Federal and state tax update

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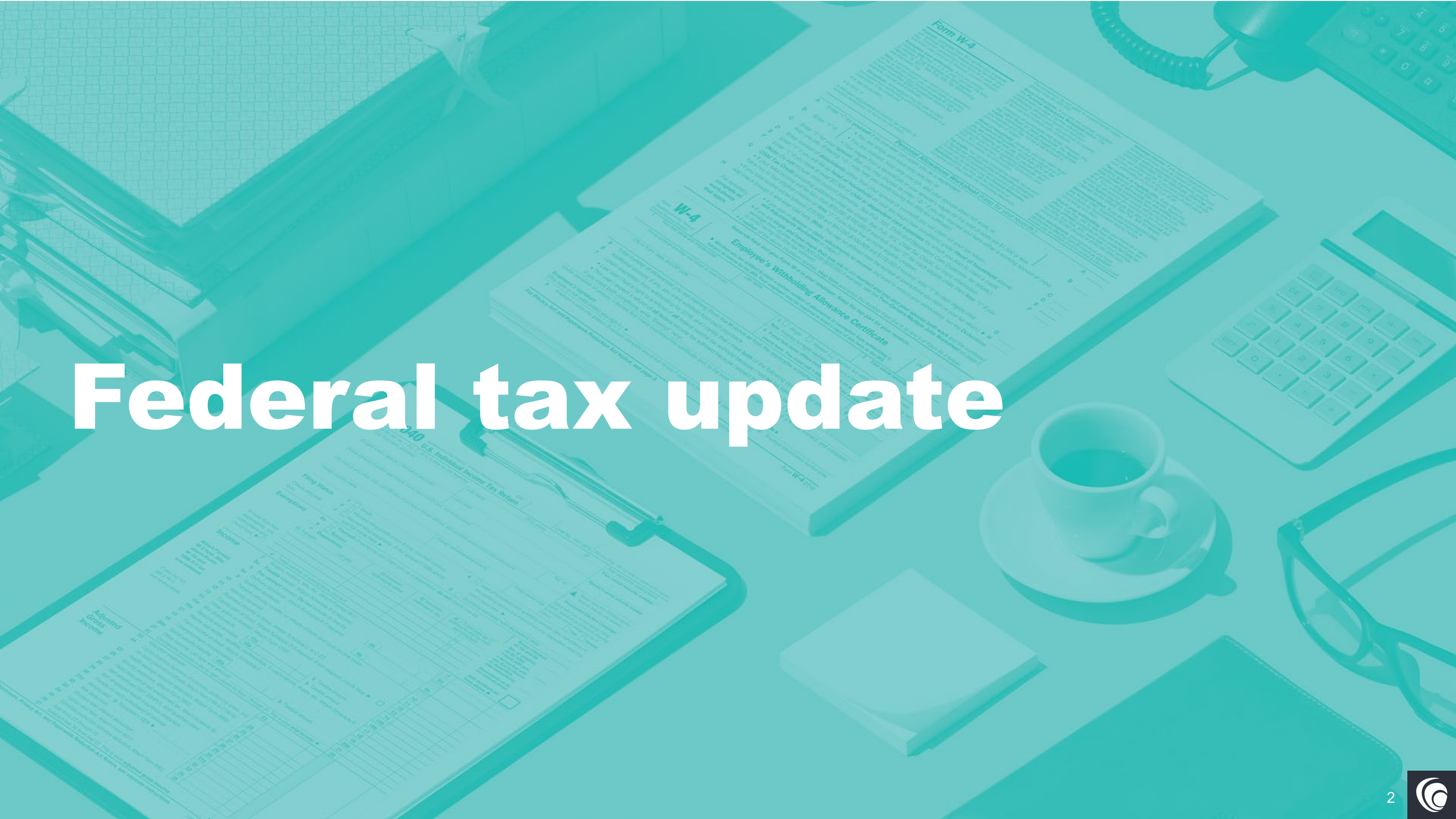
Agenda

- Federal tax update
- State tax update
- Review and update on additional states with pass-through entity tax (PTET) elections
- Updates on the MTC's Statement regarding P.L. 86-272



Federal tax update

Federal tax update

- First year bonus depreciation
  - Bonus depreciation rates will phase down to 80% from 100% in 2023, 60% in 2024, 40% in 2025 and 20% in 2026. For property with a longer production period and certain aircraft the phase down is: 80% in 2024, 60% in 2025, 40% in 2026 and 20% in 2027
- Business interest expense limitation: For tax years beginning after 2021 (Tax Law Change Alert), no add back allowed to taxable income when calculating ATI for:
  - depreciation under IRC Sec. 167 or 168;
  - amortization of intangibles under IRC Sec. 167 or 197;
  - other amortized expenditures under IRC Sec. 195(b)(1)(B), 248, or 1245(a)(2)(C); or
  - depletion under IRC Sec. 611
- Section 174 Research and Experimental Expenditures Paid and Incurred in Tax Years After 2021
- New Lease Accounting Standard (ASC 842) Tax Impact
- FinCEN Regulations– Beneficial Ownership Reporting

Pennsylvania state tax update

PA state tax update

- Corporate income tax: PA corporate rate reduction
- Pennsylvania DOR has begun transitioning online business tax filings from eTides to the new online tax filing system, myPATH.
- Philadelphia businesses that file and pay business and income receipts Tax (BIRT) can now carry forward net operating losses incurred in 2022 and thereafter to 20 future years.

Pass-through entity level taxes

How we got here

- States began enacting in response to state and local tax (SALT) deduction limitation as result of 2017 TCJA which maximized schedule A to $10,000
- Primary benefit is reduction of federal income taxes; however, care must be taken when evaluating whether benefit exists on state returns
- Twenty-nine states plus New York City have enacted a PTET regime and all are elective with exception of Connecticut.
- Majority of the elections are irrevocable; meaning once made, it can not be reversed
- Limitation is currently valid tax years 2018-2025

How we got here

Notice 2020-75 (11/9/2020)

- “Specified income tax payments” are deductible by partnerships and S corporations in computing their non-separately stated income or loss
- “Any amount paid by a PTE to a state, a political subdivision of a state or the District of Columbia to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the PTE”
- Applies regardless of whether the PTE tax:
  - Is mandatory or elective
  - If the owners receive a deduction or credit reducing the owners’ individual income tax liabilities in the domestic jurisdiction

State PTE considerations

State	Effective date	State	Effective Date	State	Effective date
Alabama	*January 1, 2021*	**Louisiana**	*January 1, 2019*	**New York City**	*January 1, 2022*
Arizona	*January 1, 2022*	**Maryland**	*January 1, 2020*	**North Carolina**	*January 1, 2022*
Arkansas	*January 1, 2022*	**Massachusetts**	*January 1, 2021*	**Ohio**	*January 1, 2022*
California	*January 1, 2021*	**Michigan**	*January 1, 2021*	**Oklahoma**	*January 1, 2019*
Colorado	*January 1, 2018* **Retroactive*	**Minnesota**	*January 1, 2021*	**Oregon**	*January 1, 2022*
Connecticut	*January 1, 2018*	**Mississippi**	*January 1, 2022*	**Rhode Island**	*January 1, 2019*
Georgia	*January 1, 2022*	**Missouri**	*January 1, 2022*	**South Carolina**	*January 1, 2021*
Idaho	*January 1, 2021*	**New Jersey**	*January 1, 2020*	**Utah**	*January 1, 2022*
Illinois	*January 1, 2021*	**New Mexico**	*January 1, 2022*	**Virginia**	*January 1, 2021* ** Retroactive*
Kansas	*January 1, 2022*	**New York State**	*January 1, 2021*	**Wisconsin**	*Depends*

Most PTE laws will be repealed if the federal SALT cap is repealed

State PTE considerations

- Mandatory or elective
- **How and when to make election**
- **Who can make the election**
- Revocable or irrevocable
- Required estimated payments
- **How to calculate tax**
- Tax rate differentials
- Loss of shareholder/partner/member deductions
- Members requirement to file tax return
- **Credit for taxes paid and credit ordering rules (OOST v PTET)**
- Members' personal tax attributes
- Partnership agreement
- ***List is NOT all inclusive***

How to make the election

- Generally, election is made by either checking box on return OR filing specific state form
- However, several states **require additional action** by specific dates in order for election to be valid
  - **California**
    1. Payment must be made by **June 15th** of the tax year for which the election is being made
       - *2023 return:* estimated tax payment must be made by June 15, 2023
    2. *Then*, taxpayer makes election made on timely filed return (assuming timely prepayment)
       - An underpayment of the statutorily required prepayment does **not** count as a timely made payment and taxpayer is not eligible to make election
  - **Michigan**
    - Election (via payment) must be made before the **15th day of the 3rd month** of the tax year for which the election is being made
      - *2023 return for calendar year taxpayer:* must make election by March 15, 2023

How to make the election

- **New York**
  - Election must be made by **March 15th** of the tax year for which the election is being made
    - *2023 return for calendar year taxpayer*: must make election by March 15, 2023
  - All NYS PTET returns must be filed on a calendar year basis
    - *Fiscal year filers*: election must be made by March 15th of the calendar year in which the fiscal year ends
      - **Example**: April 30, 2023, fiscal year end filer must make election by March 15, 2023
- **New York City**
  - Election must be made by **March 15th** of the tax year for which the election is being made
    - **2022 tax year only**: Election must be made by **March 15, 2023** *(assuming NYS PTET for 2022 was timely made by September 15, 2022)*
  - All NYC PTET returns must be filed on a calendar year basis, similar to NYS PTET
  - **For tax years after 2022, election must be made at the same time as the NYS PTET election**
    - **2022 tax year only**: NYS election must have already been made by September 15, 2022
  - Partnerships: must have at least one partner that is a NYC resident
  - S Corporations: *all* shareholders must be NYC residents

How to make the election

- Some states have requirements regarding the channel through which the election is made
  - **Alabama**
    - Submit form PTE-E via My Alabama Taxes (MAT). All electing PTEs **must** be registered to use MAT.
  - **Louisiana**
    - Email form to section732.2election@la.gov
    - State will review and grant approval of election. You **must** receive acceptance of the election for it to be valid.
  - **Michigan**
    - Payment (to make election) and all FTE returns must be submitted through Michigan Treasury Online (MTO)

How to make the election

- **New Jersey**
  - Election must be made electronically on the PTE Election Form through New Jersey's Online Filing System
- **New York**
  - Required to use New York's Business Online Services account
    - **Must** be done by an **authorized person**. A POA with an accounting firm is **not** an authorized person and **cannot** make the election.
- **New York City**
  - Required to use New York's Business Online Services account

Who can make the election?

Who is a **qualified entity** to make a PTE election?

Qualifying entities *generally*:

- **Includes** partnerships, limited liability companies, and S corporations
- **Excludes** sole proprietorship and disregarded entities (SMLLC, QSub), investment partnerships
- **Exceptions**
  - *Example*: **California** qualifying entity does not include publicly traded partnerships or entities required to be included in a combined group

Who can make the election?

Who is a **qualifying member** of an electing PTE?

- Varies by state
  - **California** – individuals, fiduciaries, estates, trusts, or DREs whose sole owner is an individual, estate, or trust subject to California personal income tax
  - **New Jersey** – no limitation on qualifying members

Do all members need to be included in electing PTE return?

1. Binding for all qualifying members
   - Examples: **Minnesota, Wisconsin**
2. Binding for all *consenting* members
   - Examples: **California**
   - S corporation concern – second class of stock

How to calculate the PTE tax

How does an electing PTE calculate taxable income for members?

- Two methods to calculate pass through entity tax
  1. **Apportioned state distributive income** for all members
     - **Examples**: Illinois, Maryland, Massachusetts, Minnesota, New Jersey, New York (S corporations)
  2. **Separate calculations** for residents and nonresidents
     - **Residents**: Total income
     - **Nonresidents**: Apportioned income
     - **Examples**: California, Colorado, Wisconsin, New York (partnerships)
     - Second class of stock - does this impact the S election?

Example: New York

- Calculation of taxable income is different S Corporation versus Partnership
- **S Corporation**
  - **Residents AND nonresidents** income derived from sources in New York (apportioned income)
  - **Resident New York S Corporation** (all shareholders must be NY residents) 100% of distributive share of the electing PTE's income
    - Must certify all shareholders are residents of NY when filing the annual PTET return or extension
- **Partnership**
  - **Residents:** 100% of distributive share of the electing PTE's income
  - **Nonresidents**: Portion of income derived from sources in New York (apportioned income)
  - Guaranteed payments

How to calculate the PTE tax

- The following member tax attributes are ***generally*** lost when making a PTE election:
  - Net operating losses
  - Tax credits
  - Charitable contribution deductions
  - Personal or standard deductions
- Similar state taxable income calculation to composite tax return
  - **Exception**: Illinois personal service deduction disallowed
- Some states allow loss carry forward at the PTE level
  - Arkansas, Colorado

Example: California

- Tax rate: 9.3% qualified net income
  - *Compared to 12.3% or 13.3% composite tax rate*
- Calculated on distributive share of income and guaranteed payments subject to personal income tax in state
  - Residents: Total income
  - Nonresidents: California sourced

Limitation

- Excess PTE credit may be carried forward five years
- PTE credit is used **after** credit for taxes paid to other states **(effective 2022)**
- Eliminated TMT limit

Example: California calculation

Facts

- Qualified taxpayer earns $1 million qualified income *(share of distributive income from a pass-through entity)*
- California regular tax is $133k (1M x 13.3%)
- California PTE election and related tax is $93k ($1M x 9.3%) – *paid by electing entity*

Example: California calculation

PTE Implication

- Federal deduction of $93k and <u>federal savings of $34k </u>($93k x 37% fed tax rate)
- Member can use PTE credit of $93k ($133k regular tax - $93k) to offset its California individual income tax (legislative fix removed the TMT limitation)
- Entity makes payment of $93k (PTE) and individual member makes payment of $40k (balance of tax owed)
- **Credit ordering rules PTE v. OSTC**
- A PTE may file a group return (composite return) but cannot claim the PTE elective tax credit because it is not a flow-through item from the entity
  - **The PTE elective tax credit is only available on the individual return of the qualified taxpayer**
- If member's personal CA effective tax rate is below 9.3%, PTE tax credit could be "trapped" and can be carried forward 5 years by individual

Credit for taxes paid

What is an eligible credit for taxes paid?

- Items to consider:
  - Definition of “substantially similar”
  - “On or behalf of the taxpayer” language
  - Who is the “taxpayer”
  - States already limiting what's an allowable credit – however given the increase of states enacting PTET regimes, this issue has lessened BUT still needs to considered
  - States with NO PTE election available have not adjusted statutes or regulations for these considerations
  - Credit ordering

Credit for taxes paid

Credit for taxes paid to other states considerations:

1. Calculation of credit for taxes paid at electing PTE
2. Calculation of credit for taxes paid on resident return
3. Member of an electing PTE in nonresident state

Credit for taxes paid

Entity-level credit for taxes paid:

- The electing entity claims the credit for taxes paid on behalf of resident members
- Residents and nonresidents do not report income from electing pass-through entity on their individual return (income from other sources should still be reported)
- Example of states with this reporting:
  - Georgia
  - Oklahoma
  - South Carolina
  - Wisconsin

Credit for taxes paid

Entity-level credit for taxes paid:

- Consideration given to whether the following taxes can be used to offset entity-level credit for taxes paid:
  - Estimated state tax payments paid individually
  - Composite tax paid by PTE
  - Withholding tax paid by PTE
  - Electing PTE tax paid by PTE

Credit for taxes paid – Entity-level credit example

Facts:

- Wisconsin S corporation
- 2 individual shareholders
  - Shareholder A: 50% ownership, Wisconsin resident
  - Shareholder B: 50% ownership, Wisconsin resident
- S corporation files in following states:
  - $1 million federal taxable income

State	PTE Election	Filing Position	Apportionment
Wisconsin	Yes	S corporation PTE election	25%
Ohio	No	Composite	25%
Minnesota	Yes	S corporation PTE election	25%
California	No	Nonresident filer	25%

Credit for taxes paid – Entity-level credit example

Wisconsin PTE return – 7.9% tax rate:

State	PTE Election
Wisconsin PTE tax	**$79,000**
Credit for taxes paid to other states – Ohio composite (4.979%)	$(12,450)
Credit for taxes paid to other states – Minnesota PTE tax (9.85%)	$(24,625)
Credit for taxes paid to other states – CA individual income tax (9.3%)	$0
Total Tax Due/(Refunded)	**$41,925**

- Considerations
  - NO credit for tax paid individually
  - Watch limitations on credit for taxes paid (tax rate differentials)
  - Allows composites, PTE taxes, and *some* withholding as credit for taxes paid

Credit for taxes paid – Entity-level credit example

Wisconsin – Shareholder A:

- Wisconsin resident return
  - NO other sources of income

State	PTE Election
Wisconsin individual income tax	**$0**
Credit for taxes paid to other states – California individual income tax (9.3%)	$(11,625)
Total Tax Due/(Refunded)	$0

- Considerations
  - Lose credit for taxes paid to California versus additional California tax rate to include in composite return or elect PTE

Credit for taxes paid – Entity-level credit example

Wisconsin Summary:

Electing PTE’s entity-level credit for taxes paid:

- Resident members are taxed on 100% of income
- Allowable credits:
  - Net minimum, income tax, or franchise tax paid by the entity in another state on behalf of its resident members
  - Composite returns that include resident members
  - ‘Allowable’ withholding in other states on behalf of members
- Credits NOT allowed:
  - Any taxes paid by the shareholder, partner or member to another state on their proportionate share of income from the entity

Credit for taxes paid

Member-level credit for taxes paid:

- **IF** tax is apportioned at electing PTE, members of an electing-pass through entity are allowed a credit for their pro-rata share of the tax paid by the electing PTE
- **Residents' consideration**: Can the following state taxes be used to offset individual income tax liability?
  - State taxes paid individually by resident
  - Pro-rata share of composite tax paid by PTE
  - Withholding tax paid by PTE
  - Pro-rata share of PTE tax paid by electing PTE

Credit for taxes paid

Nonresident considerations:

- Does member need to file a nonresident individual income tax return?
- Can nonresident join a composite return?
  - Is the PTE tax credit refundable or nonrefundable to PTE
  - If nonrefundable, how long can excess credit be carried forward if PTE liability exceeds composite tax calculated at PTE
  - Can it use pro-rata share of PTE tax to offset composite income tax liability
- If filing a nonresident individual income tax return:
  - Is the PTE tax credit refundable or nonrefundable to individual
  - If nonrefundable, how long can excess credit be carried forward if personal liability exceeds tax calculated at PTE
  - Can it use pro-rata share of PTE tax to offset nonresident income tax liability

Key takeaways

- Benefit of PTE election is the federal deduction
- Modeling is **critical**, this is a fact specific analysis that should incorporate member/owner tax attributes – there can be winners and losers
- Don’t underestimate credit for taxes paid
- Review partnership agreements
- Ensure elections don’t create 2nd class of stock which could blow federal S corp election
- Still waiting on forms for 2022 and additional guidance

Update on MTC’s statement regarding Federal Public Law 86-872

Federal Public Law 86-272 (P.L. 86-272)

- If business sells tangible personal property (TPP) only and its instate activity is limited to solicitation of sales, it may be protected from paying state income taxes
- The sales order must be approved outside of state and the goods must ship from a point outside the state
- Employee may work from home office whereas, an independent contractor may work from an office but is required to solicit for more than one principal
- Whether P.L. 86-272 protection applies is a fact-based analysis
- Additional guidance regarding the interpretation of P.L. 86-272 can be found in *WDOR vs. William Wrigley Jr., Co.*

Federal Public Law 86-272 (P.L. 86-272)

- *Enacted in 1959*
- *No State…shall have power to impose…a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following: (1)* ***the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State****; and (2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1)*

MTC's update statement

- Quasi governmental body
- Multistate Tax Commission (MTC) post *Wayfair* updated their Statement as of August 2021 – resulting in limiting the scope of Public Law 86-272
    - Some virtual contacts constitute an in-state activity that exceeds solicitation, rendering PL 86-272 inapplicable
- P.L. 86-272 doesn't mention physical presence
- Activity conducted on website can create income tax nexus
    - Online job applications for non-sales positions via website
    - Post–sale assistance on how to use products via seller's website (chat and/or email functions)
    - Collection of data using cookies that influence seller's production, inventory, product development, etc
    - Remote fixes or product upgrades via electronic means
    - **This list is not all inclusive**
- Both California and New York have issued their own guidance

Disclosure