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Multi-State Passthrough Entity Taxes

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Agenda

- Disclaimer
- PET Regime Basics
- PET Federal Income Tax Implications
- California v. New York State PET Comparison
- Passthrough Entity Taxation Considerations
- PET Planning





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Learning Objectives

At the end of the session, you will be able to:

- Discuss how the SALT limitation limits tax deductions for individual taxpayers
- Describe entities that may benefit from electing PTET
- Identify entities whose owners may benefit from electing PTET
- Recognize some of the pitfalls and uncertainties in electing PTET





PET Regime Basics

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PET Regimes – The Why

Passthrough Entity Taxation - Elective

- Strategy that states have legislated to “work-around” the TCJA (2017) SALT \$10,000, itemized deduction, limit at the federal income tax level
- Example: Sue owns 100% of a passthrough entity - S corporation. Sue receives a K-1 showing \$500,000 of ordinary income. The federal tax rate is 37% and the state tax rate is 5%.
 - Passthrough Entity Tax is Not Paid: Sue directly pays \$25,000 in state income taxes. Sue can only deduct \$10,000 on her tax return (assuming she has no other state taxes) and loses a deduction of \$15,000. Therefore, she reduces her federal income taxes by \$3,700.
 - Passthrough Entity Tax is Paid: Sue’s passthrough entity pays the state tax of \$25,000. Sue directly pays federal tax on the reduced income of \$475,000. Therefore, she obtains a deduction for the entire \$25,000 and reduces her federal income taxes by \$9,250 (\$5,550 extra cash).



PET Election – The Basics

- S corporations, tax partnerships, and (sometimes) SMLLCs that file on Schedule C are eligible
- State Income Tax is assessed and paid at the PE level
 - Allows the deduction to flow-through against owners' AGI (not as an itemized deduction)
- PET Credit or income exclusion at the state individual level
 - To avoid double income taxation on the flow-through income at the owner level
- Elections are generally annual and irrevocable once made for the year
 - Connecticut is the only state in which the PET is mandatory (since 2018)

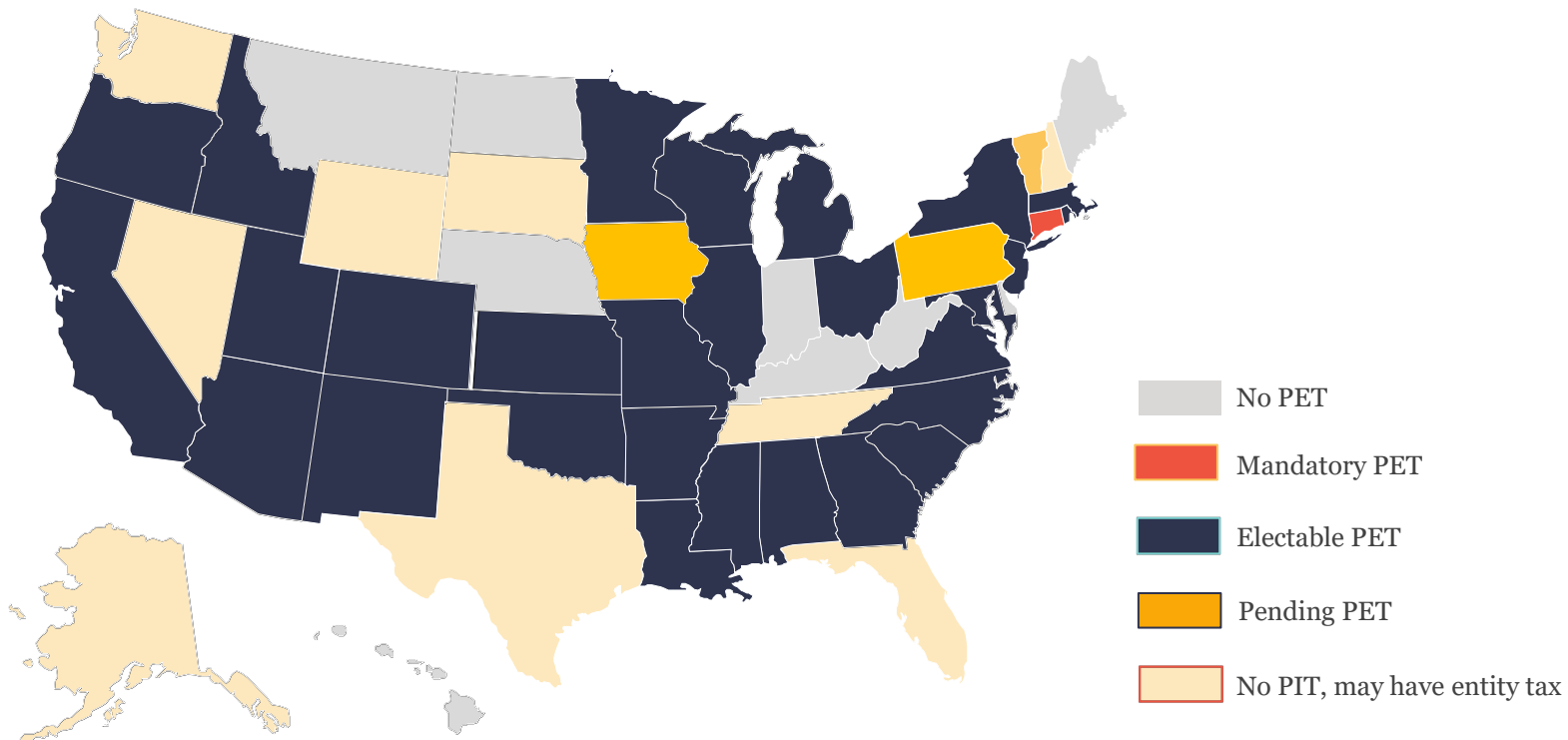


State Challenges to the Constitutionality of the Cap

- On April 18, 2022, the U.S. Supreme Court declined to hear **Connecticut, Maryland, New Jersey, and New York's** U.S. Second Circuit Court of Appeals decision which upheld the constitutionality of the \$10,000 federal cap on state and local tax deductions under the Tax Cuts and Jobs Act (2017).
- As a result, with the cap continuing to apply (at least until 2025) and with the IRS's decision that the PET is a deductible entity level tax (per Notice 2020-75), the PET regimes will continue to remain in place and likely continue to proliferate.
- There has been an explosion in State PET regimes since 2021. Nearly 30 states now have a PET regime in place.



29 States with Passthrough Entity Taxation





Federal Issues

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PET Federal Income Tax Implications

- IRS Notice 2020-75 (Issued: 11/9/2020)
 - Allows state income tax deduction (PET expense) on entity's federal income tax return to passthrough to the owners (via K-1 reporting)
 - Not treated as a tax paid “on behalf of the owners”
 - Not a deemed distribution
- Proposed Regulations to be issued
 - Still waiting



Deduction Allowed When Payment Made

- Notice 2020-75 answers only 1 question – Is PET deductible?
 - **Yes**, “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.”
- Can't accrue PET?
 - No guidance
 - IRS notice ≠ authority
 - Informally, IRS said not to take the Notice literally
- Allow accrued tax deduction
 - Recurring item exception



Liability for Tax

- Federal tax accounting principles
 - Need liability at year-end
- If Election is Not Made by End of Tax Year – Is there a liability?
 - *Cash Basis*: Liability should be considered to exist when payments made
 - *Accrual Basis*:
 - “Fixed and Determinable” liability at year-end?
 - Documented Intent (board resolution, minutes, payments, financials)
 - Economic performance rules of Sec. 461(h)



Demonstration of Intent

What actions are sufficient?

- ✓ Election statement sent to state's Department of Revenue
- ✓ Board resolution
- ✓ Minutes of a meeting concluding to elect PTET
- ✓ Accrual on financial statement
- ✓ Payment of estimated tax
- ✓ Other?



Cash Basis Taxpayers

Tax was paid by EOY

- Make the election and deduct PTET payment in the year paid

Tax was not paid by EOY

- No payment in 2021, no deduction in 2021
- Deduct when paid



Accrual Basis Taxpayers

Satisfied with liability issue

- PTE has decided to accrue and deduct
- Recurring item exception important

Determined liability for tax not satisfied

- Do not accrue PTET for 2021
- Benefit will be on 2022 return



Recurring Item Exception

Deductions allowed upon economic performance

Economic performance for taxes occurs when paid

Effect of recurring item exception

- Allows deduction for accrual of tax before tax is paid

How to elect

- Good news: By deducting the accrued expense
- Recommend attaching election statement (not required)



Sample Recurring Item Exception Election

ADOPTION OF RECURRING ITEM EXCEPTION METHOD OF ACCOUNTING

Taxpayer is adopting the recurring item exception method of IRC § 461(h)(3) for the following items incurred for the first time during the current tax year.

Listing of each trade or business for which recurring item exception method is adopted: [All]

Listing of all types of liability items for which recurring item exception method is adopted: [All forms of taxes]

These items have been properly deducted on the current year's return under the recurring item method of accounting.



Reporting on Schedules K and K-1

Business income

- Page 1
- Nets in line 1 of Sch K

Real estate rental income

- On 8825
- Nets in line 2 of Sch K

Non-real estate rental activity (i.e., a personal property rental)

- Nets in line 3 of Sch K

Sale of assets

- Follow character of the income
- Business or RE rental—page 1



Multiple Characters

- Allocations may be necessary
- Loss considerations
- Otherwise, report as “other deduction” on Schedules K, K-1
 - Line 13w (partnership) or 12s (S corporation)
 - The footnotes to Schedules K and K-1 should describe the other deduction (PET) and advise consulting a tax adviser to determine the character of the PET expense



Investment Entities

Entity return =
separately state
expense



Form 1040 =
report on Sch. A
subject to cap

Don't form a new investment
entity or make a PET election for
an existing investment entity.





State PTE Regimes and Planning

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States with PET Available For 2021 and Thereafter

State	State	State
Alabama (2021)	Arizona (2022)	Arkansas (2022)
California (2021)	Colorado (2018)	Connecticut (2018)
Georgia (2022)	Idaho (2021)	Illinois (2021)
Kansas (2022)	Louisiana (2021)	Maryland (2021)
Massachusetts (2021)	Michigan (2021)	Minnesota (2021)
Mississippi (2022)	Missouri (2022)	New Jersey (2021)
New Mexico (2022)	New York State & NYC [2021 & 2022]	North Carolina (2022)
Ohio (2022)	Oklahoma (2021)	Oregon (2022)
Rhode Island (2021)	South Carolina (2021)	Utah (2022)
Virginia (2021)	Wisconsin (2021)	29 States (as of 7/5/22)



Multistate PET Election

PET Election Decision Making Continuum

Make the Election

PE Does Business in One State with All Resident Individual Owners Electing In

Consider Making the Election

PE Does Business in State with Resident and Nonresident Individual Owners and Significant Apportionment Percentage

Don't Make the Election?

PE Does Business in State with All Non-Resident Individual Owners and De Minimis Apportionment Percentage

Caveat: Always Run the \$ before deciding.



Example of Calculating PET

Illustrative Example:

1. PE is owned by a resident and a nonresident individual, 75% and 25% respectively.
2. PE's apportionment percentage in the State is 15%.
3. PET Tax Rate is 7% and Federal Tax Rate is 37%
4. PET Taxable Income is \$1,000,000

	<u>Resident</u>	<u>Nonresident</u>	
Ownership %	75%	25%	
Taxable Income	<u>\$1,000,000</u>	<u>\$1,000,000</u>	
Distributive Income	\$750,000	\$250,000	
Apportionment %		<u>15%</u>	
PET Taxable Income Base	<u>\$750,000</u>	<u>\$37,500</u>	\$787,500
PET Tax Rate			<u>7%</u>
PET Tax	<u>\$52,500</u>	<u>\$2,625</u>	<u>\$55,125</u>
PET Deduction Allocation (by %)	(\$41,344)	(\$13,781)	
Federal Income Tax Rate	<u>37%</u>	<u>37%</u>	
Federal Income Tax Benefit	<u>(\$15,297)</u>	<u>(\$5,099)</u>	





California v. New York State PET Regimes

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California

- Effective for tax years beginning on or after January 1, 2021
- Expires on the earlier of
 - January 1, 2026, or
 - When SALT tax deduction cap is repealed
- Tax Rate is 9.3%



California

- Irrevocable election made annually on an original, timely filed return
- Qualified Entities
 - Partnerships, multi-member LLCs treated as partnerships, and S Corporations
- Disqualified Entities
 - Publicly traded partnerships
 - Entities that are permitted or required to be in a combined group



California

- All owners must be Qualified Taxpayers
 - Individuals
 - Trusts
 - Estates
 - Partnerships
 - “Exclusively Corporations”
- Qualified owners must separately *consent* to the election
- If an owner elects to not be included, the qualifying entity can still pay the PTE tax for owners electing in.



California

- PTEs are subject to tax on their qualified net income
 - Pro rata share or distributive share of income subject to tax under the personal income tax law for each qualified consenting owner
 - Distributive income of corporate and partnership partners is not included in the tax base
- PET Credit Mechanism
 - Consenting qualified owners receive a nonrefundable credit against their California regular income tax liability
 - If credit exceeds the qualified owners' California liability, the excess credit can be carried over for up to 5 years



California - Estimated Tax Payments

For tax years beginning between Jan. 1, 2021, and Jan. 1, 2022 (i.e., 2021 taxable year):

Tax is payable on or before the **due date of the tax return** without regard to any extension of time to file.

For tax years beginning on or after Jan. 1, 2022, and prior to Jan. 1, 2026 (i.e., 2022 to 2025 taxable years):

Tax is payable in two installments:

- ✓ 1st installment is due by **June 15** of the **current tax year of the election** and is the *greater* of \$1,000 or 50% of the PET liability in the prior year.
- ✓ 2nd installment is due on or before the **due date of the tax return without** regard to any extension of time to file.

PET may be required to be paid via CA FTB Webpay electronically, if certain criteria are met. Recommended remittance approach.

IMPORTANT: Beginning on or after January 1, 2022, and before January 1, 2026, the election must be made when the tax return for the taxable year is filed, **AND** the PTE must make an initial payment by June 15. The election for these years (made with the filing of the return) will be deemed **INVALID** if an initial payment is not made based on the above requirements.

- Need to know if going to make the election by June 15th (not with the filing of the return).
- Consider adding a significant “cushion,” if applicable.



New York State

- Effective for tax years beginning on or after January 1, 2021 (irrevocable election had to be made by 10/15/2021 for 2021 calendar tax years)
- Eligible entities include New York recognized S corporations (but, generally, not deemed “mandatory S corporations”) and tax treated partnerships (not disregarded entities) – with income tax nexus or a resident partner filing requirement – that have at least one “Article 22” taxpayer (e.g., individual, trust, estate)
- Annual irrevocable election period for calendar and fiscal tax years between January 1 and March 15 (for 2022, extended to September 15, 2022)
- Tiered PTEs (e.g., Tiered Partnership Structures) – Election made for each level; combined returns are not allowed



New York State

- Different PTE taxable income computations for New York S corporations and Partnerships:
 - S corporations – Two Classes:
 - *Standard*: New York Sourced Taxable Income (associated with Article 22 taxpayers, regardless of residency, S corporations with at least 1 nonresident shareholder)
 - *Electing Resident*: 100% of S corporation's Taxable Income (all resident shareholders)
 - Partnerships: Nonresident New York Sourced income + Resident Worldwide Income (both associated with Article 22 taxpayers)
- Different apportionment rules apply to S corporations (corporate apportionment rules: single receipts factor, market-base receipts sourcing) and partnerships (3-factor; performance and originating office base receipts sourcing)
- Tax rates imposed on PTE taxable income are the graduated individual income tax rates ranging from 6.85% to 10.9%



New York State

- The New York State passthrough entity tax was revised with respect to the calculation of a New York State S corporation's PET taxable income base.
- To provide certain S corporation shareholders with significantly more federal income tax benefit, effective 2022, 100% of an S corporation's taxable income will be taxable rather than just its New York State sourced income, if the S corporation is owned *solely* by New York State resident shareholders (this type of entity is now known as a "Resident S Corporation").

As a result, two "classes" of New York State S corporations now exist:

1. "Standard S Corporation": PE NY Taxable Income *based on apportionment*.
2. "Electing Resident S Corporation": 100% of Taxable income (without apportionment).



New York State

- Quarterly estimated PTE payments required starting in 2022. Consider obtaining nonresident opt-out elections for PTE withholding taxes; consider impact on Article 22 owners' New York estimated tax payments
- Article 22 owners are to addback their respective credit amount (not NY PTE deduction amount; deduction and credit amount may not always be the same) and receive a 100% PTE refundable credit
- Composite (group) return tax liability is not eligible for the PTE credit. PTE owners must file nonresident personal income tax return to claim the PTE credit
- Joint and several liability (certain classes of Article 22 PE owners are personally liable) for unpaid PTE



New York State

- New York Article 22 residents are generally allowed a PET income tax credit for all states that have currently enacted a “work-around” PET regime. Nonresidents of New York may or may not obtain a credit for the New York PET in their resident state



New York State – Estimated Tax Payments

- **Extended PET Election Due Date:** For the 2022 PET taxable year, relief has been provided for PEs that missed the original March 15th election deadline by providing for an extended election due date to September 15, 2022.
- In light of the election due date extension, the following changes have been made to the PET estimated tax payment due date requirements:
 - Elections made **after March 15, 2022 and before June 15, 2022:** For such election to be valid, the electing entity is required to make an estimated tax with its election of **25%** of the required annual payment.
 - Elections made **after June 15, 2022 and before September 15, 2022:** For such election to be valid, the electing entity is required to make an estimated tax with its election of **50%** of the required annual payment.
- ***“Electing Resident S Corporation” Election Prior to March 15, 2022:*** An “Electing Resident S Corporation” that made an election before March 15, 2022 is required to make estimated tax payments on March 15 and June 15, 2022 of 25% each of the required annual payment *as if* the electing resident S corporation was an electing “*Standard S Corporation*.” As of September 15, 2022, all Electing Resident S Corporation must pay in at least seventy-five percent (75%) of the required annual payment.



New York City

Effective for tax years beginning on or after January 1, 2023.

Eligible Entities: Partnerships/LLCs and S Corporations.

- “Eligible City Resident S Corporations”: A NYS S corporation that only has NYC residents.
- “Eligible City Partnerships”: A Partnership that has a NYS partnership return filing requirement where at least 1 partner is a NYC resident.
- Must Have Elected the NYS PET (e.g., “Electing Resident S Corporation”).

Election Due Date: March 15th of the applicable tax year.

Tax Rate: 3.876%

PEs, if doing business in NYC, are still subject to the NYC Unincorporated Business Tax (for partnerships) and NYC General Corporate Tax (for S corporations).



Considerations	Connecticut	California	New York State
Type of Entity Restrictions?	Yes	Yes	Yes
PE Ownership Restrictions?	No	Yes	No
PET is Elective or Mandatory?	Mandatory	Elective	Elective
Election is Irrevocable?	Yes	Yes	Yes
Annual Election?	Mandatory	Yes	Yes
Election Due Date	Mandatory w/ filing of tax return – 3/15	Filing of Tax Return - 3/15; but must meet 6/15 estimated tax payment requirement	3/15 of Elective Tax Year (Online); 2022 extended.
Can Related PEs Elected a Combined Return?	Yes	No	No
Owners Can Opt-Out?	No	Yes	No
Taxable Income Base	Standard v. Alternative (Elective)	“Qualified Taxpayers”	“Article 22 Taxpayers”
Guaranteed Payments Included in Taxable Income?	Yes	Yes	Yes
Apportionment	Single Sales Factor	Single Sales Factor	Single Sales Factor (S Corp.)/Partnerships (3 Factor)
Tax Rate	Flat: 6.99%	Flat: 9.3%	Graduated: 6.85% to 10.90%
Estimated Tax Payment Requirements?	Yes – Quarterly of Tax Year	Yes - June 15 th of Elective Tax Year	Yes - Quarterly of Elective Tax Year
Nonresident Owner Withholding Tax Requirement?	N/A	Yes – 7%	No - Form IT-2658
Owner should file state return?	Yes	Yes	Yes
Composite Tax Liability Allowed PET Credit?	Yes	No	No
PET Credit or Income Exclusion for Owner	Credit; Refundable	Credit; Non-Refundable – 5 Year Carryforward	Credit; Refundable
PET Expiration Date	None	2026	None
Potential S Corporation Second Class of Stock Issue?	Likely, No	Potentially, Yes (if shareholders opt-out)	Likely, No





Passthrough Entity Tax Considerations

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Passthrough Entity Tax Considerations

- Eligibility: Determine which passthrough entities are eligible to make the election and the effective date.
- Election: Don't miss the election deadline and determine upfront who needs to make the election (PTE (type of entity), owners of PTE, tiered entity structures, combined return PTE elections). Generally, elections are made with the filing of the tax return. Some states have an "upfront" election date. No late election relief. Consider PE v. Owner election regimes.
- Combined Returns: Can related PEs elect to be included in a combined PET Return?



Passthrough Entity Tax Considerations

- Taxable Income Base: Calculating the PTE taxable income base varies amongst the states (including nonbusiness income, which owner's distributive share of income is included in the taxable base, *apportionment methodologies*, unsourced intangible income, PTE tiered entities, combined returns).
- Guaranteed Payments: Determine how partners' guaranteed payments are treated in the taxable income base and how "contract only partners" will be affected by the PET election (no passthrough PET deduction). Consider adjusting the guaranteed payment amounts to consider the PET and to allow "contract only partners" the ability to participate in the federal income tax benefit.



Passthrough Entity Tax Considerations

- Deductibility of PET: Consider the federal/state income tax consequences with respect to PET deductibility (e.g., timing of deduction) and who receives the deduction (are the intended owners obtaining the full benefit of a deduction?). Can the PET be deducted for “pure investment” entities? Can the PET be deducted in cases of PET regimes that allow owners to opt-out at their discretion (e.g., CA)?
- Allocation of the PET Deduction: Understand how the PET deduction will be allocated to the passthrough entity owners (*pro-rata for S corporations; pursuant to operating agreement for partnerships (special allocations)*).



Passthrough Entity Tax Considerations

- PET Credit: Understand how the rules allocate the PET credit to owners; the credit allocation may not necessarily follow the PET deduction flow-through. What taxes can the PET Credit *not* offset (e.g., UBI Tax)?
- Refundable PET Credits: Does OSTC come before the PET Credit (e.g., CA said no, then said yes)? Also, consider the federal/state income tax consequence (taxability) of PET refunds received by either the PTE or the owners as a refundable credit.
- Resident OSTC: Consider whether an individual/trust owner will receive a resident (home state) credit for the taxes *paid by the PTE* to an owner's nonresident state. Watch out for double state income taxation.



Passthrough Entity Tax Considerations

- Distributions: For *S Corporations*, if the PET election is to be made by *each shareholder*, consider second class of stock termination with respect to proportional cash distributions of *electing and nonelecting shareholders*. For *Partnerships*, consider adjusting distributions to make distributions equitable for all partners; review partnership operating agreement.
- Economic Effect and Cash Flow: Consider the tax and economic effect of the election on the owners (e.g., individuals, trusts, estates, corporations, partnerships). Are there winner v. loser owners? Are taxes required to be double or over paid (cash flow issues for the PTE and its owners:
 - Nonresident PTE Withholding Taxes, Estimated Tax, and Composite Tax Payment Requirements.
 - Subsequent Receipt of Tax Refunds.



Passthrough Entity Tax Considerations

- PE Owner's Tax Return Filing Requirement: Does the owner have to file an income tax return if the PET has been paid by the passthrough entity and fully satisfies the owner's tax liability?
- Composite Tax Returns: Is the PET Credit allowed on a composite tax return or does each owner have to file their own tax return in order to obtain the credit?
- Complicated Bookkeeping: Entities may find that making owners whole requires some complicated math, bookkeeping and tracking.



Passthrough Entity Tax Considerations

- M&A Transactions: Don't forget to consider the PET in business sales and whether it makes sense to sell the asset vs. ownership interest in the PE. Need plenty of lead time for analysis.
- Run the \$: Don't have to make the election for every state in which the PE is filing a tax return.
 - Single State Nexus PE: Probably makes sense to make the election if the passthrough entity is doing business in one state and all the owners are residents of that one state.
 - Multistate Nexus PE: Look for states with the highest apportionment percentage and/or the states with the highest percentage of resident owners.



Passthrough Entity Tax Considerations

- Twelve (12) States Currently Don't Have a PET regime: Delaware, Hawaii, Indiana, Iowa, Kentucky, Maine, Montana, Nebraska, North Dakota, Pennsylvania, Vermont, West Virginia. *Note*: Nine (9) states don't have a personal income tax and the remaining states (and New York City) do have a PET regime in place.
- States Tweaking: States continue to revise their PET regimes soon after they are enacted (e.g., CO, CA, NJ, NY).
- Federal Tax Legislation: Keep your eyes and ears open on the proposed repeal/increase of the federal SALT itemized deduction cap and how this may affect a decision into an irrevocable PET election. SALT Cap is due to expire in 2025 w/ no cap in 2026 and thereafter.
 - Some state PET regimes legislatively evaporate after 2025.
- Financial Statements: How is PET treated on the financial statements?
 - GAAP v. Non-GAAP PET Treatment.





PET Planning Ideas

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PET Planning Ideas

- Document *All Events Test* is Met to Obtain Accrued Deduction
- Create a Multi-Member LLC from a SMLLC
- Elect S corporation Status (For Federal and State)
- Restructure Passthrough Entity to Include Qualified Owners
 - Remove non-qualified owners if it hinders the ability to elect the PET regime or doesn't provide the sought-after benefit
- Amend Partnership Agreement To Allow for PET Deduction Special Allocations and Distributions (if needed)
- *Be Proactive*: Run the numbers; don't have to make the election for every state that offers the PET. Don't miss out on some federal income tax benefit.





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