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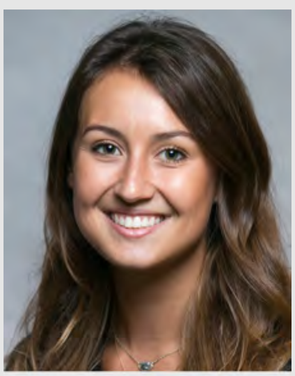

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In this installment of From the SALT Minds, the authors discuss a recent white paper from the American Institute of CPAs on passthrough entity taxes, which the authors recommend as guidance for state officials and lawmakers considering these taxes in their states.

On October 12 — in light of Connecticut's recent enactment of an entity-level tax on passthrough entities (PTEs) and reports of several other states considering similar taxes — the American Institute of CPAs released a very timely white paper titled "State Pass-Through Entity-Level Tax Implementation Issues."[1]

Eileen Sherr, senior manager of AICPA Tax Policy and Advocacy, explained that:

> a state PTE-level tax, such as Connecticut enacted, is an emerging issue involving one of the work-around approaches to the federal deduction limit on state and local taxes. The AICPA analyzed the various implementation issues with a state PTE-level tax and developed a paper for state CPA societies to consider. . . . We tried to list the issues involved to help the state CPA societies as the [proposal] may emerge in the various states over the next legislative session.[2]

Although the Connecticut law does not say so, news reports and comments by state officials blame the new tax on the state and local tax deduction cap in the federal Tax Cuts and Jobs Act (P.L. 115-97).[3] The TCJA amended IRC section 164 to impose a $10,000 limit on the amount of state and local taxes that individuals filing jointly can deduct for regular federal income tax purposes, beginning with calendar year 2018. Conversely, legislative history and public comments by Treasury officials suggest that the generally

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[1] *See* AICPA, "State Pass-Through Entity-Level Tax Implementation Issues" (Oct. 4, 2018). *See also*, Amy Hamilton, "News Analysis: Could the IRS Identify SALT Workarounds as Listed Transactions?" *State Tax Notes*, Oct. 29, 2018, p. 447.

[2] Email from Eileen Sherr to Bruce P. Ely.

[3] *See* Tax Cuts and Jobs Act, No. 115-97, 131 Stat. 2054 (2017).

unlimited SALT deduction for C corporations remained untouched.

Several typically high-tax states have reacted to the limit by proposing, and in some cases enacting, ways to assist their taxpayers in mitigating or avoiding that new limitation. One idea is to shift the state tax on PTE income from the owners to the PTE, thus allowing the PTE to deduct the entity's state and local income taxes as a tax on the business at the federal level, while granting the owners a credit for all, or nearly all, their distributive or pro rata share of the state PTE tax.

Connecticut's PTE tax, and the model act being advocated by the Parity for Main Street Employers (PMSE) coalition,[4] appears to avoid the SALT cap, at least as interpreted by the proposed regulations under IRC section 170 discussed below. But it would be an understatement to say that those taxes will result in compliance headaches, and perhaps legal challenges. Many tax practitioners fear that the methods states use to tax income and capital, the lack of guidance from state tax authorities, and the variety of taxpayer-specific fact patterns will lead to such complications.

Connecticut's PTE tax, enacted May 31, imposes a 6.99 percent entity-level income tax on most PTEs in Connecticut. The tax applies to S corporations, partnerships, and limited liability companies taxed as partnerships or S corporations. PTE owners are then entitled to a credit against their Connecticut personal income tax for an amount equal to 93.01 percent of their distributive or pro rata share of the PTE tax paid. On June 6 and again on August 21, the Connecticut Department of Revenue Services issued helpful guidance on the PTE-level tax and its estimated tax payment requirements.[5]

Reportedly, Michigan, Iowa, Arkansas, and at least two other states are considering whether to enact their own PTE tax, based on the PMSE coalition model act, which is generally based on the Connecticut statute. New York's PTE tax proposal, termed an unincorporated business tax, has been circulating for several months.[6] Conversely, California Gov. Jerry Brown (D) recently vetoed a tax proposal, dealing with the charitable deduction state tax credit work-around approach and citing the IRS's announced intent to challenge SALT cap workarounds.[7]

At the outset, the AICPA reaffirmed that it does "not take any position on those state tax proposals, either as a concept or on any of the specific legislative drafts that some states have recently released." Its thorough white paper outlines the potential benefits, challenges, and complexities that accompany a state PTE-level tax. The following is a selective summary of the pros and cons.

Potential Benefits

The determination of nexus is simplified by requiring testing solely at the PTE level rather than at the owner level. Also, compliance costs for multitier PTEs may be reduced because state income tax nexus is limited to the entity level. Further, administrative burdens could be reduced because multiple tiers will not be required to separately calculate combined apportionment factors at each tier. Composite returns and filing requirements for nonresident PTE owners can be eliminated. Corporate partners and other partnership owners of PTEs likely would see administrative simplification.

Finally, and perhaps most importantly, such a tax could reduce administrative burdens for the states because they would avoid the time and expense of attempting to collect tax from nonresident owners. That's always been the states' principal argument in favor of a composite return or withholding requirement imposed on PTEs with nonresident owners.

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[4] "Model Pass-Through Entity Tax," mainstreetemployers.org (May 22, 2018).

[5] *See* Connecticut Department of Revenue Services, "Guidance on 2018 Estimated Payments for the Newly Enacted Pass-Through Tax," SN 2018(4) (June 6, 2018); "Regarding the Calculation of the Pass-Through Entity Tax," OCG-6 (June 19, 2018); and "Regarding the Pass-Through Entity Tax Credit," OCG-7 (Aug. 21, 2018).

[6] Paige Jones, "Tax Department Proposes Unincorporated Business Tax," *State Tax Notes*, May 21, 2018, p. 845.

[7] *See* Paul Jones, "Governor Vetoes SALT Deduction Cap Workaround Legislation," *State Tax Notes*, Oct. 8, 2018, p. 148.

Potential Challenges and Complexities

According to the white paper, PTE-level taxes could lead to double taxation or an unintentional increase in individual income taxes. To protect against that burden, all states would need to provide a full credit to residents for PTE-level taxes to avoid double taxation. The individual-level tax credit treatment might implicate the U.S. Constitution's commerce and due process clauses and state due process clauses. A state imposing an entity-level tax should allow its residents to "apply credit for income taxes paid to another state by the entity." Because the resident individual won't pay the PTE-level tax personally, residents may lose their credit for taxes paid to other states. Also, states must decide how their residents will receive credit for a nonresident PTE-level tax imposed on passthrough income by another state.

If a state tax credit is not provided, a taxpayer would be subject to double taxation. However, the white paper points out that some states differentiate between taxes imposed on an entity and on an individual. California, for example, provides a credit for taxes paid at the individual level but does not provide a credit for the entity-level Texas margin tax. Different treatment for nonresidents in different states can offend the commerce and due process clauses and violate U.S. Supreme Court cases such as *Comptroller of Treasury of Maryland v. Wynne.*[8]

States must decide if some state tax credits, such as research and development credits, can offset the PTE-level tax. Also, there could be differences between the sourcing rules applied to determine the PTE-level tax and those applied at the owner level. Legislation will be required to clarify corporate-type apportionment and allocation rules. Moreover, states could consider formation or registration of a PTE as minimal contact with a state for the PTE-level tax. Here, the PTE-level tax might apply to all PTEs, including investment partnerships, which are typically exempt from those taxes or composite return regimes. Another issue is whether the scope of the PTE tax will include single-member LLCs and other entities typically disregarded for federal income tax purposes.

States must decide whether the PTE-level tax is mandatory or elective, taking into account the abysmal number of New York businesses that have opted into the relatively new payroll tax that clearly looks like a SALT cap workaround.[9] And in terms of separately stated items, states must decide, for example, whether charitable donations made by the PTE are deductible by the PTE, and if so, what limitations apply. States must provide details on the treatment of net operating losses to address whether losses are carried forward at the PTE level or flow through to the owners.

Also, according to the white paper, "States may not provide appropriate treatment of a PTE-level tax imposed on the income allocated to tax-exempt and foreign partners and shareholders."[10] Likewise, corporate partners "may not receive credit for their share of the PTE-level taxes paid by the PTE to another state."[11] Further, the state could "subject C corporations doing business in the state to additional [tax] liability solely due to their ownership of interests in PTEs and the state applying the tax to entities owned either directly or indirectly by C corporations."[12]

Whether a Connecticut-style PTE tax will be deductible by the individual owners for federal income tax purposes is uncertain. The IRS has warned that it will apply substance-over-form principles when interpreting the $10,000 SALT deduction cap.[13] Connecticut's new tax by election can result in the PTE only paying the tax on income allocated to noncorporate owners. The paper discusses whether this election could lead to a challenge that the PTE-level tax is like a withholding regime. As the paper discusses, the "IRS could apply a *quid pro quo* challenge to the PTE-level tax approach, similar to that which it has made in proposed regulations challenging the

[8] *Comptroller of Treasury of Maryland v. Wynne*, 575 U.S. ___ (2015). *See* David Sawyer and Eric Yauch, "U.S. Supreme Court Strikes Down Maryland's Income Tax Regime," *State Tax Notes*, May 25, 2015, p. 563.

[9] *See* Richard Rubin and Mike Vilensky, "New York Found a Fix for Some Hit by Tax Law. Employers Are Skeptical," *The Wall Street Journal*, May 2, 2018.

[10] AICPA, *supra* note 1, at 8.

[11] *Id.*

[12] *Id.*

[13] *See* IRS Notice 2018-54, 2018-24 IRB 750.

state tax credits for charitable contributions in Prop. Reg. section 1.170A-1."

Those transactions could possibly be classified by the IRS as "listed transactions" that must be disclosed on the federal income tax return.[14] Moreover, the paper discusses that there could be independent return preparer reporting obligations.

In summary, we commend the white paper as a nonexclusive checklist for any state official or lawmaker who is considering such a tax in their state — although we hope they conclude that the better route is to enact a nonresident owner withholding or composite return regime, or perhaps to tighten their existing regime.[15] ■

[14] *See* 26 C.F.R. section 1.6011-4; and IRS, Recognized Abusive and Listed Transactions.

[15] For further information on the rules applicable to entity-level taxes on LLCs and limited liability partnerships, pre-Connecticut, see Bruce P. Ely, Christopher R. Grissom, and William T. Thistle II, "An Update on the State Tax Treatment of LLCs and LLPs," *State Tax Notes*, Jan. 8, 2018, p. 155.