STATE PASS-THROUGH ENTITY-LEVEL TAX IMPLEMENTATION ISSUES

BACKGROUND

As part of the 2017 federal tax reform (commonly referred to as the Tax Cuts and Jobs Act (TCJA), Congress enacted a limit ($10,000 for most individuals and married couples filing a joint return and $5,000 for married individuals filing separately) on the amount of state and local taxes an individual may deduct for regular federal income tax purposes. There were no changes to the deduction for state and local taxes paid by a business.

Individual owners of pass-through entities (PTEs) report their proportionate share of business income on their individual income tax returns and are subject to the $10,000/$5,000 annual limit for state and local income taxes paid. These PTEs include S-corporations, partnerships, limited partnerships, limited liability partnerships (LLPs), and limited liability companies (LLCs).

ISSUE

In response to these new federal limitations, many state tax policy makers are proposing, and several state legislatures have enacted, various approaches to assist their taxpayers in mitigating this new limitation on the federal income tax deduction for state and local taxes.

One state legislative approach that several states have proposed, and one state already has enacted, is intended to shift the tax on PTE income from the owner to the PTE. Such an approach, its proponents believe, would 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 owners’ income. These state proposals also would provide that the owner is permitted to claim 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.

A PTE state-level tax was recently enacted in Connecticut, and other states are considering similar proposals. As states consider enacting PTE-level taxes, states and state CPA societies should consider various perspectives and implementation issues regarding this approach.

IMPORTANCE TO CPAs

Given the number of PTEs and the novelty of the recently enacted federal limitations on the deductibility of state and local taxes for PTE owners, we anticipate some states will consider enacting an entity-level tax with a corresponding credit to the PTE owners. PTE-level taxes will have broad federal and state tax consequences. In addition, many CPA firms are formed as PTEs.
CPAs are interested in working with state tax authorities and legislatures as they consider possible entity-level taxes on PTEs. Entity-level taxes have implications regarding both state tax revenues and state taxpayers, including PTEs and individual taxpayers.

**RECENT STATE ACTIVITY**

On May 31, 2018, the Governor of Connecticut signed into law an entity-level income tax on most PTEs in Connecticut. Owners of PTEs are entitled to a credit against their Connecticut personal income tax for the PTE owner’s share of the PTE-level tax paid by their PTE.

Other states, such as New York, New Jersey and Arkansas, have announced that they are considering whether to enact their own PTE-level tax similar to Connecticut’s. Specifically, the New York Department of Taxation and Finance released its own draft of a proposed Unincorporated Business Tax (UBT), which, similar to the Connecticut tax, would provide a credit for PTE owners against their corresponding New York state personal income tax liabilities.

**AICPA POSITION**

The AICPA does not take any position on these state tax proposals, either as a concept or on any of the specific legislative drafts that some states have recently released. To assist state CPA societies, the AICPA identified the following list of issues for consideration in evaluating any proposed state PTE-level tax.

**Potential benefits include:**

- Simplified nexus for all PTEs, including multi-tiered entities, which will also have reduced administrative burdens; and
- Other administrative simplification and burden reduction.

**Potential challenges and complexities include:**

- Double taxation potential and individual level state credits for taxes paid;
- Determination of tax or credits to owners;
- Treatment of credits otherwise creditable to owners;
- Treatment of PTE credits for taxes paid to non-resident states by the entity;
- Tax rate disparity;
- Sourcing rules, determination of in-state source income, and treatment of investment partnerships;
- De minimis exception;
- Mandatory or elective tax;
- Separately stated Form 1040 Schedule K-1 items;
- Basis step-up adjustments;
- Net operating loss treatment;
- SMLLCs and other disregarded entities;
• Unreimbursed business expenses;
• Treatment of pass-through income from other PTEs and treatment of compensation;
• Capital accounts;
• Tax-exempt and foreign partners and shareholders;
• Corporate partners;
• Administrative burdens of tracking, reporting, and payments increased;
• Different federal and state tax treatment and potential impact on federal calculations; and
• Federal deductibility of individual state income taxes.

PRESENT LAW

For federal purposes, income is calculated and reported at the entity level, but the income tax is imposed on the owners based on their allocable share of the entity’s income.

For the most part, states have adopted the same tax regime as the federal tax regime for these types of PTEs. Most entity-level taxes currently imposed by states on PTEs are considered gross receipts or business activity taxes, as contrasted with income taxes. Roughly half of the states that impose such taxes are notable for having no individual income tax regime.

Specifically, at least eleven states, plus NYC and DC, impose an entity-level income tax on PTEs. Five of these states do not levy an individual income tax (i.e., Nevada, New Hampshire, Tennessee, Texas, and Washington) and three states (i.e., Connecticut, Kentucky, and Ohio) and DC and NYC provide some type of partial offsetting personal income tax credit or deduction. Other states impose annual fees or flat taxes on PTEs, such as annual filing fees or partnership fees.

Issued: October 4, 2018