They're All Different and That's the Problem: State PTEs

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By

STEVEN N.J. WLODYCHAK

Steven N.J. Wlodychak is the former indirect (state and local) tax policy leader for EY's Americas Tax Policy and a retired principal in EY's National Tax Department in Washington, D.C.

In this installment of The Hissing Goose, Wlodychak looks at recent state passthrough entity tax legislation.

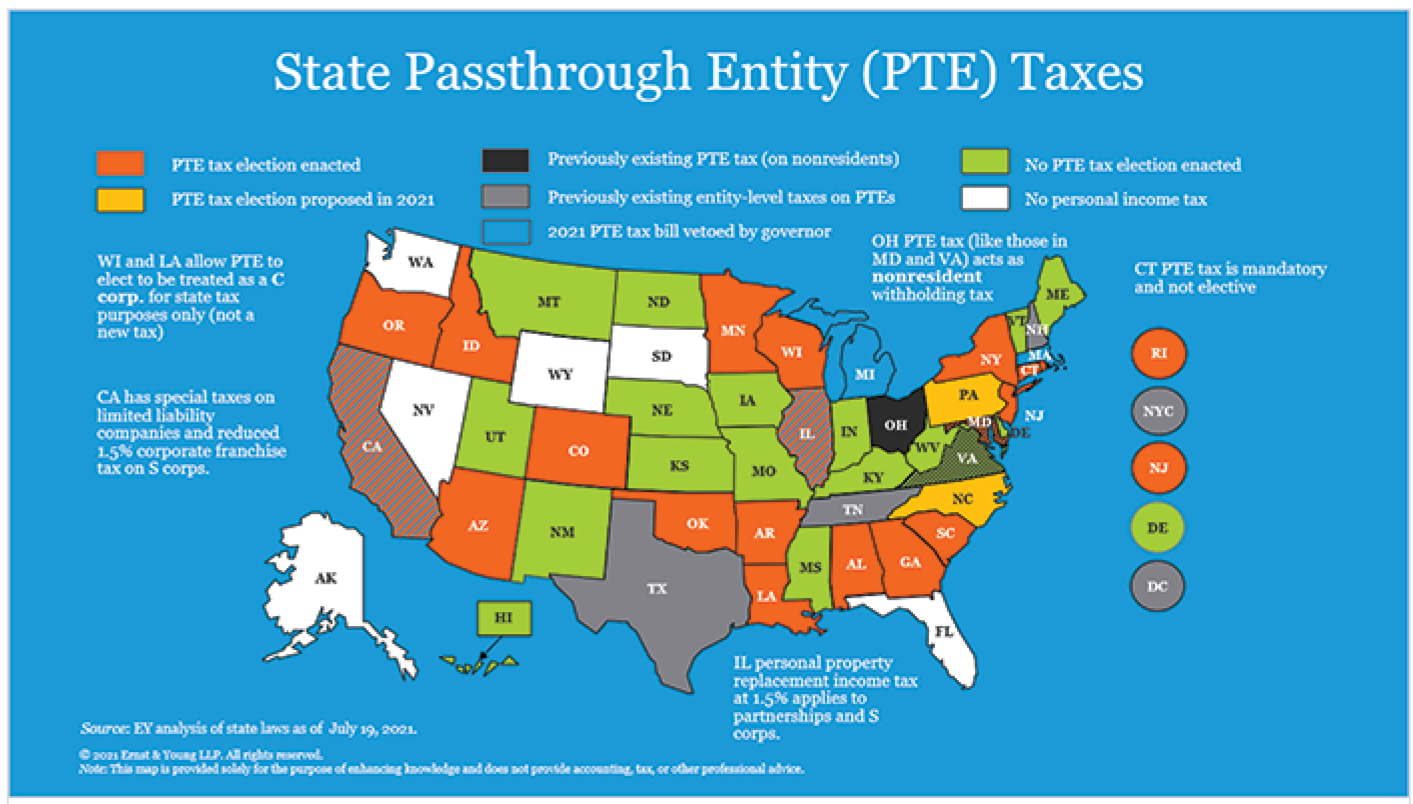
STEVEN N.J. WLODYCHAK

In an article published in these pages in December 2020,[1] I predicted a flood of newly enacted state passthrough entity (PTE) taxes in response to the IRS's announcement in Notice 2020-75, 2020-49 IRB 1453 (Notice). The Notice was issued by the IRS shortly after the federal presidential election in early November 2020. In a surprise to many (including me), the IRS in the Notice essentially blessed the state PTE tax concept as a way to enable owners of PTEs (for example, partnerships, S corporations, and limited liability companies treated as partnerships or S corporations) to get around, and deduct in excess of, the $10,000 annual state and local tax deduction limitation enacted as part of the Tax Cuts and Jobs Act (codified at IRC section 163(b)(6)) (SALT deduction limitation). The dam broke and the deluge has begun.

As the state legislative season began in earnest in late January, I started accumulating the various proposals and writing this article. I anticipated that it would be easy, that the states would follow a single model, and that writing this article would be a rather modest effort. Week after week, however, as I read the proposed legislation in the various states, it became readily apparent that was not to be. Instead, as the state legislative proposals were introduced and then amended

through the legislative process, every single one of these state PTE taxes — every one — has differed from the other and many in material, significant ways.

This lack of uniformity among these new state PTE tax laws will make an already complex state PTE and individual tax compliance season even more difficult (as if the 2020 and 2021 tax return seasons weren't challenging enough) and will cause taxpayers and their advisers to have to make a bunch of tough choices. Not only will tax return preparers with clients with multistate activities have to navigate competing laws but they will also have to worry that the statutory language in one state is nowhere near the same as that in another. Even for PTEs and their owners who are subject to tax in a single state, the analysis of the PTE tax in one state won't necessarily be the same as in another. Moreover, as I cautioned in my previous article, nonresident owners of PTEs engaged in multistate activities and their tax advisers must be especially cautious because of the impact an election in a nonresident state will have in the owners' resident states (which may or may not have enacted a PTE tax) on their continued eligibility for a credit against their resident state income tax for their share of the PTE taxes paid to the other states.



Without more guidance, the tax authorities in resident states may deem the PTE taxes enacted in the other states as not "sufficiently similar" to their PTE taxes to qualify for the resident state tax credit. If so, I don't know if the courts will provide any protections to affected taxpayers against potential double tax under

the commerce or due process clauses of the U.S. Constitution. After all, we're used to owners of C corporations being subject to a double tax at the entity and individual levels, and the courts may simply conclude that the legislatures intend the same thing for PTEs (more so when the taxpayers *elected* to be subject to that state's PTE tax). Surely, the courts may conclude they had to know what they were getting into. Yes, be prepared for a wild ride (and for the lawyers out there, a new litigation opportunity).

When the state PTE tax concept first surfaced shortly after enactment of the SALT deduction limitation, in mid-2019 my colleagues Bruce Ely and Kelvin Lawrence published a great article in a competing publication, highlighting the various proposed state PTE tax approaches.[2] At that time, one would have thought that every state legislature would have taken, for example, the model proposal of the Mainstreet Employer group[3] off the shelf and simply introduced and enacted it. That would have provided a uniform body of law that everyone from coast to coast could understand. Instead, one by one, states have enacted their own versions of a PTE tax, and while they have some similarities, every single one is different in marked ways from the other.

Following is a discussion of a few of these state PTE tax law variations. Also, I provide a state-by-state matrix of some of the key provisions of these newly enacted (as well as proposed) state PTE tax laws for reference, along with a map of the states (Figure 1) that attempts to differentiate among the various state PTE tax types and those that have and have not yet enacted a PTE tax.

As I mentioned, I have been working on this article since late January but decided to delay completion until most state 2021 legislative sessions were over. No doubt, however, even some of the proposals may become law before this article is published (and in fact, some of the legislatures have already amended the PTE tax law statutes they just enacted). Moreover, this will continue to be a dynamic process as the remaining state legislatures address the PTE taxes and amend and modify the existing taxes, and, perhaps more importantly, as the state taxing authorities wrestle with and issue much-needed guidance.

They Are All Different

The first thing to notice in comparing these state PTE tax laws is that the variations among them occur on so many different and overlapping levels. Let's start with an easy one — whether the state's PTE tax is mandatory or elective.

Elective or Mandatory?

The "good news" (well, the simple news) is that only one state's PTE tax is mandatory — Connecticut's. All the others are elective. Being the first of these laws, and preceding any IRS guidance on the issue, presumably Connecticut's PTE tax was made mandatory to strengthen the state's position that its tax would withstand an IRS challenge because it wasn't a substitute for a tax paid at the individual level.

A New Tax or Reliance Upon an Existing Tax?

Next in order of complexity, most states enacted a completely new entity-level tax on PTEs. Still, a few states (for example, Louisiana and Wisconsin) simply allow a PTE to elect to be subject to the state's existing tax on C corporations. A few jurisdictions already had a mandatory entity-level tax on PTEs. For example, New York City[4] and the District of Columbia[5] both imposed their existing corporate income taxes on S corporations by disregarding the federal elections, and each imposes a direct tax based on net income on "unincorporated businesses" (known as an "unincorporated business tax"[6]). Virginia,[7] Maryland,[8] and Ohio[9] have long had "pass-through entity" taxes on PTEs, but they applied only to the aggregate distributive share of income attributed to nonresidents. Of these three states, only Maryland has expanded its PTE tax model to enable residents to benefit from these provisions[10] (although the author has heard that both Ohio and Virginia are considering following Maryland's lead).

One objective of the proponents of these PTE taxes was to allow the owners to qualify for the business entity exception to the federal SALT deduction limitation set forth in IRC section 164(b)(6) without raising (or, let's be honest, significantly raising) the state tax liability of the owners. In essence, these taxes were to be revenue neutral (or pretty close). To achieve that objective and to continue the single layer of tax on the PTE owner's distributive share of the PTE's income, the first states enacting these PTE taxes provided a credit against the PTE owner's direct state tax liability (for example, Connecticut, New Jersey, and New York). Others, such as Alabama, Georgia, and South Carolina, took a different tact. Instead of providing a credit against the historic personal or corporate income state tax liability of the owners, these states chose to exclude the income subject to their PTE taxes from the owner's direct state income tax liability.

Thus, for example, if the owner's income was wholly derived from its distributive share of PTE income, it would have no income to report for purposes of the state's income tax. Instead of a credit, these states provide an outright exclusion of income subject to the state's PTE tax. In some cases (for example, Connecticut), the state PTE tax laws provide that if a nonresident PTE owner's

income is exclusively derived from income from a PTE that is subject to the state's PTE tax, that nonresident owner doesn't have to file a state personal income tax return.[11]

Even which PTEs qualify to elect into the PTE regime differs among the states. A few state PTE tax laws impose no limitations whatsoever on the type of owners a PTE can have other than the usual restrictions that apply for other income tax purposes. For example, the state PTE law might not address the ownership of the PTEs, but of course, an S corporation can't be an S corporation for federal or state income tax purposes if it has a corporate owner and is thus ineligible for the state's PTE tax. On the other hand, no "regular tax" ownership restrictions apply to a partnership. A partnership can have owners with widely varying characteristics (for example, partners can be individuals, corporations, other partnerships, insurance companies, or nonprofit organizations).

Thus, unlike an S corporation, the characteristics of the owners of a partnership are highly flexible. In enacting their PTE taxes, however, a few states (for example, California) have chosen to strictly limit the PTE election to those PTEs whose owners consist only of individuals, trusts, or other fiduciaries. In these states, ownership of an interest in the PTE by a single ineligible owner (no matter how small that interest may be) could disqualify the PTE from electing into that state's PTE regime.

One state (that is, Arizona (as originally proposed)) probably went too far in its original proposal by strictly limiting the PTE elective tax only to a PTE whose individual owners consist solely of Arizona residents.[12] Surely, that provision could not be constitutional, and it appears that the Arizona Senate picked up on that defect in its version of the bill.[13] Likewise, some states' laws limit PTEs that are engaged in a business that might be subject to a different state tax regime than as a flowthrough entity. In the current Michigan PTE tax proposal, for example (which was recently vetoed by Gov. Gretchen Whitmer (D)), while there appear to be no limitations on the nature of the owners of the PTE, a PTE that is subject to Michigan tax as a financial institution or is either a disregarded entity (DRE) or publicly traded partnership for U.S. federal income tax (U.S. FIT) purposes cannot make a Michigan PTE tax election.[14]

PTE Tax Base

Even the income base upon which the PTE tax is based can vary. For purposes of constructing the state's PTE tax base, most states use the PTE's income reported for U.S. FIT purposes as the starting point, just as they had under their existing PTE information reporting or tax return filing regimes. One interesting PTE tax base approach worth mentioning — and incidentally, that is tangentially

related to the character of the PTE's owners discussed in the previous paragraph — is New York's. Rather than using the taxable income of the PTE itself as the tax base, the New York PTE tax law establishes a special tax base defined as "pass-through entity taxable income" (PTETI).[15]

I must admit, the first time I saw this provision, I ran right past it like a stop sign hidden behind a tree, thinking that it was nothing other than the PTE's own taxable income. Don't make my mistake. Understanding this definition is crucial to recognizing how New York's PTE tax works and, in the author's opinion, an incredibly elegant legislative drafting solution to what seemed to be an almost insurmountable problem between PTE owners who want the tax and those who don't.

In the original proposal, the New York tax law would have prohibited any partnership that had any owner that wasn't an individual from its PTE tax regime.[16] As enacted and as a compromise to those corporate taxpayers that opposed the PTE tax in the first place,[17] the New York PTETI tax base is basically the accumulation of only those distributive shares accruing to resident and nonresident taxpayers subject to New York's personal income tax. Thus, by the statute's silence, the New York PTETI tax base would exclude the distributive shares of the partnership's income that would be distributed to, for example, corporate owners or owners that are other partnerships, and would avoid subjecting the income of those owners to the state's PTE tax regime.

Related to the eligible ownership issue discussed above, the purpose for this income exclusion, of course, is to allow any partnership, even one with a "blended ownership" (that is, partnerships that include not only individual owners but also corporate and other owners that aren't interested in the benefits (and burdens) of the PTE tax), to elect into the New York PTE tax regime. By doing so, New York's PTE tax appears to satisfy the delicate objective of providing U.S. FIT deduction benefits to those owners who want them without adversely affecting those who don't. The lesson learned from a careful reading of the New York PTE tax law applicable to all these new state PTE taxes is that one cannot assume that the tax bases are the same.

State PTE Tax Rates

The first of these new PTE taxes, Connecticut's, imposed a flat, stated rate of 6.99 percent, which is equivalent to the highest marginal tax rate under Connecticut's personal income tax law.[18] For Connecticut taxpayers, the personal income tax rate brackets are relatively compressed with a tax rate of 5.5 percent applying to income of $50,000 for unmarried individuals filing separately. The incremental rate differential between the highest bracket and that midrange bracket is only 1.49 percent. Perhaps the rate differential under the fixed rate PTE tax and the personal income tax

compared with the perceived federal tax benefit of being able to deduct the tax for federal income tax purposes, along with the fact that any difference is fully refundable,[19] mitigates any PTE owner's concern that she would be paying more estimated state taxes under the PTE regime than if the PTE did not make the election and she had to file tax returns under the state's personal income tax.

Following the same method, states with broader income tax rate differentials faced resistance when they sought to follow Connecticut's lead and simply apply the state's highest marginal personal income tax rate to the PTE tax. In New York, for example, after recent amendments, the top marginal tax rate for 2021 is 10.9 percent (for income in excess of $25 million), while for taxpayers earning more than $43,000 but not more than $161,550, that rate is 5.97 percent, or nearly half the highest marginal New York personal income tax rate.[20]

Obviously, if New York followed Connecticut's lead and used the highest marginal tax rate, New York PTE owners would have seen a substantial increase in their estimated taxes even though the difference between the PTE tax and the personal income tax liability would be fully refundable.[21] New York legislators, thus, had to take a slightly different tact and imposed the same rate brackets as under the personal income tax but based upon only the PTETI of the PTE (not of the individual taxpayers).[22] The problem, of course, is that the PTETI is an aggregate of all the distributive shares of the individual owners of the PTE. Thus, it should be obvious that owners of a PTE with many owners will be subject to PTE tax at a much higher rate than owners of PTEs with few owners with the same average amount of PTE distributive shares. Again, that the estimated taxes are fully refundable and the owners obtain a federal tax benefit they otherwise would not have gotten probably mitigates the concerns of the higher rate brackets on these PTE owners.

In fact, this issue might have been so complex for California legislators (whose state has a broad series of personal income tax brackets) that they left the rate blank (literally, a series of underscores) in the original introduced version of the PTE tax legislation.[23]

On the other hand, at least one state, Alabama, in enacting its PTE tax provided corporate taxpayers with the possibility of using PTEs to reduce their state tax rate by up to 20 percent if they restructure their Alabama business income into a partnership. Unlike some states' PTE laws, Alabama's PTE tax law allows any "Subchapter K Entity as defined by [Ala. Code] Section 40-18-1[(35)][24] . . . to pay Alabama income tax at the rate prescribed by [2021 Ala. Acts 1, section 10] subsection (e)."[25]

The definition of a subchapter K entity in the Alabama tax law does not appear to impose any additional restriction on the nature of the owners of those entities other than those imposed for federal income tax law purposes (along with an express exclusion of a DRE from the definition). Subsection (e) of Alabama's PTE tax law instructs that electing PTEs "shall pay a tax at the highest marginal rate provided in [Ala. Code] Section 40-18-5."[26] The Alabama Code section in that clause is a reference to the Alabama personal income tax law, under which the highest rate imposed is 5 percent.[27] In contrast, Alabama corporate income tax is imposed at the rate of 6.5 percent.[28] Rather than provide its taxpayers with a credit against their own tax liability for tax paid at the PTE level, Alabama, like neighboring Georgia and South Carolina, allows PTE owners to exclude any of their income subject to tax at the PTE level from the determination of their own Alabama tax liability.[29] Thus, by creating a partnership and having all their tax liability taxed at the PTE level, a corporation in effect could reduce its Alabama tax rate by 1.5 percentage points or, effectively, reduce its effective tax rate by 23 percent.

Resident or Other State Tax Credits for Similar PTE Taxes

Generally (and appropriately), for PTEs engaged in multistate activities, most states extend the PTE tax only to the PTE's income that is apportioned or allocated to the state. Resident taxpayers may find this confusing since under their state's personal income tax, most states require that the resident taxpayer pay tax on 100 percent of income from whatever source derived while the state's PTE tax will be based on only the PTE's income apportioned to the state based on the PTE's own apportionment factors. To obtain the full benefit of the offset to the federal SALT deduction limitation, the PTE owner will have to expect first, that every state in which the PTE operates provides for a PTE tax (together with an offsetting tax credit, exclusion, or exemption from the state's personal or corporate income tax, as the case may be) and second, perhaps even more importantly, that the owner's resident state recognizes the amounts paid at the PTE level in other states as a creditable tax against their own resident state personal income tax liability.

In the states that use a credit mechanism, that may not be so clear. New York's new PTE tax law also modified the state's existing resident tax credit rule under its personal income tax law (contained in N.Y. Tax Law section 620)[30] and added a new subsection (b), which reads:

> (b) Pass-through entity taxes.
>
> (1) A resident shall be allowed a credit against the tax otherwise due pursuant to this article for any pass-through entity tax *substantially similar* to the tax imposed pursuant to article twenty-

four-A of this chapter [i.e., New York's elective PTE tax law] imposed on the income of a partnership or S corporation of which the resident is a partner, member or shareholder for the taxable year by another state of the United States, a political subdivision of such state, or the District of Columbia upon income both derived therefrom and subject to tax under this article.

(2) Such credit shall be equal to the taxpayer's direct share of the pass-through entity tax paid by the electing partnership or electing S corporation to such other state, political subdivision of such other state or the District of Columbia.

(3) However, *such credit will be allowed on* [New York personal income] *tax paid only if*:

(A) the state of the United States, political subdivision of such state, or the District of Columbia imposing such tax also imposes an income tax substantially similar to the tax imposed under this article [that is, article 22 of the New York Tax Law (New York's personal income tax)]; and

(B) in the case of taxes paid by an S corporation, such S corporation was treated as a New York S corporation. [Emphasis added.]

In effect, the statute says that first, the PTE tax in the other state must be "substantially similar" to New York's, and more importantly, clause (b)(3)(A) is clear that the other state must impose a personal income tax substantially similar to New York's personal income tax. Thus, as should be obvious, New York resident taxpayers who own interests in a PTE that pays tax at the entity level in states that don't have a personal income tax (such as New Hampshire, Tennessee, and Texas) can't claim a credit for the taxes paid to those states. Likewise, one questions whether the existing PTE taxes that are imposed by states such as California and Illinois (that is, the 1.5 percent California corporate franchise tax on S corporations[31] and the 1.5 percent "personal property tax replacement income tax" imposed by Illinois on partnerships, LLCs, and S corporations[32]) are substantially similar to New York's tax regime to qualify for the tax credit.

Last but not least (the greatest uncertainty of all), and as should be obvious from the discussion above, since none of these state PTE taxes is exactly the same as the other, how can the tax authority determine that the PTE tax paid to another state is eligible for the New York resident tax credit? Moreover, what's going to happen when the only avenue open to a PTE tax in the other state is the election to be treated as a C corporation for state tax purposes, such as those provided by Louisiana and Wisconsin? Is New York going to view that tax as substantially similar to its own? If so, why isn't Texas's margins tax or the Tennessee franchise or excise tax, both applicable to S

corporations, LLCs, and partnerships, substantially similar to New York's new PTE tax? Considering New York's recent adventures during the COVID-19 crisis (and even from many years before) regarding its "convenience of the employer" test on the treatment of nonresidents working hundreds, if not thousands, of miles away from New York — and not even taking into consideration New York's aggressive stance asserting residency for "statutory residents" — one wonders how "reasonable" the New York Department of Taxation and Finance is going to be in allowing these resident state tax credits for the PTE taxes paid to other states.

This is not just to pick on New York. Some states, such as Alabama, Georgia, and South Carolina, which followed the income exclusion route as opposed to the tax credit route in avoiding the double tax at the individual and entity level, didn't even provide an amendment to their existing resident state tax credit laws to reflect the potential existence of a claim for a resident state tax credit against personal income tax for residents engaged in a multistate business who paid a PTE tax to another state. As indicated above, those taxpayers might not even have to file a personal income tax return (let alone join in a composite return) to evidence the state personal income tax on their share of income.

Again, because of the wide variations in the state approaches to these PTE taxes, the greatest fear taxpayers should have must be the administrative denial of the resident or other state tax credit because of a state PTE tax election. That denial would mean that the taxpayer agreeing to a state PTE election potentially turned a 39-cent U.S. FIT benefit into a dollar-for-dollar increase in state taxes.

Conclusion

It was a no-brainer for state legislators to enact these elective state PTE taxes. In the weeks and months ahead, it's easy to foresee every state enacting one of these taxes. Legislators quickly realized there is no economic cost to the state (and likely a possible increase in state tax revenue), and it directly helps small business, PTE owners, who likely are the legislators' greatest financial supporters of their campaigns. What could go wrong?

The "good news" is that if you own a dental practice in Poughkeepsie, New York, a car dealership in Tustin, California, or a personal injury practice in Atlanta, Georgia, you are a resident of those same states, and you only have sales solely sourced to that state, you're in luck: These state PTE taxes are a welcome relief from the federal SALT deduction limitation. Even so, significant risks remain, foremost of which is whether the Biden administration is going to follow through with one of the

last promises made by the Trump administration — the issuance of proposed regulations promised by Notice 2020-75 that these state PTE taxes do what they say they do and qualify for the business tax exception to the SALT deduction limitation.

On a similar vein, there's been much talk, mostly coming from leaders of President Biden's own party, about potentially repealing the SALT deduction limitation entirely, which would make these PTE taxes and the associated elections irrelevant. On the other hand, none of Biden's recent budget proposals suggest any relief from the SALT deduction limitation, and considering how much revenue the elimination of the SALT deduction limitation would cost, it seems unlikely that Congress will actually go through anything other than posturing to repeal the provision (which expires on its own for tax years beginning in 2026). Congress and the Biden administration could go in an entirely different direction and impose (or in some cases reimpose) limitations on the deductibility of SALT taxes under a modified alternative minimum tax or a new targeted limitation on the total amount of itemized deductions (including the SALT deduction) depending upon the income level of the taxpayer.

At the state level itself, the number one focus must be on ensuring that for multistate taxpayers, the PTE taxes paid to other states will be taken into account and reduce the taxes imposed by the owner's resident state, regardless of whether the resident state enacts its own PTE tax. That could come in the form of a modification of the resident state's already existing other state tax credit or by otherwise excluding or exempting income taxed by the other state from the resident state tax.

Another concern would be the manipulation of the percentage for computing the "in-state credit" for the PTE tax paid against the owner's direct tax liability for the state. As mentioned above, Connecticut legislators quickly figured out they could raise revenue from PTE owners by reducing the PTE tax credit percentage used to compute the tax credit for the direct tax liability. In the future, an even greater concern would be whether these PTE taxes become permanent features of the state's tax law, with legislators deciding to make them mandatory as opposed to elective and perhaps even remove the in-state credits for PTE tax paid as a way to impose a "double layer" of tax similar to that imposed on C corporations and use them as a way to raise revenue.

As noted at the beginning, these state PTE taxes, as simple as they seem to be, are anything but. Taxpayers and their advisers will have to carefully consider each state's PTE tax and their own tax situations, and somehow predict the future before making any election into a state's PTE tax regime.