cap

- Prior to the Tax Cuts and Jobs Act (TCJA, P.L. 115-97), individuals could claim a deduction for all state and local income taxes (if itemizing)
 - A benefit may not have been available in all instances, for example, if the individual taxpayer was subject to the alternative minimum tax
- In 2017, the TCJA added a provision limiting the federal SALT deduction for individuals to no more than \$10,000 annually (\$5,000 if married filing separately) for taxable years 2018 through 2025
- In response, some states have enacted (or are contemplating the enactment of) tax laws that impose either a mandatory or elective entity-level income tax on partnerships and S corporations (“passthrough entities”) that do business in the state or have income derived from or connected with sources within the state
 - In most cases, the state provides a corresponding owner-level state tax benefit (e.g., a full or partial credit, deduction, or exclusion)

IRS Notice 2020-75

On November 9, 2020, Treasury and the IRS issued Notice 2020-75.

- Announced intent to issue proposed regulations providing that “specified income tax payments” are deductible by partnerships and S corporations in computing their non-separately stated income or loss.
 - A Specified Income Tax Payment is “any amount paid by a partnership or an S corporation 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 partnership or the S corporation.”
- Applies regardless of whether:
 - The Pass-through Entity Tax (“PET”) is mandatory or elective; or
 - The owners receive a deduction or credit reducing their individual income tax liabilities in their Domestic Jurisdiction.
- Applies to payments made on or after November 9, 2020, but taxpayers can apply to payments in a taxable year of the pass-through entity ending after December 31, 2017 and can rely on the notice prior to the issuance of the proposed regulations.

Pass-through Entity Taxes - Potential benefits for individual taxpayers

- Under current law, due to the SALT deduction cap, individual taxpayers do not receive a tax benefit for SALT payments in excess of \$10,000.
 - **CURRENTLY SALT CAP AMOUNT IS UNDECIDED IN BUILD BACK BETTER ACT (WAS \$80K in HOUSE VERSION)**
- Under Notice 2020-75, pass-through entity tax payments by partnerships and S corporations may be disregarded when applying the SALT deduction limitation to individuals who are partners in partnership or shareholders in S corporations. Thus, through the passthrough entity, the owners receive a deduction for federal purposes that would have been subject to the SALT cap limitation if the SALT was paid by the owner directly
- As individual tax attributes may vary significantly, the owner-level benefit may be materially different for each owner and **modeling needs to be done**

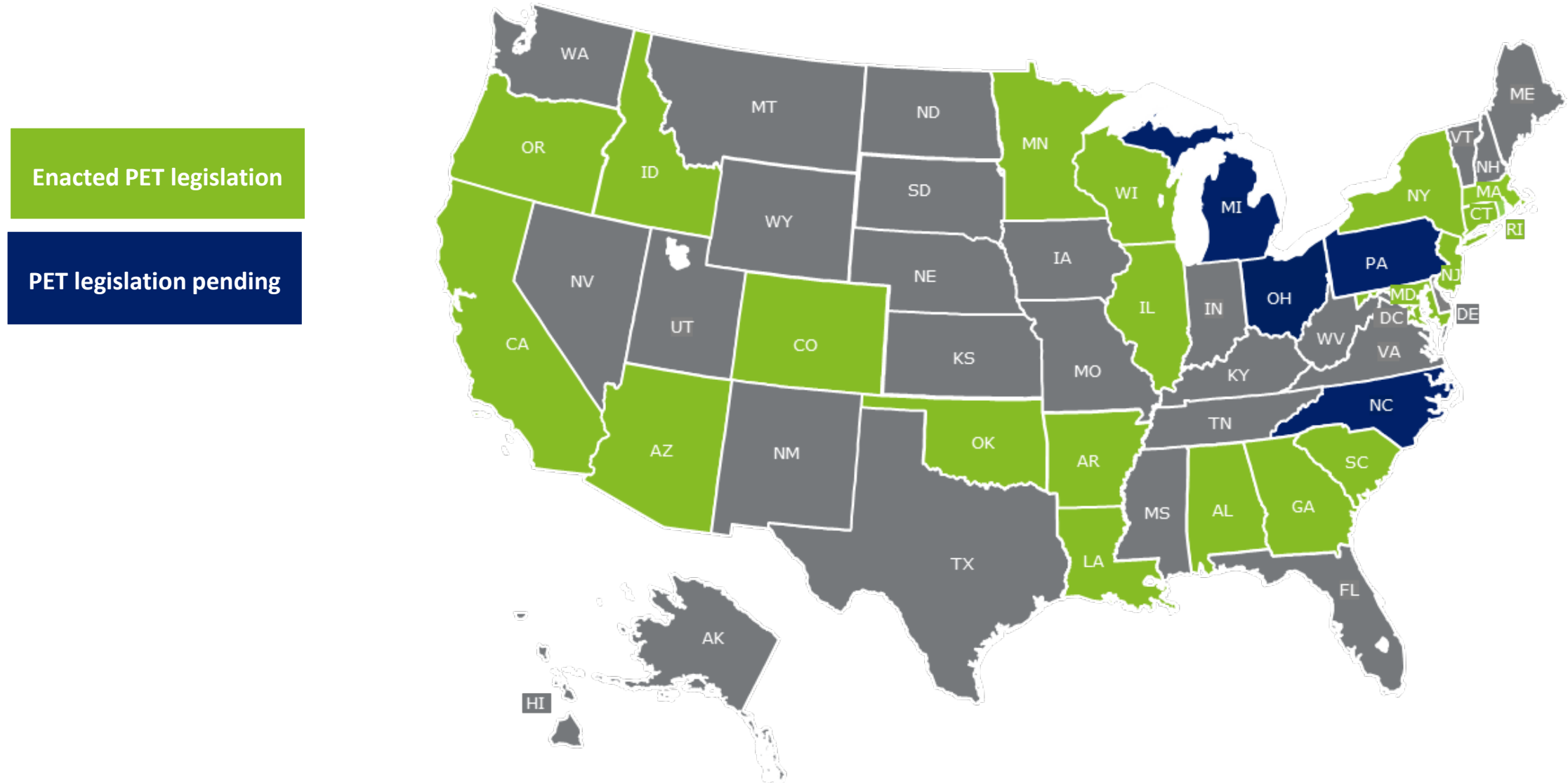
Polling Question

Do you think the SALT Cap will be materially changed by Congress?

- A. Definitely
- B. Maybe
- C. No way
- D. Not sure



States with Enacted and Proposed PETs – As of October 10th, 2021



*Some jurisdictions such as DC, NH, NYC, TN, and TX impose an income tax directly on pass-through entities.

PET Effective Dates

Effective for or before Tax Year 2021

- | | |
|----------------------|----------------------|
| 1. Alabama | 11. New York |
| 2. California | 12. Oklahoma |
| 3. Connecticut | 13. Rhode Island |
| 4. Idaho | 14. South Carolina |
| 5. Illinois | 15. Wisconsin |
| 6. Louisiana | |
| 7. Maryland | |
| 8. Massachusetts | |
| 9. Minnesota | |
| 10. New Jersey | |

Effective for Tax Year 2022

- 1. Arizona**
2. Arkansas
- 3. Colorado**
4. Georgia
5. Oregon

**States in blue font use pre-apportioned income for residents when computing the PET income base.*

[Individual Taxpayer] v. Maine Revenue Servs., Docket No BTA-2020-1 (Me. Bd. Tax App. Mar. 1, 2021).

Background

- Taxpayer was a Maine resident who was a shareholder in an S corporation
- S corporation had nexus in Connecticut and was subject to PET
- CT PET payments offset all of the taxpayer's nonresident income tax liability in CT
- Maine refused to give a credit for taxes paid for the CT PET payments

Holding

- Maine Board of Tax Appeals cited to its decision in *Goggin v. State Tax Assessor*, which disallowed a credit for taxes paid for NH Business Profits Tax and Business Enterprise Tax, to determine that the tax was imposed at the entity level and not creditable
- After application of PET credit, taxpayer had no CT individual income tax liability
- Treatment does not violate internal consistency under the Commerce Clause

Polling Question

Do you have clients who have made a PET election in states outside of Massachusetts?

- A. Yes
- B. No
- C. Not sure



Massachusetts Passthrough Entity Tax

Election

- Election can be made by S corporation, partnerships, and trusts for tax years beginning on or after January 1, 2021
- Annual election required
- Made annually on a timely filed Form 3, Schedule S, or Form 2
- PTEs must submit new Form 63D-ELT electronically on or before the due date for the applicable tax return filed by the PTE

Qualified Member

- Person, estate or trust that is subject to Massachusetts tax and a shareholder, partner, or beneficiary of an electing PTE
- Qualified members may not opt out of an election

Tax Computation

- The MA PET income base is “qualified income taxable in Massachusetts”:
“income of an eligible [PTE] determined under [MGL Ch. 62] allocable to a qualified member and included in the qualified member’s Massachusetts taxable income under [MGL ch. 62].”
- Taxed at 5%

Estimated Payments

- Electing PTE must make estimated tax payments if the payment is expected to be $\geq \$400$
- Payments required for the lesser of 80% of current year tax or 100% prior year tax if election was made
- Due on 4/15, 6/15, 9/15 and 1/15 for calendar year taxpayers
- All payments due on 1/15/2022 for the 2021 taxable year

Coordination with Other Payments

- Estimated income tax payments made by a qualified member cannot be applied to the PTE Excise
- Entities' required PTE withholding and member's estimated tax payments may take into account the PTE credit which will be available to members. However, for tax year 2021, payments made as withholding/estimates may not be recharacterized as PTE estimates or otherwise relieve PTE estimated payment requirement.

Treatment of Losses

- Net capital losses cannot offset other income
- Operating losses cannot be carried forward by the PTE

Tax Credit

- PTE members can claim a refundable credit against their Massachusetts individual income tax in an amount proportionate to each qualified member's share of the tax due and paid by the eligible pass-through entity multiplied by 0.9.
 - Some S corporations also pay a Massachusetts corporate excise tax at the entity level; the PET is in addition to that tax.
- PTE report must show the amount of tax allocated to each of its qualified members on Schedule K-1
- For fiscal year PTEs, credit is allowed in the individual's tax year that includes the PTEs fiscal year end.
- Member may claim the credit for taxable year in which the electing PTE's taxable year ends (i.e., if partnership has 6/30/2022 year end, partner can claim the credit on his or her 2022 return)
- Excess credit is treated as an overpayment which may be refunded

New England PET Comparison

State	Mandatory or Election	Amount of Credit to Partners	Application to All Owners	Interplay with Nonresident W/H
Massachusetts	Annual Election	90%	All “qualified members” – person/trust/estate	Estimated payments made by individuals cannot be credited against PTE, but W/H may take into account PTE credits
Rhode Island	Annual Election	100%	Yes – entity must elect for all income and owners or not at all	Nonresident W/H not required if electing PET
Connecticut	Mandatory	100%	Yes	PET replaces PTE composite returns and w/h

Q&A