

1

D. R. Payne & Associates, Inc.

Oklahoma Pass-Through Entity Tax Equity Act of 2019

Mark O. Neumeister


Last Updated 09/09/2019

1

2

D. R. Payne & Associates, Inc.

Mark O. Neumeister



Mark Neumeister is Director of Tax Services at D. R. Payne & Associates, where he is responsible for all aspects of the Firm's tax services. Mark is a certified public accountant and serves several professional accounting organizations including the Oklahoma Society of CPAs, where he serves on the small firms practice committee and tax committee. Mark provides a variety of tax services to his clients including tax preparation, planning, tax controversies, and criminal tax defense. Mark also serves as an expert witness for tax and accounting matters. Mark has volunteered his time on numerous civic and charitable activities over the years, and is currently active with such organizations as the Oklahoma Business Ethics Consortium and the Rotary Club of Oklahoma City.

Mark O. Neumeister

Last Updated 09/09/2019

2

3

D. R. Payne & Associates, Inc.

Disclaimer

- This presentation is provided solely for the purpose of enhancing knowledge on tax matters. It does not provide tax advice to any taxpayer because it does not take into account any specific taxpayer's facts and circumstances.
- These slides are for educational purposes only and are not intended, and should not be relied upon, as accounting or tax advice.
- Views expressed in this presentation are not necessarily those of D. R. Payne & Associates, Inc.

Mark O. Neumeister

Last Updated 09/09/2019

3

4

D. R. Payne & Associates, Inc.

Objectives

Explore	Examples	Consider
Explore new provisions of the Act.	Work through example calculations.	Consider which taxpayers may or may not benefit.

Mark O. Neumeister

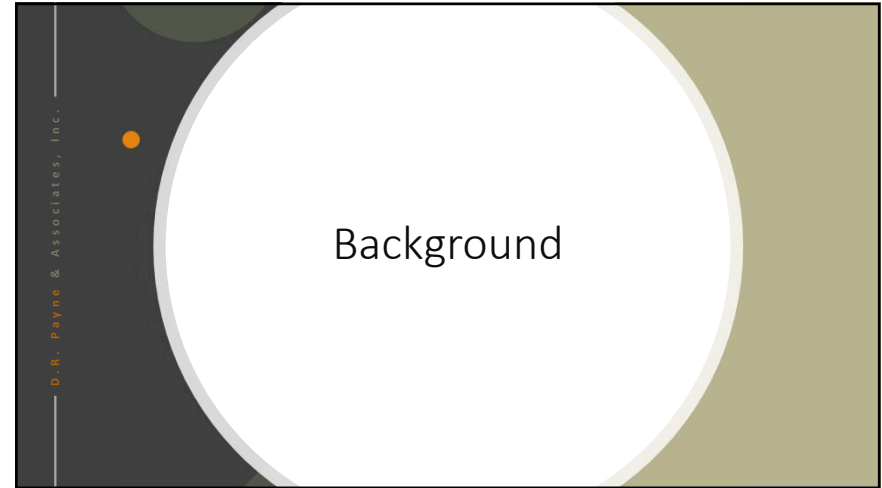
4

Table of Contents 5

- Background 6
- Oklahoma’s Pass-Through Entity Tax Equity Act of 2019 12
- Election 14
- Impact of Election on Entity 20
- Impact of Election on Owner 26
- Definitions 31
- OTC FAQs 35
- Additional Considerations 41
- Examples 62
- Resource Table 65
- Presentations by Mark Neumeister 68

Mark O. Neumeister Last Updated 09/09/2019

5



6

Tax Cuts and Jobs Act of 2017 7

Bloomberg Tax **Tax Reform Roadmap**

Topic	Prior Law	Individual		
		2017 Tax Act, as Amended	Bloomberg Tax Coverage	Act Sections
State and Local Tax Deduction	Individuals may claim itemized deductions for state and local government income and property taxes paid. In lieu of the itemized deduction for state and local income taxes, individuals may claim an itemized deduction for state and local government sales taxes.	The Act provides that individual taxpayers may elect to deduct state and local sales, income, or property taxes up to \$10,000 (\$5,000 for a married taxpayer filing a separate return) for tax years beginning after Dec. 31, 2017, and beginning before Jan. 1, 2026. For amounts paid in a tax year beginning before Jan. 1, 2018, with respect to state or local income taxes, beginning after Dec. 31, 2017, the payment is treated as if paid on the last day of the tax year for which such tax is imposed for purposes of applying the limitation of the deduction. The Act also provides that individuals may deduct state, local, and foreign property taxes and state and local sales taxes when paid or accrued in carrying on a trade or business and generally disallows a deduction for individual state and local income, war profits, and excess profits taxes.	Portfolios 500 T.M. 3.A. Tax Practice Series 57340.02.A.	§11049 §10640

Mark O. Neumeister Last Updated 09/09/2019

7

- States Workaround Solutions 8
- 1. Charitable contributions
 - Localities develop “charities” and taxpayers “donate” the amount of property tax otherwise owed to the “charities,” receiving a property tax credit for the donation.
 - Effectively, then, the workaround converts a property tax payment to a charitable contribution.
 - IRS Issues Notice 2018-54 <https://www.irs.gov/newsroom/irs-issues-notice-on-state-and-local-tax-deductions>
 - Warns that “federal law controls the proper characterization of payments for federal income tax purposes.”
 - Substance over form warning.
 - IRS Issues Regulations 6/11/2019, TD 9864 effective August 12, 2019.
- Mark O. Neumeister Last Updated 09/09/2019

8

D. R. Payne & Associates, Inc.

States Workaround Solutions 9

- 2. State Payroll Tax
 - Replaces state personal income taxes with a payroll tax paid by employers.
 - New York enacted an optional payroll tax
- 3. Trusts
 - Use of non-grantor trusts to skirt the \$10,000 limitation.
 - Property transferred to LLC owned by multiple non-grantor trusts. Idea is that each trust has its own \$10,000 limit.
 - Number of non-grantor trusts required: Property tax divided by \$10,000.

Mark O. Neumeister
Last Updated 09/09/2019

9

D. R. Payne & Associates, Inc.

States Workaround Solutions 10

- 4. Entity Level Tax
 - Several states have enacted entity level taxes on pass-through entities, with corresponding state tax credit to owners.
 - Connecticut in 2018 became the first state to enact a SALT deduction cap workaround involving an entity-level tax on passthroughs and an offsetting personal income tax credit for entity members.

Mark O. Neumeister
Last Updated 09/09/2019

10

D. R. Payne & Associates, Inc.

Federal Deduction for State Tax Paid by Pass-Through Entity 11

- Tax Cuts and Jobs Act conference report at footnote 172:
 - "... Additionally, taxes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner's or S corporation shareholder's distributive or pro-rata share of income or loss on a Schedule K-1 (or similar form), will continue to reduce such partner's or shareholder's distributive or pro-rata share of income as under present law."
- More on deduction issues in the Additional Considerations section.

Mark O. Neumeister
Last Updated 09/09/2019

11

D. R. Payne & Associates, Inc.

Oklahoma's Pass-Through Entity Tax Equity Act of 2019

12

Pass-Through Entity Tax Equity Act of 2019 13

- It is hereby declared to be the purpose of the Pass-Through Entity Tax Equity Act of 2019 to establish a revenue-neutral mechanism to provide a more fair and simplified taxation of pass-through entities and their members in this state while maintaining revenue levels for support of general governmental functions of the State of Oklahoma. [68 O.S. § 2355.1P-3(A)]
- For statute language see, 68 O.S. 2355.1P (OSCN 2019)
 - <http://www.oscn.net/applications/oscn/DeliverDocument.asp?CiteID=483686>

Mark O. Neumeister Last Updated 09/09/2019

13

Election

Mark O. Neumeister

14

Election 15

- Act provides that a pass-through can choose each year to be an “electing pass-through entity.”
- Any entity required to file an Oklahoma partnership income tax return (Form 514) or an Oklahoma S corporation income tax return (Form 512-S), may elect to become an electing pass-through entity.
- Use Form 586—Pass-Through Entity Election Form.
 - See <https://www.ok.gov/tax/documents/586-19.pdf>
 - Form 586 is also used to revoke the election.
 - OTC has informally indicated that election can be made by using Form 586 or substantially equivalent notice.
 - Suggestion: Use the Form 586.

Mark O. Neumeister Last Updated 09/09/2019

15

Election Details 16

- Due date for election:
- 2019 tax year
 - Election due within 60 days of enactment = June 28, 2019
 - New entities formed after June 28, 2019 cannot meet the deadline to elect for 2019.
 - Fiscal year entities must elect for 2019 by June 28, 2019
- Years after 2019
 - May elect anytime during the preceding tax year.
 - May elect within the first two months and fifteen days after the beginning of the tax year.

Mark O. Neumeister Last Updated 09/09/2019

16

17

Election Details (continued)

- Election made during the entity's taxable year but after the two month and fifteen-day date, such election is then effective on the first day of the next tax year.
- Any election is binding until revoked.
- Elections are binding on the electing entity only. Other (related) pass-through entities must make their own elections. I.e., each pass-through entity makes elections under this Act independently.
- According to OTC, approximately 8,900 entities made the election by the June 28, 2019 deadline.

Mark O. Neumeister Last Updated 09/09/2019

17

18

Revocation of Election


- Due date for revocation:
- 2019 tax year
 - Revocation can be made within 60 days of enactment = June 28, 2019
 - Fiscal year entities must make revocation for 2019 by June 28, 2019
- Years after 2019
 - May revoke anytime during the preceding tax year.
 - May revoke within the first two months and fifteen days after the beginning of the tax year.
- Effectively, an entity can choose each year to be subject to the tax or not.

Mark O. Neumeister Last Updated 09/09/2019

18

19

More on the Election

- Form 586 (or equivalent) must be signed by an authorized person.
- Electing entity will receive from OTC an acknowledgement letter
 - *Example of letter:* 
- Each electing pass-through entity must provide their shareholders, partners, or members a copy of the OTC acknowledgement letter.
- Each entity must advise the shareholders, partners, or members to attach a copy of the acknowledgement letter to their Oklahoma income tax return.
- The electing pass-through entity must attach the OTC acknowledgement letter to their Oklahoma income tax return.

Mark O. Neumeister Last Updated 09/09/2019

19

20

Impact of Election on Entity

Mark O. Neumeister

20

D. R. Payne & Associates, Inc.

Impact of the Election on the Entity 21

- Electing entity calculates and pays the pass-through entity tax.
- Multiply each member's Oklahoma distributive share of the electing pass-through entity's Oklahoma net entity income for the tax year by:
 - Highest marginal rate on individuals, trusts, or estates;
 - 6% on corporations (not S corporations);
 - 6% on pass-through entity members;
 - 6% on financial institutions subject to section 2370; or
 - Highest marginal rate on organizations described in section 2359 (tax exempt organizations, insurance companies, etc.)

Mark O. Neumeister Last Updated 09/09/2019

21

D. R. Payne & Associates, Inc.

Simple Example 22

Schedule K-1, Line Item	Individual Owner	Corporate Owner	Entity Totals
Ordinary Income	100,000	150,000	250,000
Interest	5,000	7,500	12,500
Charitable contribution	(1,000)	(1,500)	(2,500)
Oklahoma Net Entity Income	104,000	156,000	260,000
Applicable Rate	5.0%	6.0%	
Oklahoma Tax	5,200	9,360	14,560

Mark O. Neumeister Last Updated 09/09/2019

22

D. R. Payne & Associates, Inc.

Impact of the Election on the Entity (continued) 23

- An electing entity is not required to withhold tax on non-resident owners.
- Pass-through entity tax is due and payable on the same date as the entity's income tax return.
- Estimated tax:
 - Tax year 2019: not required
 - But, may want to pay tax in 2019 to secure deduction benefit
 - Use OKTap to make payment. Or, use Form OW-8-ESC <https://www.ok.gov/tax/documents/OW-8-ESC-19.pdf>
 - Tax years after 2019: estimated payments required
 - 68 O. S. Supp. 2019, §2355.1P-4(C) provides for tax years beginning on or after January 1, 2020, estimated tax payments shall be required as provided in 68 O. S. § 2385.9, which provides generally for required annual payment of estimated tax to be paid in four equal installments; and that "required annual payment" shall mean the lesser of (1) seventy percent (70%) of the tax shown on the return for the taxable year; or (2) one hundred percent (100%) of the tax shown on the return for the preceding taxable year of twelve (12) months; and for applying "annualized taxable income" under certain rules.

Mark O. Neumeister Last Updated 09/09/2019

23

D. R. Payne & Associates, Inc.

Impact of the Election on the Entity (continued) 24

- Oklahoma net entity loss
 - Carried back and forward by the entity in accordance with section 2358 (generally follows federal rules).
- Non-resident individual owners of an electing pass-through entity
 - Not required to file an Oklahoma income tax return, if, for the taxable year, the only source of income allocable or apportionable to Oklahoma is from the electing pass-through entity.
- Pass-through entity election has priority over and revokes any election to file a composite Oklahoma partnership return, or requirement of an S corporation to report and pay tax on behalf of a non-resident shareholder, for the same tax year.

Mark O. Neumeister Last Updated 09/09/2019

24

D. R. Payne & Associates, Inc.

Impact of the Election on the Entity (continued) 25

- If the amount of tax required to be paid by a pass-through entity is not paid when due,
 - the OTC may revoke the pass-through entity's election.
 - Such revocation is effective for first year for which tax is not paid.
- If the total amount of tax attributable to any resulting Oklahoma net entity income has not been paid
 - The adjustment to the owner's Oklahoma income is denied.
- Oklahoma Credits: "tax credits generated by an electing pass-through entity stay at the entity level and may not be allocated to shareholders, partners, or members. [OTC FAQ #8]"

Mark O. Neumeister Last Updated 09/09/2019

25

D. R. Payne & Associates, Inc.

Impact of Election on Owner

Mark O. Neumeister

26

D. R. Payne & Associates, Inc.

Impact of the Election on the Owner 27

- Each electing pass-through entity owner adjusts their Oklahoma income by their share of "Oklahoma net entity income (loss)."
 - For taxable years beginning on or after January 1, 2019, there shall be subtracted from Oklahoma taxable income or adjusted gross income any item of income or gain, and there shall be added to Oklahoma taxable income or adjusted gross income any item of loss or deduction that ***in the absence of an election pursuant to the provisions of the Pass-Through Entity Tax Equity Act of 2019 would be allocated to a member or to an indirect member of an electing pass-through*** entity pursuant to Section 2351 et seq. of this title,

Mark O. Neumeister Last Updated 09/09/2019

27

D. R. Payne & Associates, Inc.

Impact of the Election on the Owner 28

- if (i) the electing pass-through entity has accounted for such item in computing its Oklahoma net entity income or loss pursuant to the provisions of the Pass-Through Entity Tax Equity Act of 2019, and (ii) the total amount of tax attributable to any resulting Oklahoma net entity income has been paid. The Oklahoma Tax Commission shall promulgate rules for the reporting of such exclusion to direct and indirect members of the electing pass-through entity.
- Anticipated that owner's adjustment will be a line item on 511-A, 511-B or 511-C, or similar for entity owners.

Mark O. Neumeister Last Updated 09/09/2019

28

Simple Example 29

- Oklahoma pass-through entity adjustment on owner's return.

Schedule K-1, Line Item	Individual	Corporate	Entity
	Owner	Owner	Totals
Ordinary Income	100,000	150,000	250,000
Interest	5,000	7,500	12,500
Charitable contribution	(1,000)	(1,500)	(2,500)
Oklahoma Net Entity Income	104,000	156,000	260,000
Applicable Rate	5.00%	6.00%	
Oklahoma Tax	5,200	9,360	14,560
Okla. K-1 Adj - state tax	5,200	9,360	
Okla. K-1 Adj - Okla. net entity income	(104,000)	(156,000)	

Mark O. Neumeister Last Updated 09/09/2019

29

Impact of the Election on the Owner (continued) 30

- Basis in owner's interest in electing pass-through entity.
 - "Notwithstanding the application of this paragraph, the adjusted tax basis of any ownership interest in a pass-through entity for purposes of Section 2351 et. seq. of this title shall be equal to its adjusted tax basis for federal income tax purposes."
- Effectively recaptures benefit of additional state income tax deducted upon disposition of pass-through entity interest.
 - May benefit from rate arbitrage, i.e., deductions taken at higher rate than gains.
 - If disposition qualifies for Oklahoma capital gain exclusion, then no additional Oklahoma tax.

Mark O. Neumeister Last Updated 09/09/2019

30

Definitions

Mark O. Neumeister

31

Definitions 32

- Distributive share
 - means a member's percentage share of Oklahoma net entity income or net entity loss.
- Electing pass-through entity
 - means any pass-through entity as defined in paragraph 6 of this section that has made an election pursuant to subsection F of Section 4 of this act to pay income tax as computed pursuant to Section 2358 of Title 68 of the Oklahoma Statutes.

Mark O. Neumeister Last Updated 09/09/2019

32

33

Definitions (continued)

- Indirect member
 - means, with respect to any particular electing pass-through entity, an individual, fiduciary, or entity that (i) owns an interest in a pass-through entity other than the electing pass-through entity and (ii) has been allocated items of Oklahoma income, gain, loss or deduction that the electing pass-through entity included in computing its tax pursuant to the provisions of the Pass-Through Entity Tax Equity Act of 2019.
- Member
 - means any individual, fiduciary, or entity holding an ownership interest in an electing pass-through entity.

Mark O. Neumeister Last Updated 09/09/2019

33

34

Definitions (continued)

- Oklahoma net entity income, or Oklahoma net entity loss
 - means the positive or negative sum of an electing pass-through entity's items of Oklahoma income, gain, loss, and deduction determined under Section 2351 et seq. of Title 68 of the Oklahoma Statutes, regardless of whether any such items are required for federal income tax purposes to be separately stated.
- Pass-through entity
 - means a general partnership, a limited partnership, a limited liability partnership, a limited liability limited partnership, a limited liability company, or a corporation, if any of the enumerated entity's items of income, gain, loss, and deduction, as applicable, are subject to being included on another person's return for federal income tax purposes under Subchapter K or Subchapter S of the Internal Revenue Code.

Mark O. Neumeister Last Updated 09/09/2019

34

OTC FAQs

Mark O. Neumeister

35

36

OTC FAQs

- <https://www.ok.gov/tax/faqs.html#c579>
- 1. What is the Pass-Through Entity Tax Equity Act of 2019?
 - For general information click here. https://www.ok.gov/tax/Businesses/Tax_Types/Income_Tax_Corporate/Pass-Through_Entity_Tax_Equity_Act_of_2019.html
- 2. For tax years beginning on or after January 1, 2019 and prior to January 1, 2020, when must the election to be an electing pass-through entity (PTE) be filed?
 - The election must be filed with the Oklahoma Tax Commission no later than June 28, 2019.
- 3. Can the election be revoked prior to filing 2019 returns?
 - For 2019 tax year, the revocation must be filed no later than June 28, 2019.

Mark O. Neumeister Last Updated 09/09/2019

36

37

OTC FAQs (continued)

- 4. Can the election be revoked for subsequent tax years?
 - Yes, but the revocation must be made no later than two (2) months and 15 days after the beginning of the PTE's taxable year.
- 5. Will the election be available to newly-formed PTEs after June 28, 2019?
 - New PTEs formed after June 28, 2019 will not be able to elect to become an electing PTE for tax year 2019. New PTEs formed after December 31, 2019 will be able to make the election within two months and fifteen days of the beginning of their tax year.
- 6. What entities may elect to be an electing PTE?
 - The Pass-Through Entity Act of 2019 (Act) provides that an "electing pass-through entity" means any pass-through entity (general partnership, a limited partnership, a limited liability partnership, a limited liability limited partnership, a limited liability company, or a corporation) that is required to file an Oklahoma partnership income tax return or an Oklahoma S corporation income tax return.

Mark O. Neumeister Last Updated 09/09/2019

37

38

OTC FAQs (continued)

- 7. Can a single-member LLC elect to be an electing pass-through entity?
 - "Pass-through entity" includes a limited liability company if any of the LLC's items of income, gain, loss, and deduction, are subject to being included on another person's return for federal income tax purposes under Subchapter K or Subchapter S of the Internal Revenue Code. If a single-member LLC does not elect to be treated as a corporation, the LLC is a "disregarded entity," and the LLC's activities are reflected on its owner's federal tax return; the LLC is not eligible to be an electing PTE.

If a single-member LLC elects to be treated as a corporation and also elects to be treated as an S corporation that is required to file an Oklahoma S corporation income tax return, the LLC is eligible to be an electing PTE. Top of Pass-Through Entity Tax Equity Act
- 8. How are pass-through tax credits affected by the Act?
 - Tax credits generated by an electing PTE stay at the entity level and may not be allocated to shareholders, partners, or members.

Mark O. Neumeister Last Updated 09/09/2019

38

39

OTC FAQs (continued)

- 9. Can nonresident partners, members or shareholders opt out and, if so, what is the procedure for doing so?
 - No, the election is binding on all partners\members\shareholders of the electing PTE.
- 10. Is an electing PTE required to file Form 512-SA, Nonresident Shareholder Agreement?
 - The electing PTE is not required to file Form 512-SA because the nonresident shareholder will not be required to file an Oklahoma income tax return on the nonresident shareholder's share of distributable income of the PTE.
- 11. Is an electing PTE required to withhold tax from distributions made to nonresident partners, members or shareholders?
 - The electing PTE is not required to withhold tax from distributions made to nonresident partners, members or shareholders because the PTE elected to pay the income tax on the Oklahoma portion of the distributions at the entity level.

Mark O. Neumeister Last Updated 09/09/2019

39

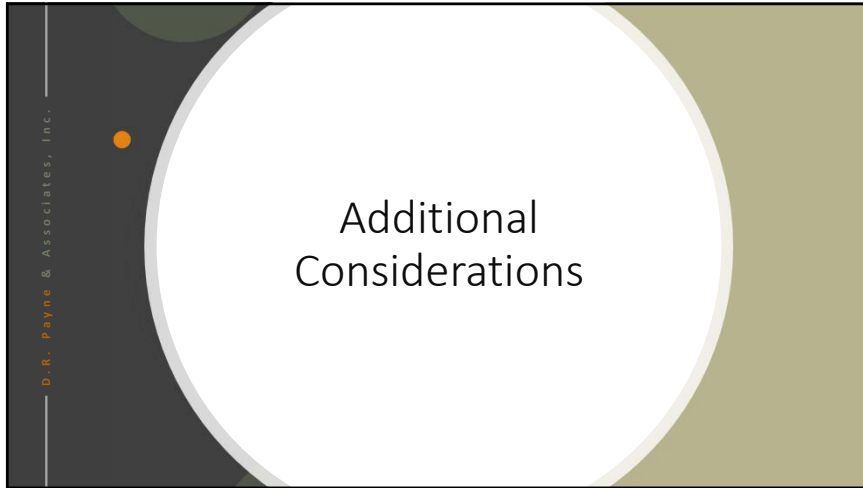
40

OTC FAQs (continued)

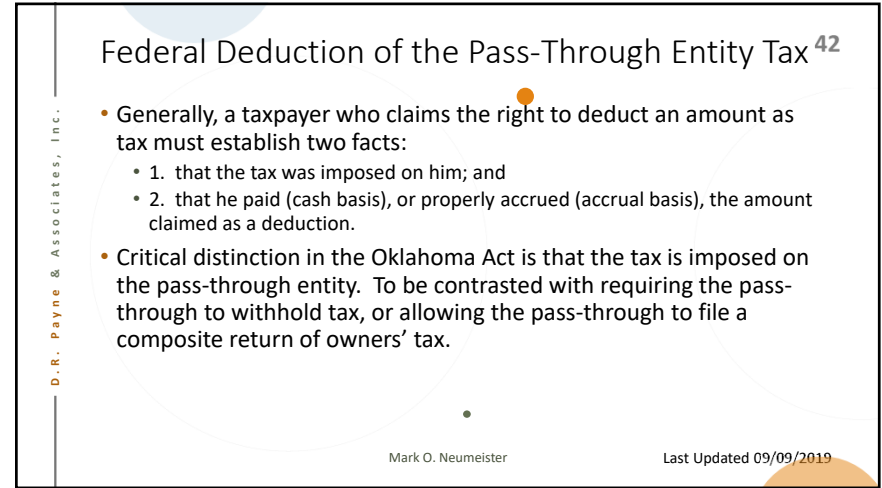
- 12. Can the electing Pass-Through Entity (PTE) deduct the Oklahoma "Accrued Income Tax" deduction?
 - An electing PTE may deduct the Oklahoma "Accrued Income Tax" deduction. The PTE will reduce the "Accrued Income" tax deduction for Oklahoma tax credits.
- 13. Can the electing Pass-Through Entity (PTE) deduct the Oklahoma Capital Gain deduction?
 - An electing PTE may deduct the "Oklahoma Capital Gain Deduction." The Capital Gain Deduction is not dependent on the members' ownership term, only the PTE's ownership of the asset.

Mark O. Neumeister Last Updated 09/09/2019

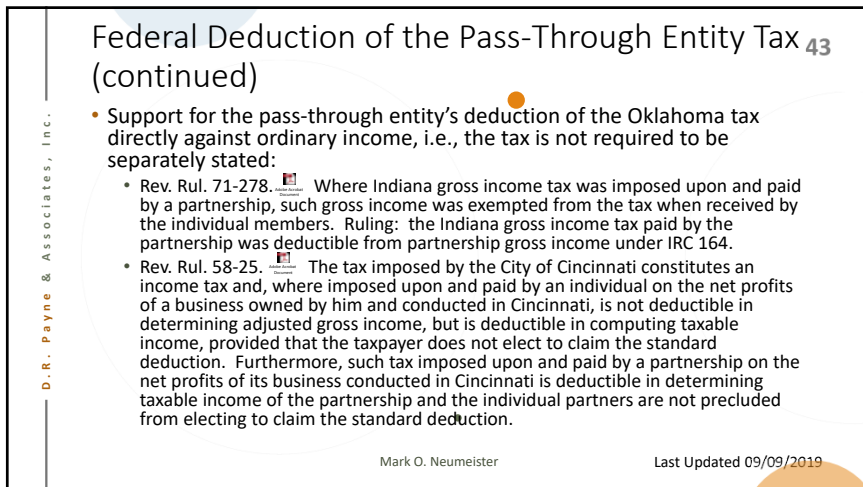
40



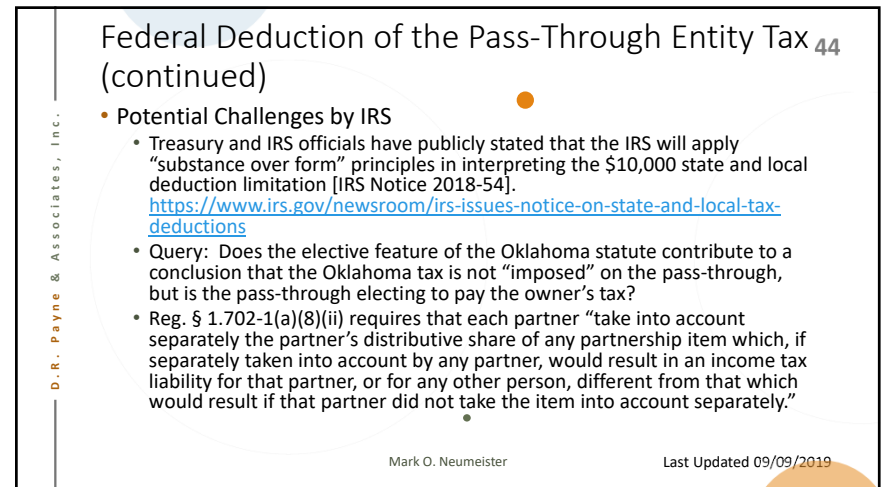
41



42



43



44

45

Federal Deduction of the Pass-Through Entity Tax (continued)

- Reg. § 1.1366-1(a)(2): Each shareholder must take into account separately the shareholder's pro rata share of any item of income (including tax-exempt income), loss, deduction, or credit of the S corporation that if separately taken into account by any shareholder could affect the shareholder's tax liability for that taxable year differently than if the shareholder did not take the item into account separately.
- Tax Cuts and Jobs Act conference report at footnote 172:
 - "... Additionally, taxes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner's or S corporation shareholder's distributive or pro-rata share of income or loss on a Schedule K-1 (or similar form), will continue to reduce such partner's or shareholder's distributive or pro-rata share of income as under present law."
 - However, see the same conference report: "In the case of State and local income taxes, the deduction is an itemized deduction notwithstanding that the tax may be imposed on profits from a trade or business." Referencing footnote 168.
 - See "[News Analysis: Could the IRS Identify SALT Workarounds as Listed Transactions](#)" for more discussion.

Mark O. Neumeister Last Updated 09/09/2019

45

46

Federal Deduction of the Pass-Through Entity Tax—Non-business Activities

- Can HB 2665 tax imposed on a pass-through entity, directly offset rent or royalty, or investment income?
 - Form 1065 instruction for Line 14:
 - Taxes paid or incurred for the production or collection of income, or for the management, conservation, or maintenance of property held to produce income. Report these taxes separately on line 13d of Schedule K and in box 13 of Schedule K-1 using code W.
 - Form 1120S instruction for Line 12:
 - Taxes paid or incurred for the production or collection of income, or for the management, conservation, or maintenance of property held to produce income. Report these taxes separately on line 12d of Schedule K and in box 12 of Schedule K-1 using code S.
- Query: How do we treat activities such as rental that otherwise qualify as "trade or business?"

Mark O. Neumeister Last Updated 09/09/2019

46

47

Federal Deduction of the Pass-Through Entity Tax—Tax Position Confidence Level & Disclosure

- Confidence level required of the tax preparer for a tax position:
- National Association of Enrolled Agents: Code of Ethics and Rules of Professional Conduct <https://tinyurl.com/y45dpxf7>
 - Rule of Professional Conduct #8: Members and associates will take a position on a tax return favorable to their clients only if there is **substantial authority** that the position will be sustained on its merits, unless the position is **disclosed** and there is at least a **reasonable basis** for it. If applicable law is unsettled, or the application of law to the facts in a given situation is uncertain, members and associates must explain the probable effects of various alternatives to their clients who make the final decision as to the position taken.
 - Rule of Professional Conduct #21: Tax preparation or representation services will be offered as authorized by the most current provisions of Circular 230.

Mark O. Neumeister Last Updated 09/09/2019

47

48

Federal Deduction of the Pass-Through Entity Tax—Tax Position Confidence Level & Disclosure

- AICPA Statement on Standards for Tax Services No. 1—Tax Return Positions
 - If no higher standard applies,
 - 5a. A member should not recommend a tax return position or prepare or sign a tax return taking a position unless the member has a good-faith belief that the position has at least a **realistic possibility** of being sustained administratively or judicially on its merits if challenged.
 - Notwithstanding paragraph 5a, a member may prepare or sign a tax return that reflects a position if
 - (i) the member concludes there is a **reasonable basis** for the position and
 - (ii) the position is **appropriately disclosed**.

Mark O. Neumeister Last Updated 09/09/2019

48

Federal Deduction of the Pass-Through Entity Tax—Tax Position Confidence Level & Disclosure 49

- IRC § 6694 preparer penalties.
 - Reasonable basis + disclosure, or
 - Substantial authority
- Circular 230, § 10.34(a)—tax returns or refund claims.
 - Reasonable Basis, but references § 6694 (above).
- Consider need to add appropriate disclosure
 - Consider using Form 8275—Disclosure Statement, or Form 8275-R—Regulation Disclosure Statement

Mark O. Neumeister
Last Updated 09/09/2019

49

AICPA <https://tinurl.com/v67ywnngs>
Tax Section

LEVELS OF CONFIDENCE FOR TAX RETURN POSITIONS 50

Purpose: To understand the relationship between the levels of confidence, disclosure, and potential penalties for preparers and taxpayers.

Levels of Confidence ¹ (Percentages are approximate and represent relative levels of accuracy)	Taxpayer Penalty				Preparer Penalty	
	Negligence	Substantial understatement	Oversight of rule	7 or 8 letter	Not a tax shelter	Is a tax shelter
Will (at least 90%) While the term is not defined by law, this means a virtually certain position. Be cautious in using this term as it can relay a certain level of confidence. ²	✓	✓	⚠	✓	✓	✓
Should (at least 70%) While not defined by law, the preponderance and weight of support is favorable. Be cautious in using this term as it can relay a certain level of confidence. ²	✓	✓	⚠	✓	✓	✓
More Likely than Not (at least +50%) Reasonable belief that the tax treatment of an item of the form the return is filed is more likely than not the proper tax treatment (i.e., there is a greater than 50% chance it will be upheld if challenged by the IRS) based on an analysis of pertinent facts and authorities in the manner described in Regs. Sec. 1.6062-4(d)(3)(ii) (Regs. Sec. 1.6064-4(d)(2)(ii))	✓	✓	⚠	✓	✓	✓
Substantial Authority (at least 40%) An objective standard involving an analysis of the law and application of the law to the relevant facts. Substantial authority exists if the weight of the authority supporting the treatment is substantial in relation to the weight of the authority supporting contrary treatment. (Regs. Sec. 1.6062-4(d))	✓	✓	⚠	✗	✓	⚠
Realistic Possibility of Success (at least 30%) A reasonable and well-informed analysis of the law and the facts by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one-in-three (or greater) likelihood of being sustained on its merits. https://www.irs.gov/irm/part15/150010101_01.html	✓	⚠	⚠	✗	⚠	✗
Reasonable Basis (20%) If a position is based on one or more authorities, it will generally satisfy reasonable basis even though it does not satisfy the substantial authority standard (not merely arguable or not merely a colorable claim). (Regs. Sec. 1.6062-3(b)(2). See Compliance on Taxpayers https://www.irs.gov/irm/part15/150010101_01.html)	✓	⚠	⚠	✗	⚠	✗
Below Reasonable Basis, Including Frivolous (below 20%) A position that is patently improper with no plausible argument in support of the position. [Not defined by statute or regulation]	✗	✗	✗	✗	✗	✗

✓ No disclosure is required
⚠ No penalty with proper disclosure; see Forms 8275 or 8275-R.
✗ Penalty with or without disclosure

1. The level of confidence means the level of authority needed for either a taxpayer or a preparer to avoid the relevant penalty. See Regs. Sec. 1.6062-4(d)(3)(ii) and https://www.irs.gov/irm/part15/150010101_01.html.
 2. In rendering the advice for a return position, it's advisable to use the terminology in the Code and regulations to describe the level of confidence. Examples are a "will" term, "should" or "will" because it clarifies the intended meaning.
 3. To avoid a penalty, a taxpayer must have substantial authority and establish a reasonable belief that the treatment meets the more likely than not standard.
 4. See https://www.irs.gov/irm/part15/150010101_01.html, Sec. 6064, and Sec. 6702A.

9/09/2019

50

Complexities of Oklahoma Net Entity Income 51

- Oklahoma net entity income, or Oklahoma net entity loss
 - means the positive or negative sum of an electing pass-through entity's items of Oklahoma income, gain, loss, and deduction determined under Section 2351 et seq. of Title 68 of the Oklahoma Statutes, regardless of whether any such items are required for federal income tax purposes to be separately stated.
- Query: Do we use the federal concept of "analysis of net income" (partnerships) or "income/loss reconciliation" (S corporations)?
 - Partnerships: Sum of Schedule K-1 Lines 1—11, less Lines 12—13d and 16p
 - S corporations: Sum of Schedule K-1 Lines 1—10, less Lines 11—12d and 14p
 - Plus/minus other Oklahoma adjustments such as non-Oklahoma tax exempt interest, non-deductible state tax, etc.

Mark O. Neumeister
Last Updated 09/09/2019

51

Complexities of Oklahoma Net Entity Income (continued) 52

- Consider the following K-1 line items (not an exhaustive list):
 - Ordinary income: limitations such as passive activity, basis, at-risk ignored?
 - Capital gains (losses): netting or loss limitations ignored?
 - Cancellation of debt income: exemption or basis reduction elections ignored?
 - Section 179 deduction: limitations ignored?
 - Charitable deduction: 60%, 50%, 30% or 20% limitations ignored?
 - Intangible drilling costs (IDC): deduct or amortize?
 - Depletion: deduct without limitation?
 - Investment interest expense: deductible without limitation?
 - Etc.

Mark O. Neumeister
Last Updated 09/09/2019

52

D. R. Payne & Associates, Inc.

Complexities of Oklahoma Net Entity Income (continued) 53

- Query: Do we instead compute Oklahoma net entity income “as if” the pass-through was a corporation?
- Query: How are Oklahoma’s allocation and apportionment rules applied to “Oklahoma net entity income (loss)”

Mark O. Neumeister Last Updated 09/09/2019

53

D. R. Payne & Associates, Inc.

The Nightmare 54

Mark O. Neumeister

Source: GAO analysis of IRS documentation. (GAO-14-722)

Note: This figure, adapted from IRS documentation, illustrates a hypothetical, complex partnership structure, which shows the relationship between various types of entities. The allocation of income and losses from the audited partnership on the far left side crosses eight pass-through entities, all of which are partnerships, along the bolded line before it reaches one of its ultimate partnership owners on the right side. This figure was originally used in our report on business networks. See Tax Gap: IRS Can Improve Efforts to Address Tax Evasion by Networks of Businesses and Related Entities, (GAO-10-666) (Washington, D.C.: Sept. 24, 2010).

54

D. R. Payne & Associates, Inc.

Documentation 55

- Attachments to electing pass-through entity return:
 - OTC acknowledgement letter
 - Federal schedule K-1s (perhaps a detail schedule will be allowed)
 - Reconciliation and computation of “Oklahoma net entity income (loss)” with aggregation of all owners, and computation of tax.
- Attachment to electing pass-through entity owner’s return:
 - OTC acknowledgement letter
 - Computation of owner’s “Oklahoma net entity income (loss)”
- Tiered entities: reconciliation and/or aggregation of lower tier entities documentation.
- Additional OTC guidance to come (we hope).

Mark O. Neumeister Last Updated 09/09/2019

55

D. R. Payne & Associates, Inc.

Allocation of Tax Deduction to Owners 56

- Now that your pass-through entity has elected and qualifies for a federal tax deduction for Oklahoma taxes:
- How is the federal tax deduction for state tax by the entity allocated to the owners?
- S corporations: per-share, per-day.
- Partnerships: refer to allocation of deductions in partnership agreement.

Mark O. Neumeister Last Updated 09/09/2019

56

57

Potential Benefits

- Additional deduction of Oklahoma income tax above \$10,000 limits
- May simplify nexus determinations.
- May reduce compliance costs for multi-tiered entities.
- May simplify burdens of state apportionment calculations for multi-tiered entities.
- Elimination of composite returns for non-resident owners
- May eliminate requirement to file in Oklahoma for non-resident owners.
- Eliminate Oklahoma withholding requirements on non-resident owners.
- Reduce self-employment income. •

Mark O. Neumeister
Last Updated 09/09/2019

57

58

Potential Benefits (continued)

Lowering adjusted gross income (AGI) and potentially improving the taxpayer's ability to obtain:

- Non-deductible Roth IRA contributions
- Deductible traditional IRA contributions
- Child tax credit
- Higher education credits
- Interest on qualified education loans
- Contribute to a Coverdell Education Savings Account (CESA)
- Tax-free break for interest on U.S. saving bonds redeemed
- Offset non-passive income with up to \$25,000 of rental real estate loss
- Affordable Care Act (ACA) section 36B credit
- Exclusion of social security benefits
- Qualified business income (QBI) deduction
- Credit for adoption expenses
- Medical expenses
- Casualty losses
- Charitable contributions

Mark O. Neumeister
Last Updated 09/09/2019

58

59

Potential Detriments

- May cause double taxation on non-resident owners
- Where "Oklahoma net entity income" exceeds an owner's Oklahoma taxable income, a potential increase in Oklahoma tax exists.
- Potential loss of lower Oklahoma tax brackets.
- Query: Does the election make it easier for OTC to audit, assess and collect tax on the pass-through entity?
- Negative and positive K-1 owners can lead to loss of Oklahoma net operating loss, and increase in total Oklahoma taxes paid.

Mark O. Neumeister
Last Updated 09/09/2019

59

60

Other Implementation Issues

- See AICPA's "State Pass-Through Entity-Level Tax Implementation Issues" for a white paper discussion.
 - <https://tinyurl.com/y396bujr>

Mark O. Neumeister
Last Updated 09/09/2019

60

D. R. Payne & Associates, Inc.

Financial Statement Impact

61

- Is the Oklahoma pass-through entity tax an “income tax” of the entity requiring a tax provision under GAAP (ASC 740)?
- FASB ASC 740-10-55-228 clarifies that if income taxes paid by the entity are attributable to the—
 - a. entity, they should be accounted for following the provisions of FASB ASC 740.
 - b. owners, they should be accounted for as a transaction with owners.

Mark O. Neumeister

Last Updated 09/09/2019

61

D. R. Payne & Associates, Inc.

Examples

62

Mark O. Neumeister

62

D. R. Payne & Associates, Inc.

Example 1

63

dated 09/09/2019

New Through Entity		No PTE Election		PTE Election	
Schedule E - C, Line Item	Amount	Amount	Amount	Amount	Change
Ordinary Income	100,000	100,000	100,000	100,000	0
Interest	1,000	1,000	1,000	1,000	0
Charitable Contribution	(10,000)	(10,000)	(10,000)	(10,000)	0
Federal EIT Tax	(10,000)	(10,000)	(10,000)	(10,000)	0
All State Oklahoma Tax	(10,000)	(10,000)	(10,000)	(10,000)	0
Oklahoma Net Entity Income	70,000	70,000	70,000	70,000	0
Oklahoma Tax Rate	5.00%	5.00%	5.00%	5.00%	0
Oklahoma EIT Adjustment: State tax	3,500	3,500	3,500	3,500	0
Oklahoma EIT Adjustment: Oklahoma net entity income	(35,000)	(35,000)	(35,000)	(35,000)	0
Owner's Tax Returns					
Adjusted					
Other items of gross income	100,000	100,000	100,000	100,000	0
Oklahoma Income (Item 8-1)	100,000	100,000	100,000	100,000	0
Interest (Item 8-2)	1,000	1,000	1,000	1,000	0
Adjusted Gross Income	101,000	101,000	101,000	101,000	0
State Income Taxes	(10,000)	(10,000)	(10,000)	(10,000)	0
State Income Tax (Item 8-3)	(10,000)	(10,000)	(10,000)	(10,000)	0
Taxable Income	91,000	91,000	91,000	91,000	0
Tax Rate	21.00%	21.00%	21.00%	21.00%	0
Federal Tax	19,110	19,110	19,110	19,110	0
Adjustment					
Adjusted Gross Income 7 Taxable Income	101,000	101,000	101,000	101,000	0
Oklahoma Adjustments	(10,000)	(10,000)	(10,000)	(10,000)	0
State Income Tax (Item 8-3)	(10,000)	(10,000)	(10,000)	(10,000)	0
PTE Adjustment	(10,000)	(10,000)	(10,000)	(10,000)	0
Charitable	(10,000)	(10,000)	(10,000)	(10,000)	0
Oklahoma Taxable Income	61,000	61,000	61,000	61,000	0
Tax Rate	21.00%	21.00%	21.00%	21.00%	0
Federal Tax	12,810	12,810	12,810	12,810	0
Adjustment					
Adjusted Gross Income 7 Taxable Income	101,000	101,000	101,000	101,000	0
Oklahoma Adjustments	(10,000)	(10,000)	(10,000)	(10,000)	0
State Income Tax (Item 8-3)	(10,000)	(10,000)	(10,000)	(10,000)	0
PTE Adjustment	(10,000)	(10,000)	(10,000)	(10,000)	0
Charitable	(10,000)	(10,000)	(10,000)	(10,000)	0
Oklahoma Taxable Income	61,000	61,000	61,000	61,000	0
Tax Rate	21.00%	21.00%	21.00%	21.00%	0
Federal Tax	12,810	12,810	12,810	12,810	0
Federal Tax Savings					
Oklahoma Tax Liability of PTE	3,500	3,500	3,500	3,500	0
Oklahoma Tax Liability of Owner	15,610	15,610	15,610	15,610	0
Total Oklahoma Tax Liability	19,110	19,110	19,110	19,110	0

63

D. R. Payne & Associates, Inc.

Example 2

64

dated 09/09/2019

New Through Entity		No PTE Election		PTE Election	
Schedule E - C, Line Item	Amount	Amount	Amount	Amount	Change
Ordinary Income	100,000	100,000	100,000	100,000	0
Interest	1,000	1,000	1,000	1,000	0
Charitable Contribution	(10,000)	(10,000)	(10,000)	(10,000)	0
Federal EIT Tax	(10,000)	(10,000)	(10,000)	(10,000)	0
All State Oklahoma Tax	(10,000)	(10,000)	(10,000)	(10,000)	0
Oklahoma Net Entity Income	70,000	70,000	70,000	70,000	0
Oklahoma Tax Rate	5.00%	5.00%	5.00%	5.00%	0
Oklahoma EIT Adjustment: State tax	3,500	3,500	3,500	3,500	0
Oklahoma EIT Adjustment: Oklahoma net entity income	(35,000)	(35,000)	(35,000)	(35,000)	0
Owner's Tax Returns					
Adjusted					
Other items of gross income	100,000	100,000	100,000	100,000	0
Oklahoma Income (Item 8-1)	100,000	100,000	100,000	100,000	0
Interest (Item 8-2)	1,000	1,000	1,000	1,000	0
Adjusted Gross Income	101,000	101,000	101,000	101,000	0
State Income Taxes	(10,000)	(10,000)	(10,000)	(10,000)	0
State Income Tax (Item 8-3)	(10,000)	(10,000)	(10,000)	(10,000)	0
Taxable Income	91,000	91,000	91,000	91,000	0
Tax Rate	21.00%	21.00%	21.00%	21.00%	0
Federal Tax	19,110	19,110	19,110	19,110	0
Adjustment					
Adjusted Gross Income 7 Taxable Income	101,000	101,000	101,000	101,000	0
Oklahoma Adjustments	(10,000)	(10,000)	(10,000)	(10,000)	0
State Income Tax (Item 8-3)	(10,000)	(10,000)	(10,000)	(10,000)	0
PTE Adjustment	(10,000)	(10,000)	(10,000)	(10,000)	0
Charitable	(10,000)	(10,000)	(10,000)	(10,000)	0
Oklahoma Taxable Income	61,000	61,000	61,000	61,000	0
Tax Rate	21.00%	21.00%	21.00%	21.00%	0
Federal Tax	12,810	12,810	12,810	12,810	0
Adjustment					
Adjusted Gross Income 7 Taxable Income	101,000	101,000	101,000	101,000	0
Oklahoma Adjustments	(10,000)	(10,000)	(10,000)	(10,000)	0
State Income Tax (Item 8-3)	(10,000)	(10,000)	(10,000)	(10,000)	0
PTE Adjustment	(10,000)	(10,000)	(10,000)	(10,000)	0
Charitable	(10,000)	(10,000)	(10,000)	(10,000)	0
Oklahoma Taxable Income	61,000	61,000	61,000	61,000	0
Tax Rate	21.00%	21.00%	21.00%	21.00%	0
Federal Tax	12,810	12,810	12,810	12,810	0
Federal Tax Savings					
Oklahoma Tax Liability of PTE	3,500	3,500	3,500	3,500	0
Oklahoma Tax Liability of Owner	15,610	15,610	15,610	15,610	0
Total Oklahoma Tax Liability	19,110	19,110	19,110	19,110	0

64

65

Resource Table

- Notice 2018-54
 - <https://www.irs.gov/newsroom/irs-issues-notice-on-state-and-local-tax-deductions>
- Pass-Through Entity Tax Equity Act of 2019 (statutory language)
 - <http://www.oscn.net/applications/oscn/DeliverDocument.asp?CiteID=483686>
- Form 586—Pass-Through Entity Election Form.
 - <https://www.ok.gov/tax/documents/586-19.pdf>
- OTC acknowledgement letter
- Form OW-8-ESC
 - <https://www.ok.gov/tax/documents/OW-8-ESC-19.pdf>
- OTC FAQs
 - <https://www.ok.gov/tax/faqs.html#c579>
- Rev. Rul. 71-278, 1971-2 CB 75.
- Rev. Rul. 58-25, 1958-1 CB 95

Mark O. Neumeister
Last Updated 09/09/2019

65

66

Resource Table (continued)

- “News Analysis: Could the IRS Identify SALT Workarounds as Listed Transactions”
 - <https://www.taxnotes.com/editors-pick/news-analysis-could-irs-identify-salt-workarounds-listed-transactions>
- Tax Cuts and Jobs Act conference report at footnote 172
- NAEA: Codes of Ethics & Rules of Professional Conduct
 - <https://tinyurl.com/y45dpxf7>
- AICPA: Levels of Confidence For Tax Return Positions
 - <https://tinyurl.com/y67ywngs>
- AICPA’s “State Pass-Through Entity-Level Tax Implementation Issues”
 - <https://tinyurl.com/y396bujr>
- Example 1
- Example 2

Mark O. Neumeister
Last Updated 09/09/2019

66

Questions?

67

Presentations
By Mark
Neumeister

- Cryptocurrency
- Centralized Partnership Examinations
- Ethics in Tax Practice
- Short Subjects (“Peoples Choice”)
 - In the Weeds
 - First 1040
 - Pennies on the Dollar
 - Tax Deductions from Thin Air
 - Tax ID Theft

Mark O. Neumeister

68

69

D. R. Payne & Associates, Inc.

THANK YOU

Mark O. Neumeister
(405) 272-0511
moneumeister@drpayne.com

Last Updated 09/09/2019

69