Passthrough Entity Tax Elections: A Complex Fix to the SALT Cap

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In this report, the authors examine myriad issues related to making passthrough entity tax elections.

Background

The Tax Cuts and Jobs Act of 2017 included a provision that, at most, limits an individual's itemized federal deduction for state and local taxes to $10,000 (the SALT limitation).[1] The provision is in effect for tax years beginning after December 31, 2017, and before January 1, 2026. At this time, Congress hasn't enacted legislation to extend the provision; therefore, the SALT limitation will expire in 2026. States tried a variety of workarounds, such as creating a system whereby taxpayers could classify state taxes as a form of charitable contribution. The IRS rejected all these efforts.

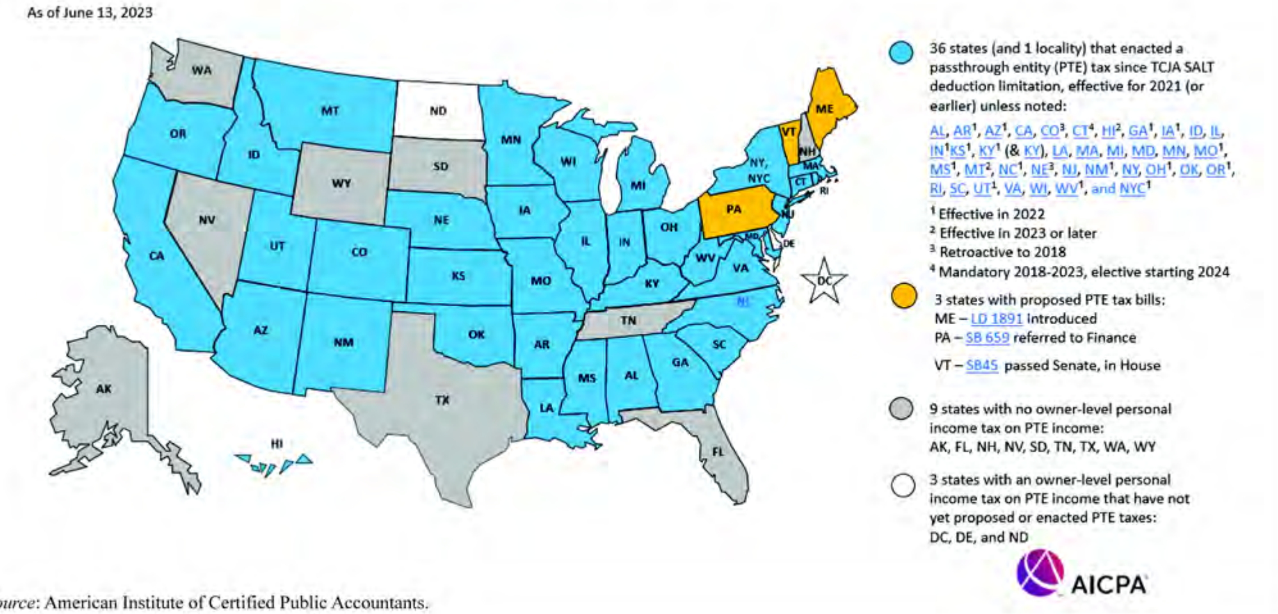
Eventually, states found a workaround that the IRS allowed. States began enacting laws that would impose either a mandatory or elective passthrough entity-level income tax on partnerships and S corporations at the state level. In response to these state-level passthrough entity tax (PTET) elections, the IRS issued Notice 2020-75,[2] which allows a federal "specified income tax payment" deduction for state passthrough entity income tax payments in the year of payment. The notice specifies that it applies to payments made after November 9, 2020. The notice indicates the IRS is planning to issue proposed regulations, although none have been published as of the date of this article. The notice offers comfort that many of these taxes should qualify for a federal deduction but offers few specifics. As such, states have taken many different approaches to PTET elections.

An American Institute of CPAs map of states with enacted or proposed PTETs as of June 15, 2023, shows that 36 states, as well as New York City, have enacted some form of PTET. Three more states have proposed PTETs without enacting them, and two states, as well as Washington, D.C., have owner-level personal income taxes on passthrough income but have taken no action to enact an entity-level tax.

[1] IRC section 164(b)(6)(B).

[2] IRS Notice 2020-75 (Nov. 9, 2020).

States With Enacted or Proposed Passthrough Entity (PTE) Level Tax



Source: American Institute of Certified Public Accountants.

States have taken various approaches to instituting these laws. Some provisions are effective retroactive to 2018, while most others were effective starting in 2021 or 2022.[3] At least one state, Connecticut, made the entity-level tax mandatory for all passthrough entities doing business within the state, while most give taxpayers the option of electing in or out.[4]

These differences in implementation, combined with limited IRS guidance to date, have raised a host of questions, issues, and controversies among tax advisers and clients alike. While the authors provide insights and possible answers in areas that appear to be settled, the primary goal of this article is to catalog many of the ambiguities so that taxpayers and tax professionals know what questions to ask when evaluating the benefit of PTET elections.

Federal Timing of a PTET Deduction

The IRS stated in Notice 2020-75 that federal deductions related to PTET elections are allowed for the tax year in which the payment is made. This can be interpreted to mean if an electing passthrough entity makes the payment to the state along with the PTET election at filing time, PTET can be deducted by the entity, and is therefore beneficial to the owners, in the year of payment.

However, the notice doesn't appear to consider other federal guidance that conceivably changes the timing of the federal deduction. For example, a federal deduction is generally not allowed until the payment is considered fixed and economic performance has occurred, or an exception applies. It's arguable this federal provision is not met in a state where the PTET election is made with the return because the passthrough entity can decide to not make the PTET election, even if it has made a PTET payment during the prior year. This is especially applicable in a state like Illinois, where payments aren't designated for PTET and can be applied to nonresident withholding or the state's 1.5 percent personal property replacement tax.[5] Accordingly, the

[3]Colo. Rev. Stat. section 39-22-343(1)(a).

[4]Conn. Gen. Stat. section 12-699(b) and (a)(3).

[5]Ill. Comp. Stat. section 5/201(p).

PTET payment may not be eligible for a federal deduction until the year following the payment.

The federal deduction timing issue has created uncertainty among taxpayers and tax professionals. The timing is especially critical in a year a passthrough entity generates substantial taxable income and doesn't expect the same in subsequent years, such as when a passthrough entity sells its entire business for a significant gain. In this case, a passthrough entity owner's federal benefit may be limited if the owner has minimal federal taxable income in the years after the disposition.

The timing issue can also affect an owner's ability to deduct state tax on their federal income tax return. For example, a situation could exist in which the PTET payment is made for the 2022 tax year, but the federal deduction cannot be taken until 2023. If the passthrough entity's ownership changes, a former owner would not be eligible for the federal tax deduction.

Further, the timing of the federal deduction can be affected between accrual and cash-basis taxpayers, with the latter possibly having more restrictions on taking a federal deduction in the tax year of the election. As a result, even issues as fundamental as tracking the year in which PTET payments are deductible for federal tax purposes remain subject to debate and detailed planning at this point.

Passthrough entities whose only activity is the holding of another passthrough entity also present challenges as to the timing of the federal deduction. The notice does not overtly provide that a passthrough entity without a trade or business could deduct PTETs as an above-the-line deduction, and it does not cite any authority that would support such a position. Consequently, passthrough entity owners are left to determine whether there is a position for a federal tax deduction based on guidance other than the notice.

Because the notice does not address all federal tax deduction issues as outlined above, the AICPA provided comments and recommendations to the IRS in an October 4, 2022, letter.[6] The recommendations included allowing a federal deduction in accordance with the passthrough entity's method of accounting and a federal election to deduct PTET in the tax year of imposition or the following year in the event a state's PTET election is made in a year after the tax year of imposition (for example, election is made in 2023 for the 2022 tax year). To date, the IRS has not publicly provided guidance, so taxpayers and tax professionals are left to make their own conclusions.

Applicable Tax Years

States adopting early effective dates include Wisconsin, where the PTET election was first effective in 2018 for S corporations and 2019 for partnerships.[7] While it's possible that the forthcoming proposed regulations from the IRS address this nuance, Notice 2020-75 specified that it applied to payments of qualified PTETs made after Nov. 9, 2020. This raises a question about whether payments made before November 9, 2020, would qualify for a federal tax deduction.

Another variable at play is the current scheduled expiration of the federal SALT limitation in tax years that begin on or after January 1, 2026.[8] Some states wrote provisions into their laws that will terminate PTET elections on January 1, 2026, or otherwise when the SALT limitation lapses.[9] Other states didn't set a sunset date. The absence of a sunset date can be an advantage if the federal provision is extended or made permanent. It can also be a benefit for passthrough entities, such as when the PTET election reduces a passthrough entity owner's compliance burden in a state where composite returns aren't allowed or results in lower state taxes. However, the lack of a sunset date could also be a detriment if the federal provision lapses and passthrough entities continue to be subject to

[6] AICPA, Additional Guidance Needed on Section 431 Accrual-Basis Taxpayers and Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Taxes (Oct. 4, 2022).

[7] Wisconsin Department of Revenue, Pass-Through Entity-Level Tax: Partnership General Election Questions (Apr. 6, 2023); Wisconsin Department of Revenue, Pass-Through Entity Tax: S Corporation Tax Payment and Transferability Questions (Dec. 20, 2022).

[8] IRC section 164(b)(6)(B).

[9] Cal. Rev. & Tax. Code section 19900(a)(1).

a state-level tax on their income that results in additional tax versus not filing a PTET return. For example, Alabama's PTET election doesn't have a sunset date and applies to future years, unless the passthrough entity timely requests to revoke its PTET election.[10]

Eligibility

Generally, all passthrough entities that are owned solely by individuals, estates, or trusts will be eligible for a PTET election in a state that allows it. In some states, such as New York, S corporations are required to complete a separate state-level S election to qualify as an S corporation.[11] A failure to do so leaves those entities treated as C corporations for state purposes and thus ineligible for PTET elections.

More significant complications start to arise when a partnership includes non-individuals among its ownership group, such as other partnerships, S corporations, and C corporations. State treatment of tiered passthrough entities vary:

- No restrictions in states such as Illinois; PTET payments can be made on behalf of any owner type.[12]
- Restrictions on the ability of business entities to be included in the election and PTET payment, such as in California.[13] PTET payments can only be made on behalf of individual owners.
- Prohibition on passthrough entities with any entity owners from PTET elections as in Minnesota.[14] Any entity with another entity as an owner can't make a PTET election at all. However, an upper-tier passthrough entity can make the election if all its members are eligible.

Owner Consent

States have taken a variety of approaches when it comes to determining how passthrough entities consent to PTET elections. Some states have set a requirement that a certain percentage of voting shares must opt in for the entity to elect. Other states empower any individual who is authorized to sign the tax return for the entity to make the election without requiring approval of the other owners. Still others are silent on owner consent regarding PTET elections and only provide guidance for how PTET elections are made mechanically.

One aspect of the election that remains unclear at this time is the impact it will have on members who aren't included in the election, whether it be individual owners who don't opt in or entity owners who can't be included in the election. At least one state, California, provides that individual owners can opt in or out of the passthrough entity-level tax.[15] That sets up a situation in which even an owner of a minority share could trigger a deduction from the entity's federal taxable income that may result in a lower taxable distribution to all owners if not addressed in the passthrough entity agreement. The electing owner would have tax paid on its behalf but receive only a portion of the benefit of the federal deduction.

Owner consent provisions raise the important question of the role and responsibilities of the passthrough entity. In states that are silent on consent requirements, is the passthrough entity required to obtain permission from all owners regarding PTET elections, or only from select owners? And how would it document the owners' decisions? It may be difficult obtaining owners' input if there are a significant number of owners with small interests. How would the passthrough entity manage conflicting decisions if there is no majority? Could it be subject to negative ramifications, such as lawsuits, if it didn't receive permission? These are all questions the passthrough entity should consider. Further, for passthrough entities to even get to the point of requesting consent, they need to understand and get ahead of a whole host of issues, including PTET election deadlines, eligibility requirements, and tax computations, which requires time and likely costs.

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[10] Ala. Code section 40-18-24.4(d).

[11] N.Y. Tax Law section 660(a).

[12] Ill. Comp. State. section 5/201(p)(3)(A).

[13] Cal. Rev. & Tax. Code section 19900(a)(2); Cal. Rev. & Tax. Code section 17052.10(b)(3)(B).

[14] Minnesota DOR, Pass-Through Entity Tax (Jan. 10, 2023).

[15] Cal. Rev. & Tax. Code section 19900(a)(2); Cal. Rev. & Tax. Code section 17052.10(b)(3)(A).

Tax Computation

Resident Owners

Absent a PTET election, most individual taxpayers will pay state income taxes in their state of residency based on 100 percent of the passthrough entity's income that flowed to them, regardless of the state where the income was generated. Residents are then entitled to a full or partial credit against the home state tax liability for taxes paid to other states.

Many states, such as Illinois, Missouri, and Oklahoma, require passthrough entities to apportion income at the entity level under a PTET election, regardless of the residency of the owners.[16] Resident owners will then only get a credit for PTET paid on a fraction of the starting income at the individual level. Individuals should consider paying individual income tax estimates in these states to avoid underpaying taxes. It's important for passthrough entities to inform their owners of this tax shortfall so that the owners don't incur penalties and interest for underpaying individual income taxes during the tax year.

Other states require passthrough entities to apportion income at the entity level for nonresidents only. For resident owners, the tax is based on 100 percent of the income that would be the starting taxable income at the individual level (for example, California and New York).[17] This results in higher taxes paid at the entity level and a higher credit at the individual level. Individual owners will then rely on a credit for taxes paid to other states, if applicable, combined with the PTET credit to likely receive a refund for the additional tax paid on income sourced out of the passthrough entity state combined with the credits for taxes paid to other states, if applicable. This could cause issues among owners as distributions may not align with provisions in the passthrough entity's agreement. Further, corporations with an S election should consider the impact of a PTET election in states with differing treatment between residents (that is, tax 100 percent of passthrough entity income) and nonresidents (that is, tax apportioned passthrough entity income).

Further complications arise with tax computation and apportionment when considering entity owners. For example, Colorado requires electing passthrough entities to pay tax on behalf of all owners (other than a unitary C corporation), and the tax isn't apportioned for resident owners.[18] Colorado states an entity is considered a resident owner if it's organized under the laws of that state.[19] Consider the scenario of an electing passthrough entity with another passthrough entity owner. The passthrough entity owner is organized in Colorado, but its ultimate individual owners aren't residents of Colorado. The lower-tier electing PTE will pay tax on 100 percent of the income of the passthrough entity owner, but that may generate a credit that's vastly overstated when used by the ultimate individual owners who aren't residents of Colorado. An additional issue is how does a lower-tier passthrough entity even know where an upper-tier owner is organized. Addresses may be one indication but are not conclusive. Thus, the lower-tier entity may need to obtain the state of formation from upper-tier entity owners.

Nonresident Owners

Nonresident owners, on the other hand, should always be subject to apportionment rules when computing PTET election taxes.

There may be a mismatch of PTET paid at the entity level versus what's ultimately owed at the individual level, such as a scenario whereby PTET is paid at a higher rate than the amount eventually owed by the individual. This can result in additional federal tax deductions compared with what's ultimately owed on the applicable income. To date, the IRS hasn't issued guidance on this mismatch, and this remains a major planning point for tiered entities, multistate entities, and entities with owners in multiple states.

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[16] Ill. Comp. Stat. section 5/201(p)(3)(A); Ill. Comp. Stat. section 5/202; Mo. Rev. Stat. section 143.436(3)(1); 68 Okla. Stat. section 2355.1P-4(A)(1).

[17] Cal. Rev. & Tax. Code section 19900(a)(2); N.Y. Tax Law section 860(h)(1).

[18] Colo. Rev. Stat. section 39-22-344(1); Colo. Rev. Stat. section 39-22-342(2).

[19] Colo. Rev. Stat. section 39-22-344(1)(b); Colo. Rev. Stat. section 39-22-103(9).

Guaranteed Payments

Guaranteed payments within a partnership agreement raise another set of questions. In many businesses, one class of income partner may receive guaranteed payments that are treated as salaries for tax purposes, while another class of equity partner may be paid based on the income of the business that flows through to them. Other passthroughs may pay guaranteed payments to owners that amount to interest paid on loans made to the business. Entities can also set up guaranteed payments as a form of pension to retired partners.

State PTET laws vary in treatment of guaranteed payments. Some states include them in the taxable income of the entity while others require the entity to deduct them before the PTET is calculated. This could be an unwelcome surprise to owners who expect to receive a federal tax benefit on their guaranteed payments but will not. It could also subject owners who don't make timely estimated tax payments during the year to penalties. For example, Colorado excludes guaranteed payments from the PTET but does subject residents to individual income tax on all their income, including guaranteed payments.[20]

In some cases, the guaranteed payments may be structured in a way that they aren't taxable to the individuals who receive them, but those same individuals could derive benefit from the PTET made by the entity. For example, some states don't tax certain retirement income reported as guaranteed payments but do include that income in computing the PTET. In these situations, the passthrough entity should determine whether it must allocate any credit for taxes paid on that guaranteed income to the retired owner, and if so, consider asking the retired owner for reimbursement. Complications could arise if the passthrough entity has issued state Schedules K-1 to retired owners with an allocated credit in a state where it wasn't required. In that case, the passthrough entity may consider amending the return or requesting reimbursement from the former owner.

Other Tax Computation Issues

A PTET election may result in an increased state tax liability that could reduce the benefits of the federal tax deduction and affect a decision to make a PTET election. For example, some states charge a higher tax rate compared with filing individually. There are also states that don't allow deductions, such as net operating losses (for example, Wisconsin) or exemptions in computing PTETs that are otherwise afforded to individuals or composite filers.[21]

Many questions also remain unanswered when it comes to the application of entity-level tax rules in special allocation situations. Partnership agreements frequently include special allocations. PTET election laws don't always offer guidance on how to distribute the benefit of the deduction among partners with different allocations. In many instances, as described above, PTET payments aren't made equally pro rata based on ownership percentage. This may require changes to passthrough entity agreements and may cause issues with entities that elected to be treated as S corporations for federal income tax purposes.

Tax Rates

Many states tie the PTET rate to their individual rate schedules, but a few have set PTET rates that don't necessarily align with individual rates. Individual rates are constantly changing, and, given that the election must be considered annually in many states, rate changes must be considered. This can affect not only the annual income tax returns but also the quarterly estimate process.

Some states have tiered individual tax rates, but static PTET rates, which may create a mismatch on the tax paid under a PTET regime or an individual regime. Some states, like Louisiana, New Jersey, New York, and Oregon, created a tiered rate structure for PTET based on passthrough entity taxable income, which may not align with a tax rate that an owner would pay at the individual level.[22] As a result, owners

[20] Colorado Book 106 — 2022 Partnership and S Corporations and Composite Filings for Nonresidents Instructions.

[21] Wis. Stat. section 71.21(6)(d)(2).

[22] La. Rev. Stat. Ann. section 47:287.732.2(B); N.J. Rev. Stat. section 54A:12-3(b)(2); N.Y. Tax Law section 862; Or. L. 2021 section 3(6).

should consider paying estimated taxes to avoid underpayment penalties and interest.

Still other states have a static mismatch on the PTET rate and the individual tax rate.

As an example, California's PTET rate is 9.3 percent, but its top individual rate is 13.3 percent.[23] As a result, nonresident individuals of electing passthrough entities subject to a higher individual tax rate are required to file a California individual tax return to pay the additional tax. Conversely, taxpayers subject to a California tax rate of less than 9.3 percent will have overpaid California income tax under a PTET election. Since California doesn't refund PTET overpayments (see "Impact on Owner Income and Tax" section), those individuals should take this factor into account in determining whether to elect into a PTET regime.[24]

In many states, nonresident owners aren't required to file an individual return if their only activity is covered by an elective PTET regime. Situations like this point to how an entity may make a PTET election without knowledge of the tax situations of their individual owners. Advisers of a passthrough entity often don't have visibility into the individual filings of all owners of the entity, thus making it difficult to weigh the impacts to owners of an entity electing PTET treatment.

NOLs

The ability of a passthrough entity to claim an NOL for PTET purposes and whether such a loss can be carried forward will vary based on state law. At least a few states, including Arkansas and Idaho, will permit NOL carryforwards for the PTET.[25] For the most part, if an entity knows it will be in an NOL situation and has the option to opt in or out of the entity-level tax on its return, it may make the most sense to opt out.

Given that some elections must be made during the tax year and estimates may be paid in based on projections of positive income, it's important to understand what the NOL rules may be for an entity-level tax in any state where a taxpayer is considering an election. This also illustrates the need for a reliable forecast of state taxable income and apportionment in states where the PTET election is made during the current tax year (for example, California, New York, and Utah) rather than with the return.[26] It can be challenging to predict the amount of state tax reasonably, and therefore whether a PTET election is beneficial for its owners.

Mechanics of Making PTET Elections

The seemingly most basic administrative tasks and rules associated with PTET elections can vary significantly among the states and affect the eligibility of a passthrough entity. These include:

- The deadline to elect — many states offer entities the option to elect into the entity-level tax on their tax returns, whether extended or not. Some states, including California, Michigan, New York, Oklahoma, and Utah, require that the entity file a form or make a payment by a deadline during the tax year in which the passthrough wants to elect into the PTET.[27] Other states require an election to be made three or four months after the tax year, regardless of whether the passthrough entity is filing an extended return (for example, Ohio and South Carolina).[28]
- The manner of election — for states that allow the election on an entity's year-end tax return, the process can be as simple as checking a box on the tax form. Other states, particularly those that stipulate that the election must be made by a deadline within the tax year, require a separate form, payment, or online submission. At least one state, Colorado, offers its taxpayers the option of electing either way, via a checked box on a return or a separate form that can be filed within the tax year.[29]

[23] Cal. Rev. & Tax. Code section 19900(a)(1); Cal. Rev. & Tax. Code section 17041(a); Cal Rev. & Tax Code section 17043(a).

[24] Cal. Rev. & Tax. Code section 17052.10(c).

[25] Ark. Code Ann. section 26-65-103(b)(2); Idaho Code section 63-3026B(4).

[26] California Franchise Tax Board, "Help With Pass-Through Elective Tax" (Apr. 19, 2023); N.Y. Tax Law section 861(c); Utah Code Ann. section 59-10-1403.2(2)(d).

[27] California FTB, *id.*; Mich. Comp. Laws Ann. section 206.813; N.Y. Tax Law section 861(c); 68 Okla. Stat. section 2355.1P-4(F); Oklahoma Form 586 (2022); Utah Code Ann. section 59-10-1403.2(2)(d).

[28] Ohio Rev. Code Ann. section 5747.38(C); S.C. Code Ann. section 12-6-545(G)(2).

[29] Colorado Form 1705 (2022).

- The duration of an election — most states that have enacted entity-level taxes allow passthroughs to elect for the current tax year and choose whether to elect again for each year they file income tax returns. Michigan states that the election is binding and irrevocable for three years.[30] Alabama states that the election remains in effect for later years until formally revoked by a request from the taxpayer.[31]
- The impact of an election — in most states that have enacted an entity-level tax, the election amounts to a relatively straightforward consent for the imposition of a tax on a passthrough. It's important to read the fine print, though. Louisiana, for instance, states that a PTET election is an election to be taxed as a C corporation, an important distinction for tax reasons.[32]

Impact on Owner Income and Tax

States vary on how a PTET election affects owners' individual filings. Generally, there are two ways: (1) income is still passed to the owner, who receives a corresponding credit for PTET paid on their behalf, or (2) no income is passed to the owner as the owner will deduct all income on which tax is paid under a PTET election on their individual return.

Passthrough Entity Owner Credits

Many states require owners to include all income from an electing passthrough entity, and the owner receives a corresponding credit for all PTETs paid on their behalf. If the PTET payment and corresponding credit is more than the ultimate tax owed by the individual, is the credit refundable? In some states, such as California, the additional credit isn't refundable; rather, it's carried forward for five years.[33] If the taxpayer can't use the remaining credit carryforward within that five-year period, the remaining credit is lost, and the net benefit of the PTET election is reduced. As a result, passthrough entities may require balancing the goal of maximizing the federal tax deduction for its owners based on best taxable income estimates while avoiding generating a credit that has the potential to expire. This is especially challenging in the case of a business disposition that generates a large gain when it's often harder to estimate taxable income, and the passthrough entity's owners no longer earn income in the PTET state.

This can be further challenging if projections aren't accurate, and credits are carried forward given that states generally require estimated PTET payments. Furthermore, credits are claimed at the owner level and can't be accounted for in future entity-level PTET elections.

Adding to the complexity are states like Massachusetts that don't allow for a full credit for PTET payments. Massachusetts allows only 90 percent of a credit generated by an electing passthrough entity to be claimed by the owner.[34] This leads to complications for planning purposes on the individual level, especially for nonresident owners, who must take into account that less than 100 percent of their Massachusetts tax has been covered by the PTET return.

Passthrough Entity Owner Income Deductions

Some states, including Wisconsin, do not provide credit to their owners for income taxed under a PTET election. Rather, owners receive a deduction for income paid at the electing passthrough entity level.[35] This could affect the decision whether to make a PTET election, and at a minimum, taxpayers and tax professionals should understand the potential consequences. For example, a partner with a loss due to special allocations from an electing partnership may not be able to offset their income from other sources with the passthrough entity's loss.

Tiered Partnerships

Tiered partnerships present a particular challenge for electing passthrough entities when accounting for PTET credits. Consider a partnership that's owned 20 percent by another partnership and 80 percent by a group of

[30] Mich. Comp. Laws Ann. section 206.813.

[31] Ala. Code section 40-18-24.4(d).

[32] La. Rev. Stat. section 47:287.732.2(A)(1).

[33] Cal. Rev. & Tax. Code section 17052.10(c).

[34] Mass. Gen. L. ch. 63D section 2.

[35] Wis. Stat. section 71.21(6)(b).

individuals. In many states, electing passthrough entities will pay PTET on behalf of individual owners, or 80 percent of the group. Other states require the PTET payment to cover all owners, even if one of the owners is a business entity. If a credit flows to the passthrough entity owner, does that entity have to make a separate PTET election on its own to benefit from the credit? Or does the credit work its way through the upper-tier entities until it eventually reaches individual owners? Given the complexity of some ownership structures, how does a state tax authority track the credit from the individual to the specific entity that generated the credit?

Anytime tiered partnerships are involved, all tracking of income, credits, and deductions becomes exponentially more complicated. This situation may involve numerous tax advisers working with a variety of entities and individuals that may have different expectations of their investments. For example, it's important for owners that are passthrough entities themselves and their advisers to communicate with passthrough entities to understand whether the passthrough entity will make an election or whether the election will need to be made by the upper-tier passthrough entity. Because of a lack of understanding and miscommunication, upper-tier passthrough entities have lost benefits from PTET elections because neither the underlying passthrough entity nor owner passthrough entity made the election.

Tiered partnerships also present exceptional challenges to state tax administrators when it comes to tracking the flow of credits and deductions related to a PTET election. Footnotes and disclosures on K-1s are incredibly important when considering PTET elections for tiered entities so upper-tier entities can track passthrough entity credit and income treatment appropriately. Even then, there have been situations when state tax authorities issue underpayment notices and requests for information that must be addressed in a timely manner. Further, payments and refunds have been delayed as state tax authorities struggle to trace payments and correctly allocate them to passthrough entity owners.

Credit for Taxes Paid to Other States

Does an individual who is a member of a passthrough entity that elects to pay tax at the entity level in another state get a full or partial credit against their state income tax liability for the payment made by the entity to the other state? Most states addressed this issue in the PTET statutes, but there are still states that don't have PTET elections.

In those states, taxpayers are forced to rely on statutes that were enacted to cover payments of taxes made to other states before PTET elections were implemented. Most of those statutes allow a credit for *individual* income taxes paid to another state. By definition, PTETs are imposed at the *entity* level. Absent state guidance, loss of a credit for taxes paid under a PTET regime will result in double taxation of the passthrough entity income at the individual resident state level. This likely nullifies any benefit gained from the deduction at the federal level as the individual would pay higher total state income taxes.

Just because a state has a PTET election doesn't guarantee that its residents can take a full or partial credit for PTETs paid to other states. Ohio enacted a PTET statute, but it still doesn't allow residents a credit for taxes paid under a PTET election in other states.[36] Take, for instance, an Ohio resident partner in a partnership that pays $100 in tax to Illinois without electing the PTET. The Ohio partner would get a $100 credit against Ohio tax for taxes paid to another state. If the partnership elects the PTET in Illinois, an Ohio owner in the 37 percent federal bracket would get a $37 benefit on her federal return. However, she would get no credit against Ohio taxes for the $100 in Illinois PTET, resulting in additional tax of $63.

If all the partners in this sample partnership are Ohio residents and the only out-of-state tax is in Illinois, it's a relatively easy decision to not elect the PTET in Illinois. But the facts are rarely that easy. If the partners are tax residents in a variety of states and a significant number would benefit from the election, it's possible some owners will benefit significantly from a PTET election while other owners will be harmed. Choices to make the

[36] Ohio Rev. Code Ann. section 5474.05(B)(1).

election in those circumstances can lead to passthroughs addressing special allocations in partnership agreements. It can also lead to discussions about whether and how to reimburse negatively affected owners. Not reimbursing disadvantaged partners, including grossing up amounts for the federal tax impact, could create relationship and legal issues among the partnership group. Reimbursement decisions are especially delicate in the situation of an S corporation as special allocations can put the entity's entire federal S election at risk.

Estimated Tax Payment Requirements

Many states have been forgiving when it comes to assessing underpayment penalties for PTET in the year of enactment. As these tax programs become more established in states, the failure to accurately calculate and timely pay estimates will result in penalties for underpayment of estimated tax. As such, it's important to make PTET election decisions as early as possible, not only because some states require elections as early as March 15 of the tax year, but also because it's important to begin making estimated PTET payments.

It's also important to transition to PTET payments when, historically, payments were made under withholding and composite regimes as most states don't allow payments made as withholding or composite payments to qualify as a PTET payment. This may be a change for some passthrough entities, since many states didn't require estimated tax payments for composite or nonresident taxes, such as Illinois.

Nonresident Withholding and Composite Returns

At least one state, California, requires withholding of tax from income distributed to nonresidents even when the passthrough entity elects to pay PTET.[37] This can create cash flow problems as passthrough entities are required to remit close to twice the amount of tax on the same income. There is a process by which entities can request an exemption from the state's Franchise Tax Board. However, this requires taxpayers to request the exemption well in advance of nonresident withholding due dates and relies on the FTB granting approval.

Many states don't allow composite return filing if the entity makes a PTET election. As a result, individual owners may be required to file an individual income tax return if their share of PTET doesn't cover their full tax liability as the case may be in states with static PTET rates that are lower than the state's individual income tax rate. This is something that owners should consider as the benefit of the PTET election may not warrant the additional administrative burden of filing individual returns.

A Vast Array of Moving Parts

Taxpayers and tax professionals have learned to live with frequent significant changes to laws, regulations, and other authority, but the depth and breadth of potential modifications related to PTETs are remarkable even by historical standards. Passthrough entities, their advisers, and their owners need to be alert for major developments in this area from a wide variety of sources, including, but not limited to:

- State legislatures that may modify statutes where PTETs have already been enacted or pass new laws in states where they don't already exist.
- State tax administrators who can issue guidance in a variety of forms that may challenge taxpayers' understanding of existing rules. These authorities can act through formal processes like regulations, informal processes such as FAQs, and even through the issuance of tax forms and instructions that may include unexpected interpretations and calculations. Many times, forms are released well after a tax year closes.
- The Federal Accounting Standards Board and AICPA have weighed in on the treatment of PTETs for accounting purposes. Depending on whether they are treated as a distribution or a tax expense for financial statement purposes, there could be repercussions for financial audits and public reporting.

[37] California FTB, *supra* note 26.

Maximize the Benefit and Avoid Pitfalls

Many states enacted SALT limitation workarounds for passthrough entities that are acceptable to the IRS. However, statutes and other authority adopted by these states vastly differ and have created confusion and hazards to new tax regimes that were intended to benefit, not harm, individual taxpayers.

There are significant considerations to determine if a PTET election is beneficial, including the eligibility of owners, requirements for electing in, PTET election due dates, estimated tax payment rules, resident individual credit for taxes paid under PTET regimes, and the timing of the deductibility for federal income tax purposes. The consequences of making a mistake could range from imposed penalties to ineligibility to a net increase in overall state income taxes. Further, evaluating and complying with PTET elections often requires the coordination of multiple parties such as the passthrough entity, its owners, tax advisers, and bankers.

Of course, looming over all PTET elections is the scheduled 2026 sunset of the SALT limitation that gave rise to PTET elections in the first place. The IRS allows PTET elections, but it's quite possible this is a flash in the pan. PTET elections are only beneficial to the extent the $10,000 individual SALT limitation exists, which may be for only a few more years. The only certainty at this point is that there is extreme uncertainty, ambiguity, and nuance in nearly every aspect of PTET elections that passthrough entities, their owners, and tax professionals should carefully evaluate to maximize benefits and avoid costly pitfalls. ■