



Pass-through Entity Tax Update

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On August 27, 2021, Illinois Governor J.B. Pritzker signed the Illinois pass-through entity tax (“PTET”) into law. This occurred two days after the New York Department of Taxation and Finance released guidance with regard to New York’s new pass-through entity tax. More than twenty states have now passed or proposed legislation that provide for PTETs. States have sought to enact PTETs in response to the state-and-local tax deduction limitation for federal income taxes, which was enacted as part of the Tax Cuts and Jobs Act of 2017. This FGMK Tax Alert provides a background regarding states’ recent PTET strategies and highlights key elements of the newly enacted Illinois PTET as well as the newly released New York PTET guidance.

SALT Deduction Cap Background

Tax Cuts and Jobs Act of 2017

As part of the Tax Cuts and Jobs Act of 2017 (the “TCJA”), Congress enacted Internal Revenue Code (the “Code”) Section 164(b)(6) which limits an individual’s federal tax deduction for the aggregate of income or sales taxes, real property taxes, and certain personal property taxes for any taxable year to \$10,000 (\$5,000 for taxpayers married filing separately). The limitation does not apply to foreign taxes described in Code Section 164(a)(3) or to any real property taxes or personal property taxes described in Code Sections 164(a)(1) and (2) that are paid and incurred in carrying on a trade or business or an activity described in Code Section 212 (expenses for the production of income).

The deduction limitation, often referred to as the “SALT deduction cap”, was a result of Congressional budget rules that pertain to tax laws passed as part of a budget reconciliation process. The provision has drawn significant criticism since its enactment, and members of Congress have pushed for its elimination or modification, especially those Congressional members from states with high income and property tax rates. The provision remains ripe for discussion and potential modification as Congressional Democrats undertake the drafting of tax legislation as part of their planned \$3.5 trillion budget package which will also occur via a budget reconciliation process.

States’ Initial Workaround Considerations

While federal legislation regarding the SALT deduction cap remains a mere discussion point, several states have passed legislation since the enactment of the TCJA in order to mollify the effect of the SALT deduction cap. Initially, states had considered legislation under which the state or a local government would provide a tax credit to a resident who donates to a designated charity. The states planned to structure these tax credits to be worth essentially the same amount as the resident taxpayer’s charitable contribution (e.g., the New York proposed law would have provided a taxpayer with a state tax credit worth 85 percent of the amount donated to a designated charity) to ensure the local government received the same amount of revenue, be it through a donation or taxes. The taxpayer would subsequently claim a charitable deduction under Code Section 170 at the federal level, which is not limited (other than certain limitations based adjusted gross income), instead of a SALT deduction, which is limited to \$10,000 pursuant to Code Section 164(b)(6). However, the Internal Revenue Service (“IRS”) and the United States Department of Treasury (“Treasury”) determined that the receipt of state tax credits in exchange for the structured “charitable contributions” would constitute a “quid pro quo” arrangement, and thus would negate the federal charitable deduction under Code Section 170.

States’ Pass-through Entity Tax Workarounds

As a result of the IRS’ and Treasury’s nullification of planned charitable deduction workarounds, several states turned to alternative methods for alleviating the impact of the SALT deduction cap on taxpayers. Specifically, several states have passed legislation that provides an entity-level tax on pass-through entities, such as partnerships and S corporations (including LLCs taxed as partnerships or S corporations). While the tax credit structure varies state-by-state, the general concept provides for the pass-through entity to pay a state and local tax and then the respective partners or shareholders of the pass-through entity receive a credit against their personal state and local income taxes. This concept ensures that the states remain whole with respect to tax revenue while the pass-through entity owners have the ability to obtain a reduced federal tax liability, since the entity-level income passed through to such owner is reduced as a result of the entity-level tax, and also obtain a state and local income tax credit to eliminate potential double taxation at the state and local level (entity pays taxes – and individual owner offsets personal state income tax with credit at owner level).

Late last year, the IRS issued [Notice 2020-75](#) which effectively approved such tax structuring. Therein, the IRS and Treasury indicated the plan to provide regulations supporting the position that pass-through entities may deduct entity level tax payments, and that the owners of such entities need not take such payments into consideration when applying the SALT cap deduction at the individual owner level.

The following provides an overview of states that have already enacted PTET provisions or have pending legislation with regard to this issue.

States that have Enacted a PTET

Alabama	Idaho	New York
Arizona	Illinois **	Oklahoma
Arkansas	Louisiana	Oregon
California	Maryland	Rhode Island
Colorado	Minnesota	South Carolina
Connecticut *	New Jersey	Wisconsin
Georgia		

* Connecticut provides for a mandatory entity-level tax election-not elective.



States with Proposed PTET Legislation



Massachusetts *

North Carolina

Michigan **

Pennsylvania

* Disagreement on amount of credit for owners at individual level between governor (100%) and legislature (90%) has delayed legislation.

** Michigan governor vetoed legislation.

[Illinois Governor Pritzker Signs Passthrough Entity Tax Legislation](#)

On Friday, August 27, 2021, Illinois Governor J.B. Pritzker signed into law the Illinois pass-through entity tax legislation ([SB2531](#)). Effective for tax years ending on or after December 31, 2021, and beginning before January 1, 2026, the new law provides an annual election for partnerships (other than publicly traded partnerships) and S corporations, as well as LLCs taxed as partnerships or S corporations, to pay an entity level tax at 4.95 percent of net taxable income.

Overview of Legislation

Net taxable income will be computed similar to the term as defined under Section 202 of the Illinois Income Tax Act ("ITA") except that the standard exemption under ITA Section 204 and the deduction for net losses allowed under ITA Section 207 do not apply. Further, the definition will not apply certain modifications to partnerships provided by ITA Section 203(d)(2)(H) and 203(d)(2)(I) (thus no deduction for personal service income or income for services rendered by partners to the partnership nor any amount allocable to partners also subject to the Illinois Personal Property Replacement Income Tax) and to S corporations provided by ITA Section 203(b)(2)(S) (thus no deduction for amounts allocable to shareholders also subject to the Illinois Personal Property Replacement Income Tax). The legislation does provide a provision for tiered partnerships which asserts that if a pass-through entity that makes the PTET election (i.e., upper-tier partnership) is a partner in a lower-tier partnership that also makes the PTET election, then the upper tier partnership would not include its distributive share of income from the lower tier partnership.

For Illinois tax purposes, each partner or shareholder of a pass-through entity that makes the PTET election will obtain a credit for the owner's allocable share of the Illinois taxes paid by the pass-through entity. This credit is a dollar-for-dollar reduction of the individual owner's personal Illinois income taxes. Because both the pass-through entity and individual tax rates are 4.95 percent, the credit is structured to create a zero-sum impact for the taxpayer at the state level.

Notably, similar to the New York PTET discussed below, the Illinois legislation provides that individual owners may obtain a credit against Illinois income tax if the pass-through entity pays a PTET to another state that is substantially similar to the Illinois PTET. The credit would be computed based on the owner's allocable and apportioned income from such other state as bears to total income of the pass-through entity allocated or apportioned to such other state.

Pass-through entities that make the election will be required to make estimated tax payments where the PTET is expected to exceed \$500. As noted below, the state needs to release guidance as to the timing of such payments. However, owners will remain liable if the pass-through entity fails to make timely payments.

Withholding payments will not be required by pass-through entities that make the PTET election. Owners, however, should be aware of the timing issue resulting from the earlier required estimated tax payments paid by entities as compared to withholding payments that are due at the time of the entity's filing for extension.

Additionally, unlike New York, which as discussed below excludes income from the PTET computation that is allocated or apportioned to ineligible partners, the Illinois PTET is based on all income, including nonbusiness income, even if income is allocable to a tax-exempt entity.

Finally, while the PTET election may negate the need for many nonresident partners to file Illinois income tax returns in the future, owners should be aware of the impact that the elimination of the withholding tax may have on their Illinois tax liability, including those owners who are subject to the Illinois Personal Property Replacement Income Tax or are subject to higher income tax rates, e.g., C corporations that are pass-through entity owners. Such owners may need to make separate estimated tax payments where they had previously relied on the pass-through entity withholding to cover such liability.

Additional Guidance Needed

The legislation asserts that the Illinois Department of Revenue shall set forth the form, manner, and timing of the annual election. Such guidance is expected to extend as to the timing of estimated tax payments. To date no such guidance has been published. However, the governor's signing of the legislation may lead to the release of guidance in the near future. It is anticipated that pass-through entities will make the election on their 2021 Illinois returns (Form IL-1065 or Form IL-1120S). Entity estimated tax payments are not likely to be required for 2021, and pass-through entity owners may potentially have the ability to factor in their estimated distributive share of the entity tax for purposes of their Q3 and Q4 2021 Illinois estimated tax payments. However, as of now, pass-through entity owners should plan to make Illinois estimated income tax payments as originally planned.

As discussed in a prior [FGMK SALT Article](#) following the Illinois legislature's passage of the PTET legislation, the election is very fact sensitive and each situation must be analyzed separately. FGMK will continue to monitor the release of guidance, including the due date for the election applicable to 2021 and the interaction of the PTET with individuals' 2021 estimated tax payments.

[New York Releases Guidance on Passthrough Entity Level Tax](#)

On Wednesday, August 25, 2021, New York state released guidance with regard to its pass-through entity level tax. For tax years beginning on or after January 1, 2021, eligible partnerships (public partnerships are not eligible) and S corporations, including LLCs taxed as partnerships or S corporations, may make an annual irrevocable election to pay a passthrough entity level tax.

Annual Election Form, Method, & Timing

Only authorized personnel may make the election. For S corporations, such personnel may be any officer, manager, or shareholder authorized under state law of where the entity is incorporated or under the corporation's organization documents that provide such authority. For partnerships, authorized personnel include any member, partner, owner, or other individual with authority to bind the entity or sign returns under New York tax law.

The election to opt into the PTET is made online, and the election is annual and irrevocable. Payment is also made online. Authorized personnel first need to set-up a Business Online Services account.

For tax years [beginning on or after January 1, 2021](#), the [election must be made by October 15, 2021](#).

For tax years [beginning on or after January 1, 2022](#), the [election may be made on or after January 1st and by March 15th of that year](#).



optional payment, personal estimated income tax payments must be made by or on behalf of the owners as if not entitled to the PTET, i.e., compute and pay estimated payments without factoring in the credit for the entity PTET payment.



For tax years beginning on or after January 1, 2022, an electing entity is required to pay estimated tax payments online. Estimated payments are due on or before March 15th, June 15th, September 15th, and December 15th in the calendar year prior to the year in which the due date of the PTET falls. For example, estimated payments are made on such dates in 2022 for the PTET due in 2023. Each payment must be at least 25 percent of the required annual payment which is the lesser of:

- 90 percent of the PTET required to be paid for the taxable year; OR
- 100 percent of the PTET required to be paid in the previous taxable year.

The 90 percent of current year required payment applies to an entity that had not made an election for a PTET for the prior taxable year. PTET estimated payments will only be applied to PTET liability. Payments may not be applied to other tax liabilities nor may they be transferred between related entities or individuals. Penalties and interest will accrue for late payment.

Annual PTET Return and Computation

All PTET returns are filed on a calendar-year basis. If an entity is a fiscal-year taxpayer, it will use its fiscal year income for the fiscal year that ends in the given calendar year. Similar to the calendar-year taxpayer due date of March 15th, the fiscal-year taxpayer must file by March 15th following the close of the calendar year in which the fiscal year ends. For example, a taxpayer with a fiscal tax-year end of June 30, 2022 would have to file its PTET return by March 15, 2023.

An entity may file a six-month extension for the filing of its annual return if such extension is filed by March 15th (otherwise required return due date).

If an entity has a PTE taxable income of zero or less, then the entity may file a return to claim a refund of estimated tax payments.

An entity may not amend an PTET return for any reason once filed.

On its annual PTET return, the entity must report its total PTET and the direct share of the PTET available to each eligible owner as a PTET credit. The sum of the eligible owners' credits may not exceed the entity PTET. Ineligible owners include C corporations and passthrough entities, e.g., partnerships. Such ineligible owners are excluded from the PTET credit allocation computations, i.e., income not included in the PTE taxable income).

The PTET is imposed on the entity's PTE taxable income. The tax rate depends on the PTE taxable income.

If the PTE taxable income is:	then the PTET due is:
\$2 million or less	6.85% of PTE taxable income.
greater than \$2 million but less than or equal to \$5 million	\$137,000 plus 9.65% of the excess of PTE taxable income greater than \$2 million.
greater than \$5 million but less than or equal to \$25 million	\$426,500 plus 10.30% of the excess of PTE taxable income greater than \$5 million.
greater than \$25 million	\$2,486,500 plus 10.90% of the excess of PTE taxable income greater than \$25 million.

Owners PTET Credits

The guidance provides that an S corporation will allocate PTET credits based on ownership percentages. Partnerships need to compute separate resident and nonresident owner PTET credit pools. Additionally, partners with special allocations create a third credit pool for PTET credit allocation purposes.

Owners that receive PTET credits may claim the credit on Form IT-653, Pass-Through Entity Tax Credit and attach it to the owner's New York State personal income tax return. A trust, which is not disregarded for tax purposes, is allowed the PTET credit. However, the trust may not distribute any portion of the PTET credit to the trust beneficiaries.

Owners may receive PTET credits from multiple entities and will aggregate such credits on their personal income tax returns. Excess credits are treated as an overpayment to be credited or refunded without interest. Owners must file an individual personal income tax return to claim the credit, and thus the credit may not be claimed on a group return for nonresidents.

For tax years beginning on or after January 1, 2021, resident owners will be allowed a resident tax credit against the New York personal income tax for any PTET imposed by another state or local government or the District of Columbia if such tax is substantially similar to New York's PTET and paid by the S corporation or partnership to another jurisdiction. The state plans to maintain a list on its website of jurisdictions that meet the substantially similar criteria.

For tax years beginning prior to January 1, 2021, owners may not claim a resident tax credit for entity PTETs paid to other jurisdictions. However, an owner is allowed a resident tax credit if such other jurisdiction taxes are calculated on income of the entity but imposed upon and payable by the owner.

Taxpayers who claim the New York PTET credit and/or resident credit for entity PTETs paid to another jurisdiction must make an additional modification to federal adjusted gross income or federal taxable income on the taxpayer's New York State personal income tax return in an amount equal to such credits claimed.

[Evaluate PTET Options Now](#)

Pass-through entity owners should begin evaluating PTETs if they have not already. Due to the states' varying credit structures and interaction with other jurisdictions' PTETs, it is critical that PTETs have their authorized personnel discuss options and computations with their tax professionals. As evidenced by New York's guidance, pass-through entities also need to be cognizant of each state's deadline for making a PTET election.

Additionally, Congress recently passed a budget resolution that provides for the potential modification of the federal SALT deduction cap in upcoming legislation. If Congress does modify the SALT deduction cap, it could impact pass-through entity owners' decisions regarding states' PTETs.

Please contact FGMK's SALT leadership if you have any questions or would like to evaluate state PTET options.



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