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PASS-THROUGH ENTITY – ELECTIVE TAX

PRESENTED BY:

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ABOUT JAMISON HANSON

- Tax, retirement and wealth advisors
  - Business, trust & estate, and individual tax planning and compliance
  - Retirement plans (401(k)s, defined benefit, 401(h), SIMPLE, SEP)
  - Wealth preservation, growth, and transfer planning and management
- Credentialed professionals (CPA, CFP)
- ~2,000 tax returns filed annually
- ~$150 million of assets under management

STATE AND LOCAL TAX (SALT) DEDUCTION

- A Brief History
  - Included as the **only deduction** when the first income tax was enacted in **1861** (expired in 1872)
  - Reinstatement of the income tax in 1894 also included a SALT deduction (tax struck down in 1895 in Pollock vs Farmers' Loan & Tr)
  - Following the 16th amendment to the Constitution, the **1913 Revenue Act** included several deductions, including for "**all** national, State, county, school, and municipal taxes paid within the year, not including those assessed against local benefits."
  - The **standard deduction** was introduced in **1944**, limiting the pertinence of the deduction.
  - Deduction **limited** to income, sales and property tax in **1964**.
  - **Tax Reform Act of 1986** enacted the **alternative minimum tax** (AMT) effectively preventing the SALT deduction for those subject to AMT.
  - Itemized deduction **phase-out** (the 'Pease' limitation) enacted in **1990**
  - **Tax Cuts and Jobs Act of 2017** imposes a SALT deduction limit of **$10,000** ($5,000 for married filing separate) and nearly **doubled** the standard deduction

PROJECTED IMPACT OF THE TAX CUTS AND JOBS ACT (TCJA) ON THE SALT DEDUCTION

- $77.4 billion of increased federal revenue projected for 2019 per the Joint Committee on Taxation
- Increase standard deduction would reduce the number of individuals itemizing from 46.5 million to approximately 18 million (88% reduction)
  - Simplifies tax returns to review under audit

STATES WITH HIGH INCOME TAX RATES PUSHBACK

- Suit filed by New York, Connecticut, and New Jersey in July 2018 alleging violation of the US Constitution's principles of federalism under the 10th and 16th amendments.
  - On April 19, 2022, the Supreme Court denied a review of a ruling from the Second Circuit
- Legislative efforts to increase the SALT cap
  - Build Back Better Act proposed increasing the cap from $10,000 to $80,000
- Workarounds explored by several states
  - Donations to charitable organizations in exchange for tax credits
    - Regs. Sec. 1.170A-1(h)(3) denied the workaround
  - Specified income tax payments (SITPs) paid by partnerships and S Corporations

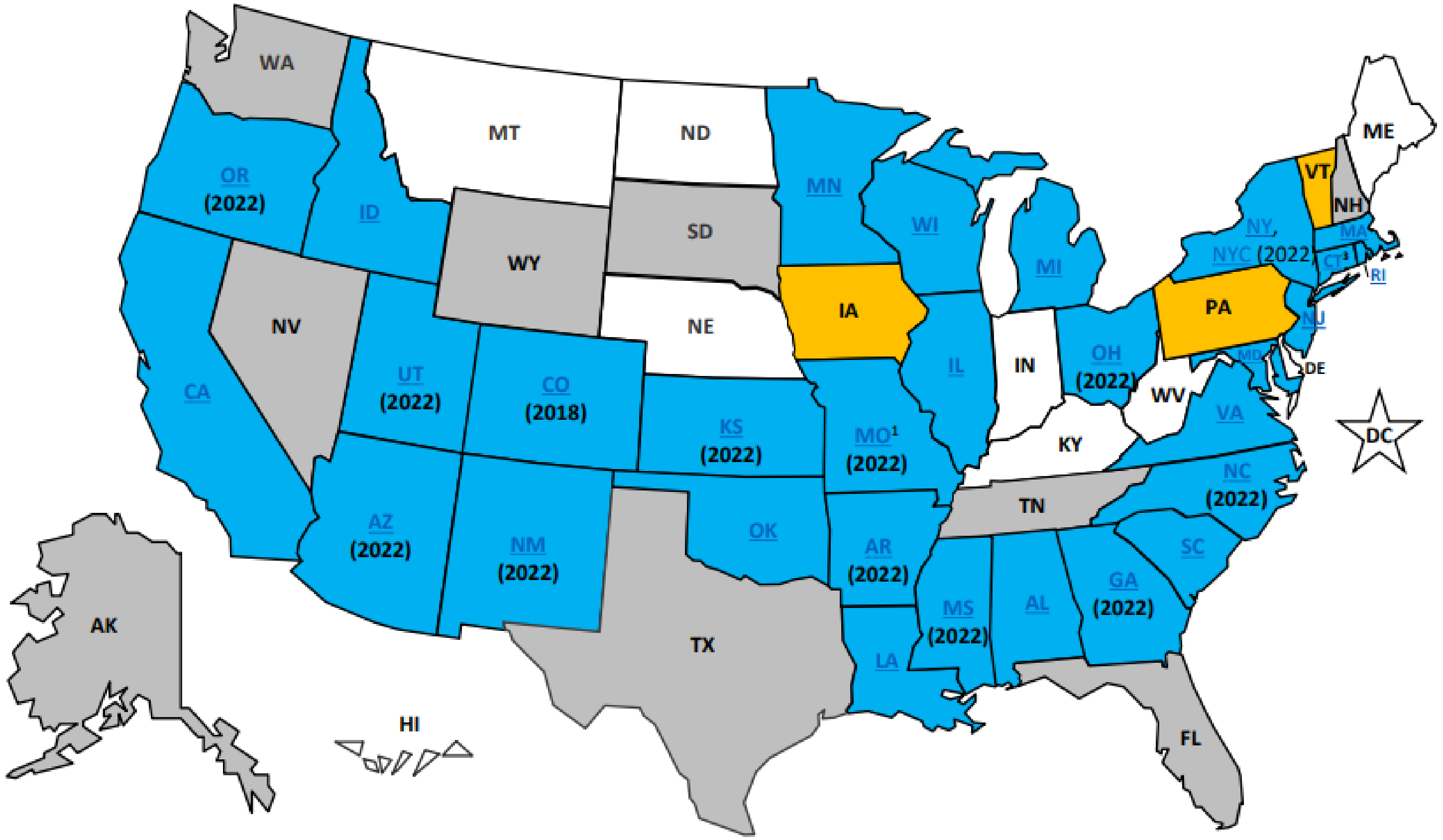
A WORK-AROUND TO THE DEDUCTION LIMITATION

Notice 2020-75

"…State and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment."

States with Enacted or Proposed Pass-Through Entity (PTE) Level Tax

As of August 31, 2022



29 states (& 1 locality) that enacted a PTE tax since TCJA SALT deduction limitation, effective for 2021 (or earlier) unless noted:

AL, AR[1], AZ[1], CA, CO[2], CT[3], GA[1], ID, IL, KS[1], LA, MA, MI, MD, MN, MO[1], MS[1], NC[1], NJ, NM[1], NY, OH[1], OK, OR[1], RI, SC, UT[1], VA, WI, and NYC[1]

[1] Effective in 2022 or later – on map (2022) or (2023)

[2] Retroactive to 2018

[3] Mandatory

3 states with proposed PTE tax bills:

IA - HF 2087, session over, not enacted

PA – HB 1709, in committee

VT - H 0527 , session over, not enacted

9 states with no owner-level personal income tax on PTE income:

AK, FL, NH, NV, SD, TN, TX, WA, WY

10 states with an owner-level personal income tax on PTE income that have not yet proposed or enacted PTE taxes:

DE, HI, IN, KY, ME, MT, NE, ND, VT, WV

AICPA

PATCHWORK OF RULES ACROSS STATES

- Eligibility
- Election method
- Frequency (annual or one time)
- Tax base and rates
- How and when to pay
- Allowance for state credit for entity tax paid to another state

OREGON PASS-THROUGH ENTITY – ELECTIVE TAX

- Effective for tax years beginning on or after January 1, 2022 and before January 1, 2024
  - Will it be extended through the end of 2025 to match the Tax Cuts and Jobs Act?
- Only entities taxed as S corporations and partnerships may elect annually to be subject to the PTE-E tax
- Tax rate is 9 percent tax on the first $250,000 of distributive proceeds and 9.9 percent tax on any amount exceeding $250,000.
- The law will expire if the federal SALT deduction limitation expires or is repealed.
  - Currently scheduled to expire at the end of 2025, reverting to prior law
- Qualifying members of an electing PTE are eligible for a credit equal to 100 percent of the member's distributive share of the PTE-E tax paid.
  - Credit is refundable

OREGON PASS-THROUGH ENTITY – ELECTIVE TAX (CONTINUED)

- The entity level election must be made by all owners. Each owner's tax situation is likely to differ, but all owners must be part of this election. The election is an annual election.
- The PTE-E rules are effectively made to work with the Oregon qualified business income reduced tax rates (QBIRTR), which allows for lower individual rates beginning at 7% for individuals that receive income from qualified businesses. Thus, when the entity pays the PTE-E tax at 9 or 9.9%, individuals paying a 7% tax will get a **refund** for the difference between 7% and the 9 or 9.9% paid by the entity
- Election is made at the time of filing the entity's tax return.
- Estimated payments are required by the pass-through entity to ensure avoidance of underpayment interest

EXAMPLE 1

Two Oregon resident owners and all income sourced to Oregon

Net income: $100,000

Interest: $15,000

Gains: $50,000

Distributive proceeds: $165,000, allocated to owner A $82,500 and owner B $82,500.

Total tax is calculated as follows:

$165,000 x 9% = $14,850. This is allocated to owner A $7,425 and owner B $7,425.

APPLICABILITY FOR ESTATES AND TRUSTS

- Same $10,000 SALT deduction limitation as individuals
- Ownership of a Pass-Through Entity by an estate or trust makes the entity ineligible for the Pass-Through Entity Elective Tax.
  - Special exception for guarantor trust
- Part year ownership of a Pass-Through Entity by an estate as a result of the death of a taxpayer?

AREAS OF UNCERTAINTY

- No indication as to the timing of issuance of proposed regulations that Notice 2020-75 indicated would be released.
- Open issues include the following:
  - Pass-through entities engaged in <u>investment activities</u> (e.g., family investment partnership)
  - <u>Accrual</u> of specified income tax payments (SITPs)
  - <u>Allocation</u> of SITPs among owners
  - Taxation of state income tax <u>refunds</u> of SITPs

PASS-THROUGH ENTITIES ENGAGED IN INVESTMENT ACTIVITIES

- Notice 2020-75 suggests that specified income tax payments (SITPs) do not need to be related to a trade or business to give rise to a deduction.
  - "…income taxes described in section 164(b)(2) for which a deduction by a partnership is not disallowed under section 703(a)(2)(B), and such income taxes for which a deduction by an S corporation is not disallowed under section 1363(b)(2)."
    - Important: The notice references section 164 not section 212
      - Section 212 relates to expenses associated with the production of income – '2% Miscellaneous Itemized Deductions' suspended by the Tax Cuts and Jobs Act through 2025 with the addition of section 67(g)
      - Section 164 deductions are specifically excluded from miscellaneous itemized deductions under section 67(b)(2).

ACCRUED SPECIFIED INCOME TAX PAYMENTS (SITPS)

- Must payments be made during a calendar to claim the deduction?
  - Deduction is based upon authority under section 164(a), which allows for a deduction for state and local income taxes paid or accrued.
    - Requirements to accrue an expense under the accrual method of accounting
      - All events have occurred that establish the fact of the liability
      - Amount of the liability can be determined with reasonable accuracy
      - Economic performance has occurred with respect to the liability
        - Generally, when paid, but exception if all the following requirements met:
          - Economic performance with respect to the liability occurs on or before the earlier of the date the taxpayer files a timely (including extension) return that tax year or September 15th of the following tax year
          - Liability is recurring in nature
            - Must be fixed. Consider a board resolution to formalize.
          - The amount of the liability is not material or the accrual results in a better matching of the liability with the income

ALLOCATION OF SPECIFIED INCOME TAX PAYMENTS (SITPS) AMONG OWNERS

- Partnerships
  - Special allocations allowed
    - Substantial economic effect rules must be satisfied (Section 704(b))
- S Corporations
  - Must be allocated pro rata to meet requirements of S election
    - What if a shareholder is not eligible or does not desire to participate?
      - Loan arrangements may be necessary for shareholders not receiving a tax credit or exclusion

REFUNDS INCLUDABLE IN FEDERAL GROSS INCOME

- The tax benefit rule of section 111 would suggest taxable to the extent the payments reduced the taxpayer's tax liability in the prior year.
  - But what about the fact that the entity claiming the deduction is not the same as the individual receiving the refund?
    - Judicial history suggests still taxable (Maines, 144 T.C. 123 (2015))

PLANNING OPPORTUNITIES

- Should a single member LLC be taxed as an S Corporation? Converted to a multimember LLC (partnership)?
  - Consider liquidity events (business, real estate and/or portfolio)
- When should the PTE-E tax payments be made?
  - Timing to maximize tax benefits

CASE STUDY: SINGLE MEMBER LLC TO MULTIMEMBER LLC

- Taxpayer sole member of LLC containing real property worth ~$10 million
- Basis in the property is ~ $1 million
- State income on the sale approximately $900k
- Gifting of interest to spouse to make multimember prior to the sale enables eligibility for the PTE-E
- Enables federal tax savings of **~$300k**
- Proceeds invested in a portfolio of securities within the same LLC structure
  - Assuming 4% taxable annual earnings on $10 million ($400,000), ongoing PTE-E payments of ~$40k resulting in annual federal tax savings of ~$15k ($40K * 37% marginal tax rate).

GETTING STARTED

- An entity must first register with the Oregon Department of Revenue to make payments for the PTE-E tax.
  - See PTE-E registration training for further details.
- You may receive an error when registering for PTE-E on Revenue Online (ROL). If you receive an error, you may need to have “Third Party Access" set to “Yes" within your ROL account. To change the setting follow these steps after logging into your ROL account:
  - From the main ROL screen select “Settings" located at the top right.
  - Once that page loads select “Manage additional logins" from under “I Want To" located on the right side of the screen.
  - On the next screen make sure “Accountants or Third-Party Logins" says “Yes" next to “Allow", if not click on “No" and change to “Yes".
  - Once you have completed registering for the PTE-E tax account, you can change the third-party access back to “No" following the same steps above.

QUESTIONS?

APPENDIX

OREGON DEPARTMENT OF REVENUE: FREQUENTLY ASKED QUESTIONS

1) Q: What is the PTE-E Tax?

A: For Oregon tax purposes, income and losses of a PTE are passed through to its members/owners. However, for taxable years beginning on or after January 1, 2022 certain qualifying pass-through entities may elect to pay a PTE-E Tax on the sum of each of the member/owner's share of distributive proceeds. The member/owner(s) may then claim a tax credit for the tax paid by the PTE on their share of distributive proceeds.

2) Q: Is the PTE-E Tax mandatory?

A: No. The PTE-E Tax is elective.

3) Q: Must the entity make an election to pay the PTE-E Tax each year?

A: Yes. The entity must make an election to pay each year. The election is made when the return is timely filed.

4) Q: Which entities may elect to pay the PTE-E Tax?

A: A PTE is a partnership or S corporation or limited liability company electing to be treated as a partnership or S corporation. The PTE may elect to pay the PTE-E Tax if all the member/owners are individuals or are pass-through entities that are owned entirely by individuals subject to the personal income tax imposed under Oregon Revised Statutes Chapter 316.

Sole proprietorships and single member LLCs electing to file as sole proprietorships may not elect to pay the PTE-E Tax.

5) Q: When is a fiscal year partnership eligible to make the PTE-E Tax election?

A: A fiscal year pass-through entity may make the election for taxable years beginning on or after January 1, 2022.

6) Q: Can a taxpayer transfer an overpayment from a composite return to a PTE's elective tax account?

A: No. The PTE-E Tax is a separate tax apart from the composite tax return filed on behalf of individuals. The overpayment from the composite return cannot be transferred to the pass-through entity's elective tax account.

FREQUENTLY ASKED QUESTIONS CONTINUED…

7) Q: Can a grantor trust be a qualified member of an eligible PTE?

A: Yes. The grantor trust is treated as a qualified member because they are subject to the personal income tax laws under ORS Chapter 316.

8) Q: Can an eligible out-of-state PTE with income, subject to tax in Oregon, elect to pay the PTE-E Tax?

A: Yes.

9) Q: Is the election to pay the PTE-E Tax revocable?

A: Yes. The election can be revoked on or before the due date of the return, including extensions.

10) Q: What income is subject to tax by the eligible pass-through entity?

A: The PTE will pay tax on the distributive proceeds of the entity. Distributive proceeds include net income, dividends, royalties, interest, rents, guaranteed payments, and gains of a PTE derived from or connected with sources within Oregon.

11) Q: Can a non-resident Oregon composite return filer claim the PTE-E tax credit?

A: Yes. A PTE that files an Oregon composite return (OR-OC) on behalf of its participating non-resident members may claim the credits allocable to the members who are included on the OR-OC.

12) Q: Will there be a registration required for the PTE-E tax?

A: Yes, you will be required to register on Revenue Online before estimated tax payments can be made. Registration will open on June 6, 2022.

13) Q: Will the members be required to show an addition for the state tax deduction if they claim a credit on their individual return for their share of the PTE-E tax paid?

A: Yes.

FREQUENTLY ASKED QUESTIONS CONTINUED…

14) Q: When are the PTE-E tax returns due?

A: The returns will be filed on a calendar year basis and will be due on the same day that the personal income tax returns are due, which is normally April 15th. For fiscal filers the returns will be due for the year that coincides with the fiscal year end. For example: if your fiscal year is July 1, 2022 to June 30, 2023 you would file a 2023 calendar year end PTE-E tax return reporting the income on the June 30, 2023 PTE return.

15) Q: If a pass-through entity elects to pay the new Pass-through Entity Elective tax, can the owners qualify for the qualified business income reduced tax rate (QBIRTR)?

A: Yes, if there is income that meets the conditions for the use of the elective rates under ORS 316.043.

16) Q: Is the addition that is required to be added back to income of an owner of a pass-through entity, that claims the credit for the Pass-Through Entity Elective (PTE-E) tax, considered qualifying income for the qualified business income reduced tax rate (QBIRTR)?

A: Any amount that is added back for the PTE-E tax that meets the conditions for the use of the elective rates under ORS 316.043 may be treated as qualifying income under ORS 316.043. If the distributive income from the PTE is a mix of qualifying and nonqualifying income, the addition that is qualifying income is a proration determined by the department by rule.

17) Q: Does a PTE have to make estimated payments?

A: Yes. A PTE that will be making the election to be liable for and pay the PTE-E tax must make estimated tax payments.

18) Q: Is making estimated payments the same as making the election to pay PTE-E tax?

A: No. The election to pay PTE-E tax is made when the PTE-E tax return is filed.

19) Q: What will happen if the PTE doesn't make estimated payments?

A: The PTE may owe underpayment interest when it files the PTE-E tax return.

FREQUENTLY ASKED QUESTIONS CONTINUED…

20) Q: When are estimated payments due?

A: Estimated payments have the same due dates as for calendar-year personal income tax filers: April 15, June 15, September 15, and January 15 after the tax year ends. For tax year 2022 only, the April 15 payment is due on June 15 along with the June 15 payment. No underpayment interest will be due for the period before June 15.

21) Q: Are the estimated tax payment due dates the same if the PTE uses a fiscal year for accounting purposes?

A: Yes, but the PTE figures the payment *amounts* based on its fiscal year that ends during the calendar year for which it is making the election.

22) Q: What is the first step in determining the PTE's estimated payment amount?

A: The PTE must estimate the income that will be taxed when the PTE-E return is filed after the end of the tax year. The PTE-E tax is based on distributive proceeds from Oregon sources, including:

- Ordinary business income or loss.
- Net rental real estate income or loss.
- Other net rental income or loss.
- If the PTE is a partnership, guaranteed payments to partners.
- Interest income.
- Ordinary dividends.
- Royalties.
- Net capital gain or loss.
- Net IRC section 1231 gain or loss.
- Other income or loss.

If the PTE only does business in Oregon, it totals its income from the listed sources, and then calculates the tax. Separately stated deductions such as IRC 179 expense or contributions are not included in the calculation.

FREQUENTLY ASKED QUESTIONS CONTINUED…

23) Q: What if the PTE also does business outside of Oregon?

A: If the PTE does business both inside and outside Oregon, it must apportion its income according to Oregon's Uniform Division of Income for Tax Purposes Act, ORS 314.605 to 314.675, unless the PTE is a financial institution or public utility. In that case, the PTE must
apportion its income using the provisions of ORS 314.280. See Schedule OR-AP Instructions, Apportionment of Income for Corporations and Partnerships, for information about apportioned and allocated income.

24) Q: How does the PTE figure its income from Oregon sources?

A: From its total income from the sources listed above, the PTE must subtract the amount that isn't apportionable. Then it multiplies the remaining amount by its apportionment percentage. Use Schedule OR-AP Instructions as a guide for estimating the apportionment percentage. Then, from the income that isn't apportionable, add back income that must be allocated to Oregon. This is the PTE's total amount of distributive proceeds from Oregon sources.

25) Q: How does the PTE estimate the tax on the distributive proceeds?

A: If the total distributive proceeds are less than $250,000, multiply the total by 9% (0.09). If the total is more than $250,000, follow these steps:

1. Subtract $250,000 from the total distributive proceeds.
2. Multiply the result by 9.9% (0.099).
3. Add $22,500. This is the total estimated tax.

26) Q: Does the PTE have to make estimated tax payments that equal 100 percent of tax that will be due when the return is filed, in order to avoid payment underpayment interest?

A: No. Underpayment interest won't be charged if the PTE timely pays at least 90 percent (90%) of the tax that it expects will be shown on the PTE-E tax return.

FREQUENTLY ASKED QUESTIONS CONTINUED…

27) Q: How do I figure out the payment amounts?

A: Estimated tax is payable in four regular installment amounts. Multiply the total estimated tax times 90 percent, then divide that amount by four.

Example: Partnership A's total estimated tax is $40,000. It takes 90% of that amount, or $36,000 ($40,000 x 0.9), and divides it by four. A's installment payments equal $9,000 each ($36,000 ÷ 4).

28) Q: What if the PTE doesn't receive its income regularly during the year?

A: A PTE that doesn't receive its income regularly during the year can figure its installment amounts on an annualized basis. For guidance for tax year 2022, use the "Annualized income worksheet" for personal income taxpayers inside Form OR-10 Instructions, Underpayment of Oregon Estimated Tax (skipping references to items that only apply to personal income taxpayers) or ORS 314.505 and 314.525 and the associated Oregon Administrative Rules for PTEs that are S corporations

29) Q: If the PTE uses a fiscal year for accounting purposes, does it have to annualize its income based on a calendar year instead?

A: No. A PTE that is a fiscal-year filer should base its estimated tax payments on the total distributive proceeds from Oregon sources for the fiscal year that ends in the calendar year for which the PTE is making the election.

Example: S Corporation B's fiscal year 2022 ends on August 31, 2023. B will make the election for calendar year 2023 based on its income from Oregon sources from September 1, 2022 through August 31, 2023. If B annualizes its income, each of its installment periods start on September 1, 2022 and end on November 30, 2022, January 31, 2023, April 30, 2023, and August 31, 2023, respectively.

30) Q: How does the PTE make the estimated tax payments?

A: To make estimated PTE-E tax payments, the PTE must first register for a PTE-E account on Revenue Online. Payment can be made by ACH debit or credit while logged into the PTE's Revenue Online account, or by using the account number if not logged in. Payments by check or money order will also be accepted if submitted with Form OR-21-V, Oregon Pass-through Entity Elective Tax Payment Voucher. See Form OR-21-V Instructions for information about making payments by mail.

FREQUENTLY ASKED QUESTIONS CONTINUED…

31) Q: If the PTE doesn't make the election, does it have to file a return in order to get a refund?

A: If the PTE makes estimated PTE-E tax payments, but will not be making the election after all, the PTE may request a refund without having to file a return. The refund request can be made through the PTE's Revenue Online account.

32) Q: Is the PTE elective tax credit Refundable

A: Yes

33) Q: Is there an exception for farmers and fishermen for estimated tax payments?

A: No

34) Q: Is a single member LLC allowed to be a member of a PTE to be eligible to pay the PTE-E tax?

A: Yes, the PTE must report the individual as the member and not the single member LLC.

35) Q: If I file the PTE Elective tax return, do I still need to file a composite for non-residents?

A: Yes, a composite return will need to be filed for individuals that are electing to be included in the composite return.

36) Q: When are the forms going to be available?

A: The OR-21 will be required to be electronically filed or filed through our Revenue Online portal. We will not be releasing the OR-21 in paper form. Please see the instructions including worksheets posted on our forms page.

QUICK LINKS

- Register for the Pass-Through Entity Elective Tax
- Make a payment
- Find forms and publications
- Get PTE-E registration training
- August 2, 2022 Rules Advisory Committee Meeting Notice
- Background Material for August 2, 2022 Rules Advisory Committee Meeting

EXAMPLE WORKSHEETS

- Example 1 Facts
  - Example 1 worksheet for OR-21-K-1
    Example 1 Worksheet for OR-21-K-1 member 2
    Example 1 Worksheet for OR-21-MD
    Example 1 Worksheet OR-21

- Example 2 Facts
  - Example 2 Worksheet for OR-21
    Example 2 Worksheet for OR-21-AP
    Example 2 Worksheet for OR-21-K-1 for Member 1
    Example 2 Worksheet for OR-21-K-1 for Member 2
    Example 2 Worksheet for OR-21-K-1 for Member 3
    Example 2 Worksheet OR-21-K-1 for Member 4
    Example 2 Worksheet for OR-21-K-1 for Partnership A
    Example 2 Worksheet for OR-21-MD
    Example 2 Worksheet for OR-21-MD-PT

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