Guidance on Certain Payments Made in Exchange for State and Local Tax Credits

NOTICE 2018-54

SECTION 1. PURPOSE

This notice informs taxpayers that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to propose regulations addressing the federal income tax treatment of certain payments made by taxpayers for which taxpayers receive a credit against their state and local taxes.

SECTION 2. BACKGROUND

Section 11042 of "The Tax Cuts and Jobs Act," Pub. L. No. 115-97, limits an individual's deduction under § 164 for the aggregate amount of state and local taxes paid during the calendar year to $10,000 ($5,000 in the case of a married individual filing a separate return). State and local tax payments in excess of those amounts are not deductible. This new limitation applies to taxable years beginning after December 31, 2017, and before January 1, 2026.

In response to this new limitation, some state legislatures are considering or have adopted legislative proposals that would allow taxpayers to make transfers to funds controlled by state or local governments, or other transferees specified by the state, in exchange for credits against the state or local taxes that the taxpayer is required to pay. The aim of these proposals is to allow taxpayers to characterize such

transfers as fully deductible charitable contributions for federal income tax purposes, while using the same transfers to satisfy state or local tax liabilities.

Despite these state efforts to circumvent the new statutory limitation on state and local tax deductions, taxpayers should be mindful that federal law controls the proper characterization of payments for federal income tax purposes.

SECTION 3. GUIDANCE TO BE ISSUED

The Treasury Department and the IRS intend to propose regulations addressing the federal income tax treatment of transfers to funds controlled by state and local governments (or other state-specified transferees) that the transferor can treat in whole or in part as satisfying state and local tax obligations. The proposed regulations will make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers. The proposed regulations will assist taxpayers in understanding the relationship between the federal charitable contribution deduction and the new statutory limitation on the deduction for state and local tax payments.

SECTION 4. DRAFTING INFORMATION

The principal authors of this notice are Mon Lam and Merrill Feldstein of the Office of Associate Chief Counsel (Income Tax & Accounting). Other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, contact Ms. Lam or Ms. Feldstein at (202) 317-5100 (not a toll-free call).

Title 68 Revenue and Taxation

Chapter 1 - Tax Codes
Oklahoma Income Tax Act
Article Article 23 - Income Tax
Section 2355.1P-1 - Pass-Through Entity Tax Equity Act of 2019

Cite as: 68 O.S. § 2355.1P-1 (OSCN 2019), Oklahoma Income Tax Act

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Sections 1 through 9 of this act shall be known and may be cited as the "Pass-Through Entity Tax Equity Act of 2019".

Historical Data

Laws 2019, HB 2665, c. 201, § 1, emerg. eff. April 29, 2019.

Section 2355.1P-2 - Definitions

Cite as: 68 O.S. § 2355.1P-2 (OSCN 2019), Oklahoma Income Tax Act

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As used in this act:

1. "Distributive share" means a member's percentage share of Oklahoma net entity income or net entity loss;

2. "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;

3. "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;

4. "Member" means any individual, fiduciary, or entity holding an ownership interest in an electing pass-through entity;

5. "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; and

6. "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.

Historical Data

Laws 2019, HB 2665, c. 201, § 2, emerg. eff. April 29, 2019**Section 2355.1P-3 -** Cite as:

68 O.S. § 2355.1P-3 Purpose - Apportionment

(OSCN 2019), Oklahoma Income Tax Act

A. 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.

B. All monies collected pursuant to the provisions of subsection A of Section 2358 of Title 68 of the Oklahoma Statutes shall be apportioned in the same manner as provided in paragraph 1 of Section 2352 of Title 68 of the Oklahoma Statutes if the tax is computed based upon a distribution made to one or more individuals, trusts and estates and shall be apportioned in the same manner as provided in paragraph 2 of Section 2352 of Title 68 of the Oklahoma Statutes if the tax is computed based upon a distribution to a corporation or to a pass-through entity as such term is defined in Section 2 of this act.

Historical Data

Laws 2019, HB 2665, c. 201, § 3, emerg. eff. April 29, 2019

Section 2355.1P-4 - Provisions
Cite as: 68 O.S. § 2355.1P-4 (OSCN 2019), Oklahoma Income Tax Act

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A. For tax years beginning on or after January 1, 2019, there is hereby levied on each electing pass-through entity the pass-through entity tax which shall be calculated as follows:

1. With regard to each member of an electing pass-through entity, the electing pass-through entity shall multiply such member's Oklahoma distributive share of the electing pass-through entity's Oklahoma net entity income for the tax year by:

a. the highest Oklahoma marginal income tax rate levied on the taxable income of natural persons pursuant to Section 2355 of Title 68 of the Oklahoma Statutes if the member is an individual, trust, or estate,

b. six percent (6%) if the member is classified as a corporation pursuant to the Internal Revenue Code, and is not classified as an S corporation,

c. six percent (6%) if the member is a pass-through entity,

d. six percent (6%) if the member is a financial institution subject to tax imposed pursuant to the provisions of Section 2370 of Title 68 of the Oklahoma Statutes, and

e. the highest Oklahoma marginal income tax rate that would be applicable to any item of the electing pass-through entity's income or gain without the election made pursuant to subsection F of this section, if the member is an organization described in Section 2359 of Title 68 of the Oklahoma Statutes; and

2. The electing pass-through entity shall aggregate the amounts determined with respect to all members pursuant to paragraph 1 of this subsection and the pass-through entity tax for the applicable tax year shall be equal to such aggregated tax amount for the tax year with respect to which the election has been made.

B. Sections 2385.29, 2385.30 and 2385.31 of Title 68 of the Oklahoma Statutes shall not be applicable to an electing pass-through entity.

C. The pass-through entity tax shall be due and payable on the same date as provided for the filing of the electing pass-through entity's Oklahoma income tax return, and for tax years beginning on or after January 1, 2020, estimated tax payments shall be required as provided in Section 2385.9 of Title 68 of the Oklahoma Statutes.

D. If the pass-through entity election results in a net entity loss for Oklahoma income tax purposes in any tax year, the net entity loss may be carried back and carried forward by the electing pass-through entity for Oklahoma income tax purposes as set forth in subparagraph b of paragraph 3 of subsection A of Section 2358 of this title.

E. Notwithstanding paragraph 2 of subsection C of Section 2368 of Title 68 of the Oklahoma Statutes, a nonresident individual who is a member of an electing pass-through entity is not required to file an Oklahoma income tax return, if, for the taxable year, the only source of income allocable or apportionable to this state for the member, or, if a joint income tax return is filed, the member and his or her spouse, is from one or more electing pass-through entities, and each electing pass-through entity files and pays the taxes due under this section.

F. Any entity required to file an Oklahoma partnership income tax return or an Oklahoma S corporation income tax return may elect to become an electing pass-through entity. The election shall be made on such form and in such manner as the Oklahoma Tax Commission may prescribe, and any election under this subsection shall have priority over and revoke any election to file a composite Oklahoma partnership return or requirement of a Subchapter S corporation to report and pay tax on behalf of a nonresident shareholder for the same tax year.

G. Pursuant to procedures prescribed by the Tax Commission, if the amount of tax required to be paid by a pass-through entity pursuant to the provisions of this section is not paid when due, the Oklahoma Tax Commission may revoke the pass-through entity's election under subsection F of this section effective for the first year for which the tax is not paid.

H. The election authorized by the provisions of this section shall be made pursuant to procedures prescribed by the Tax Commission and shall be filed (i) within sixty (60) days of enactment and pursuant to procedures prescribed by the Oklahoma Tax Commission for any income tax year beginning on or after January 1, 2019, and prior to January 1, 2020, or (ii) for any income tax year beginning on or after January 1, 2020, at any time during the preceding tax year or two (2) months and fifteen (15) days after the beginning of the tax year. Any such election shall be binding until revoked pursuant to procedures prescribed by the Tax Commission. The effective date of a revocation (i) made within two (2) months and fifteen (15) days of the electing pass-through entity's taxable year shall be the first day of such taxable year and (ii) made during the electing pass-through entity's taxable year but after such fifteenth day shall be effective on the first day of the following taxable year. No election made by a pass-through entity with respect to income tax to be paid by such entity using the calculations prescribed by this section shall be binding on any other pass-through entity, and each pass-through entity shall be able to make an election under the provisions of this act independently.

Historical Data

Laws 2019, HB 2665, c. 201, § 3, emerg. eff. April 29, 2019.

Section 2358 - Taxable Income and Adjusted Gross Income - Adjustments to Arrive at Oklahoma Taxable Income

Cite as: 68 O.S. § 2358 (OSCN 2019), Adjustments

For all tax years beginning after December 31, 1981, taxable income and adjusted gross income shall be adjusted to arrive at Oklahoma taxable income and Oklahoma adjusted gross income as required by this section.

A. The taxable income of any taxpayer shall be adjusted to arrive at Oklahoma taxable income for corporations and Oklahoma adjusted gross income for individuals, as follows:

.....

11. 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, 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. As used in this paragraph, "electing pass-through entity", "indirect member", and "member" shall be defined in the same manner as prescribed by Section 2 of this act. 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.

Form 586
Created 5-2019

Oklahoma Tax Commission
Pass-through Entity Election Form

Pass-Through Entity Tax Equity Act of 2019, hereafter called Act. 68 O.S. Sec 2355.1P-1 through 2355.1P-4.

This form is used to report to the Oklahoma Tax Commission that the below named entity is electing, or revoking the election, to become an electing pass-through entity (PTE).

Federal Employer Identification Number: _____

Name of Entity: _____

Address: _____

City: _____ State: _____ ZIP: _____

Phone Number: _____

Part 1 - Pass-through Entity Making the Election:

☐ The entity listed above is making the election to become an electing pass-through entity.

The election is effective beginning tax year _____ .

Did the PTE file an Oklahoma income tax return for the previous tax year? ☐ Yes ☐ No

Part 2 - Pass-through Entity Revoking the Election:

☐ The entity listed above is revoking its election to be an electing pass-through entity.

The revocation is effective beginning tax year _____ .

Under penalties of perjury, I declare that I have examined this form and to the best of my knowledge and belief it is true, correct and complete, and that I have the authority to execute this document on behalf of the pass-through entity.

Name: _____ Title: _____

Signature: _____ Date: _____

Mail to: Oklahoma Tax Commission
Attn: Pass-through Election
PO Box 269060
Oklahoma City, OK 73126-9060

Oklahoma Tax Commission
Pass-Through Entity Election Form

68 O.S. Sec 2355.1P-1 through 2355.1P-4

Any entity required to file an Oklahoma partnership income tax return or an Oklahoma S corporation income tax return may elect to become an electing PTE. **Complete Part 1 to make such an election**. This election has priority over and revokes any election to file a composite Oklahoma partnership return or the requirement of an S corporation to report and pay tax on behalf of a nonresident shareholder for the same tax year. An election made by one PTE is not binding on any other PTE. Each PTE must make its own election.

This election is binding until revoked by the PTE or by the Oklahoma Tax Commission (OTC). The PTE may **revoke the election by completing Part 2**. If the amount of tax required to be paid by the PTE pursuant to the provisions of the Act is not paid when due, the OTC may revoke the PTE's election effective for the first year for which the tax is not paid.

The OTC will send an acknowledgement letter to each electing PTE.

Each electing PTE must attach a copy of the OTC acknowledgement letter to their Oklahoma income tax return.

Each electing PTE must provide their shareholders, partners, or members a copy of the OTC acknowledgement letter and advise the shareholder, partner or member of the requirement to attach a copy of the acknowledgement letter to their Oklahoma income tax return.

Part 1 – Filing the Election

For Tax Years beginning on or after January 1, 2019 and prior to January 1, 2020, the election must be filed:

- No later than June 28, 2019.

For Tax Years beginning on or after January 1, 2020, the election must be filed:

- Anytime during the preceding tax year or
- Two months and fifteen days after the beginning of the tax year.

Part 2 – Revoking the Election

The effective date of a revocation:

- Revocations made within two months and 15 days of the beginning of the electing PTE's taxable year will be effective the first day of such taxable year.
- Revocations made during the electing PTE's taxable year but after such fifteenth day will be effective on the first day of the following taxable year.

Who Must Sign

If the electing PTE is required to file an Oklahoma partnership return, this form is to be signed by a partner or a member who is authorized to sign and file such income tax return.

If the electing PTE is required to file an Oklahoma Small Business Corporation (S corporation) return, this form is to be signed by a corporate officer or a member who is authorized to sign and file such income tax return.

OKLAHOMA TAX COMMISSION

TAX POLICY DIVISION
RICK MILLER, DIRECTOR

PHONE (405) 521-3133
FACSIMILE (405) 522-0063

June 5, 2019

[redacted]

RE: Oklahoma Tax Commission Form 586 (PTE 19-01)

Dear Mr. Lyne:

This letter acknowledges the receipt of Oklahoma Tax Commission Form 586 filed on behalf of [redacted] ([redacted]) whereby [redacted] elects to become an electing pass-through entity effective for tax year 2019. This election is made under the provisions of the *Pass-Through Entity Tax Equity Act of 2019* (68 O.S. § 2355.1P-1 et. seq.) and is binding until revoked under the provisions of 68 O.S. § 2355.1P-4(H).

Please be advised that all electing pass-through entities must attach a copy of this OTC acknowledgement letter to their Oklahoma income tax return. Further, please provide your shareholders/members/partners a copy of this OTC acknowledgement letter and advise them of the requirement to attach a copy to their Oklahoma income tax return.

If you need any additional assistance, please feel free to contact Mike Kaufmann or Lisa Haws at (405) 521-3133.

Sincerely,

FOR THE OKLAHOMA TAX COMMISSION

Rick Miller

Richard G. Miller, Director
Tax Policy & Research Division

ITE OW-8-ESC
Revised 7-2018

Oklahoma Corporate, Fiduciary and Partnership Estimated Tax

Tax Year 2019 Worksheet for Corporations, Partnerships and Trusts

See the general instructions for additional filing information.

A corporation or trust with an estimated income tax liability of $500 or more for the year is required to file a declaration and pay estimated tax. The corporate income tax rate is six percent of taxable income. The tax rates for trusts are in the Form 513 or 513NR instructions. Estates are not required to file an estimated tax return declaration. The tax for partnerships will be determined by reference to Form 514-PT and instructions.

1	Enter the estimated Oklahoma income tax* for the current year		00
2	Enter the income tax credits		00
3	Enter the estimated Oklahoma income tax liability (subtract line 2 from line 1)		00
4	A. Multiply line 3 by 70%	00	
	B. Enter the tax liability shown on the previous year's tax return	00	
	C. Enter the smaller of line 4a or 4b. NOTE: If line 3 is less than $500, estimated tax payments are not required		00
5	Estimated amount of withholding		00
6	Subtract line 5 from line 4c (Note: If less than zero, or line 3 minus line 5 is less than $500, estimated tax payments are not required.		00
7	Amount to be paid with each coupon (if paid quarterly, 25% of line 6)		00

*** If income is received unevenly throughout the year (e.g. operating a business on a seasonal basis), the estimated tax payment may be lowered for one or more periods by using the annualized income installment method as prescribed in the Internal Revenue Code and in the Oklahoma Tax Commission Rule 710:50-13-9. The annualization provisions found in Sections 6655(e)(2)(C) and 6655(e)(3) of the Internal Revenue Code may not be used. Computing estimated taxes on an annualized basis shall only be permitted for a taxable year of twelve months.**

Mandatory inclusion of Social Security and/or Federal Identification Numbers are required on forms filed with the Oklahoma Tax Commission pursuant to Title 68 of the Oklahoma Statutes and regulations thereunder, for identification purposes, and are deemed part of the confidential files and records of the Oklahoma Tax Commission.

The Oklahoma Tax Commission is not required to give actual notice of change in any state tax law.

Record of Estimated Tax Payments

Quarter	Date Paid	Amount
Applied from 2018 Tax Return		
1		
2		
3		
4		
	Total	

Use the coupon below for all four quarterly estimated tax payments.
The due dates are shown on page 2.

● Do not fold, staple, or paper clip **Detach Here and Return Coupon with Payment** ● Do not tear or cut below line

ITE OW-8-ESC **Oklahoma Corporate, Fiduciary and Partnership Estimated Tax Coupon** 05001

☐ Mailing Address Change
(Enter new mailing address below)

Name

Address

City State ZIP

Taxpayer FEIN	
Tax Year	2019
Quarter	
Due Date	

- - - - - - - - - - Dollars - - - - - - - - - - - - Cents - -

Amount of Payment: _____ . _____

Please remit only **one** check per coupon.

Mail this coupon, along with payment, to:
Oklahoma Tax Commission - Post Office Box 269027 - Oklahoma City, OK 73126-9027

Oklahoma Corporate, Fiduciary and Partnership Estimated Tax Declaration

General Instructions

Who Must Make a Declaration

A corporation or trust with an estimated income tax liability of $500 or more for the year is required to file a declaration and pay equal* quarterly estimated tax. Estates are not required to file an estimated tax declaration.

Estimated tax payments made on behalf of the nonresident partners electing to be included in the composite return must be made under the partnership's name and Federal Employer Identification Number.

* For purposes of determining the amount of tax due on any of the respective dates, taxpayers may compute the tax by placing taxable income on an annualized basis. See Oklahoma Tax Commission Rule 710:50-13-9.

When To File and Pay

A declaration of estimated tax should be filed and the first installment paid by April 15th for calendar year taxpayers. Fiscal year taxpayers should file and pay the first installment by the fifteenth day of the fourth month following the beginning of their taxable year. Other installments should be paid by the due dates shown below.

Interest for Underpayment

In general, underpayment of estimated tax interest is due if the tax liability is $500 or more **and** timely paid quarterly estimated tax payments are not at least 70% of the current year tax liability or 100% of the prior year tax liability. The tax liability is the tax due less all credits except amounts paid on withholding, estimated tax and extension payments. The amount of underpayment of estimated tax interest is computed at a rate of 20% per annum for the period of underpayment. **Note:** No underpayment of estimated tax interest shall be imposed if the tax shown on the return is less than $1,000. For additional information see 68 O.S. Sec. 2385.7-2385.13 or call the Tax Commission's Corporate Audit Section at (405) 521-3126.

How to Compute Estimated Tax

Trust tax rates are found in the Packet 513 or 513NR instructions. Corporate income tax is six percent of taxable income. The tax for partnerships will be determined by reference to Form 514-PT and instructions.

How to Complete Your Tax Declaration Coupon

Name and Address: Enter the name and mailing address.

- If the address has changed, place an 'X' where indicated in the upper left corner of the coupon.

Taxpayer FEIN: Enter the Federal identification number.

Quarter: Enter the quarter for this estimated payment.

Due Date: Enter the quarterly due date. See below for the due date for each quarter.

Amount of Payment: Enter the amount of estimated tax being paid with the estimated tax coupon.

Do not send coupon if no payment is required.

Additional Information

Make checks payable to: **Oklahoma Tax Commission.**
Do NOT send cash.

Mail the coupon, along with payment, to:

Oklahoma Tax Commission
Post Office Box 269027
Oklahoma City, OK 73126-9027

Do not enclose any other tax reports or correspondence in this envelope.

See below for electronic payment information.

The coupon on page 1 will be used for all quarterly estimated tax payments. The quarterly due dates are shown below.

Due Dates: **

- 1st Quarter
  (Calendar Year) April 15
  (Fiscal Year) Fifteenth day of the fourth month
- 2nd Quarter
  (Calendar Year) June 15
  (Fiscal Year) Fifteenth day of the sixth month
- 3rd Quarter
  (Calendar Year) September 15
  (Fiscal Year) Fifteenth day of the ninth month
- 4th Quarter
  (Calendar Year) January 15
  (Fiscal Year) Fifteenth day of the first month of the succeeding taxable year.

** If the due date falls on a weekend or legal holiday when the Oklahoma Tax Commission offices are closed, your payment is due the next business day.

Electronic Payment Options:

Electronic payments are accepted for estimated income tax payments at **www.tax.ok.gov**. There is a convenience fee charged for utilizing some of the electronic payment services.

Note: If you make your estimated tax payment electronically, do not mail this payment coupon. Please retain the confirmation number for your records.

Pass-Through Entity Tax Equity Act

Top of Page

1. What is the Pass–Through Entity Tax Equity Act of 2019?

For general information click here.

Top of Pass-Through Entity Tax Equity Act

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.

Top of Pass-Through Entity Tax Equity Act

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.

Top of Pass-Through Entity Tax Equity Act

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.

Top of Pass-Through Entity Tax Equity Act

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.

Top of Pass-Through Entity Tax Equity Act

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.

Top of Pass-Through Entity Tax Equity Act

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.

Top of Pass-Through Entity Tax Equity Act

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.

Top of Pass-Through Entity Tax Equity Act

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.

Top of Pass-Through Entity Tax Equity Act

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.

Top of Pass-Through Entity Tax Equity Act

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.

Top of Pass-Through Entity Tax Equity Act

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 on the PTE's ownership of the asset.

Top of Pass-Through Entity Tax Equity Act

Revenue Rulings

Rev. Rul. 71-278, 1971-2 CB 75, IRC Sec(s). 61

Headnote:

Rev. Rul. 71-278, 1971-2 CB 75 -- IRC Sec. 61 (Also Sections 164, 701; 1.164-1, 1.701-1.)

1

Reference(s): **Code Sec. 61; Reg § 1.61-1**

The Indiana gross income tax paid by a partnership is deductible from the partnership's gross income; such tax is not an allowable deduction to the individual partners; I.T. 3766 superseded.

Full Text:

The purpose of this Revenue Ruling is to update and restate, under the current statute and regulations, the position set forth in I.T. 3766, C.B. 1945, 83.

The question presented is whether the Indiana gross income tax paid by a partnership on account of the receipt by it of gross income is deductible from partnership gross income under section 164 of the Internal Revenue Code of 1954.

The Indiana gross income tax is levied upon the "receipt of gross income" of all persons residing or

domiciled in the State, upon the receipt of gross income derived from activities or business or any other source within the State, and upon the receipt of gross income by all persons who are not residents of the State who derive income from sources therein. See section 64-2602 of Burns' Indiana Statutes Annotated, and the decision of the United**<Page 76>** States Supreme Court in *J. D. Adams Manufacturing Co. v. Storen et al.,* 304 U.S. 307 (1938), where the Court upheld the constitutionality of the Indiana Gross Income Tax Act of 1933.

Partnerships are subject to the Indiana gross income tax, and if the tax imposed upon the receipt of gross income by the partnership has been paid by the partnership, such gross income is exempt from the tax when received by the individual members. For Federal income tax purposes, partnerships are not treated as taxable entities, but the members thereof are liable for tax in their individual capacities. Section 701 of the Internal Revenue Code. The taxable income of a partnership is computed, for Federal income tax purposes, in the same manner and on the same basis as in the case of an individual, with certain exceptions not material here. Thus, if a tax paid to a State by an individual is deductible under section 164 of the Code in computing the individual's taxable income, the same tax would be deductible in computing the taxable income of a partnership.

Accordingly, it is held that in computing the taxable income of a partnership and the distributable shares of the partners, the Indiana gross income tax paid by a partnership on account of the receipt by it of gross income is deductible from partnership gross income under section 164 of the Code. The partnership tax is not allowable as a deduction to the partners, but they are not precluded from claiming the optional standard deduction under section 141 of the Code.

I.T. 3766 is hereby superseded since the position therein is set forth under the current law in this Revenue Ruling.

1 ¶Prepared pursuant to Rev. Proc. 67-6, C.B. 1967-1, 576.

Revenue Rulings

Rev. Rul. 58-25, 1958-1 CB 95, IRC Sec(s). 164

Headnote:

Rev. Rul. 58-25, 1958-1 CB 95 -- IRC Sec. 164 (Also Section 141; 1.141-1.)

Reference(s): **Code Sec. 164; Reg § 1.164-1**

The tax imposed by the City of Cincinnati Ordinance No. 42-1954 constitutes an income tax and, where imposed upon and paid by an individual on the net profits of a business owned by him and conducted in Cincinnati, is not deductible in determining adjusted gross income, but is deductible in computing taxable income, provided that the taxpayer does not elect to claim the standard deduction. Furthermore, such tax imposed upon and paid by a partnership on the net profits of its business conducted in Cincinnati is deductible in determining taxable income of the partnership and the individual partners are not precluded from electing to claim the standard deduction. Such tax imposed upon a resident's share of the net profits of an unincorporated business not attributable to Cincinnati, and paid by such resident, is not deductible in computing adjusted gross income, but is deductible in determining taxable income, provided that the taxpayer does not elect to claim the standard deduction.

I. T. 3829, C. B. 1946-2, 38 and Revenue Ruling 54-598, C. B. 1954-2, 121, distinguished.

Full Text:

Advice has been requested whether the earned income tax, imposed by the City of Cincinnati Ordinance No. 42-1954 with respect to income during the period April 1, 1954, to October 31, 1954, both inclusive, is deductible as a business expense by unincorporated businesses, proprietorships and partnerships when the individual or partner elects to take the standard deduction on their individual Federal income tax returns.

Under section 2 of the City of Cincinnati Earned Income Tax Ordinance No. 42-1954, as far is applicable, a tax is levied at the rate of 1 percent upon the net profits of all unincorporated businesses, etc., as follows:

> On the net profits of all unincorporated businesses, professions, or other activities, on sales made, work done, and services performed, or businesses or other activities conducted in the City of Cincinnati, whether or not such unincorporated businesses, professions, or other activities have an office or place of business in the City of Cincinnati.
> On a resident's share of the net profits of an unincorporated business, profession, or other activity whether located in or outside the City of Cincinnati, not attributable to Cincinnati, under the formula or separate accounting method provided for herein.

Section 1 of the ordinance defines "net profits" as "the net gain from the operation of a business, profession, or enterprise after provision for all ordinary and necessary expenses paid or incurred in the conduct thereof, except taxes imposed by the Ordinance and the Federal taxes based on income." Section 1 also defines a "business" as "an enterprise, activity, profession, or undertaking of any nature conducted for profit or ordinarily conducted for profit, whether by an individual, copartnership, association, corporation, or any other entity."

Section 3 of Article II-C of the Earned Income Tax Regulations provides, "The tax imposed on unincorporated businesses owned by two or more persons is upon the entity rather than the individual members or owners thereof but the tax imposed on an unincorporated business owned by one person is upon the individual owner."

Section 1 of Article II-D of the Earned Income Tax Regulations provides, "In the case of a resident individual partner or part owner of an unincorporated business, profession or other activity, there is imposed a tax of one percent (1%) on such individual's distributive share of net profits earned during the period April 1, 1954, to October 31, 1954, both inclusive, and not attributable to Cincinnati under the formula or separate accounting method provided for in section 2 of the Ordinance and not taxed against the entity."

In general, as provided in sections 161 and 164(a) of the Internal Revenue Code of 1954, in computing taxable income under section 63(a) of the Code, there shall be allowed as a deduction taxes paid or accrued within the taxable year.

Section 141 of the Code provides that, in the case of an individual, the standard deduction referred

to in section 63(b) of the Code shall be an amount equal to 10 percent of the adjusted gross income, or $1,000, whichever is the lesser, except that in the case of a separate **<Page 97>** return by a married individual, the standard deduction shall not exceed $500. An individual may elect to take such deduction in lieu of all nonbusiness deductions, that is, deductions other than those allowable under section 62 of the Code, and in lieu of certain other credits allowable had he not so elected. See section 1.141-1(c) of the Income Tax Regulations.

Section 62 of the Code defines adjusted gross income in the case of an individual as gross income minus trade or business expenses, as well as minus certain other specified items.

Section 1.62-1(d) of the Income Tax Regulations, in defining adjusted gross income provides, in part:

***

To be deductible for the purpose of determining adjusted gross income, expenses must be those directly, and not those merely remotely, connected with the conduct of a trade or business. For example, taxes are deductible in arriving at adjusted gross income only if they constitute expenditures directly attributable to a trade or business or to property from which rents or royalties are derived. Thus, property taxes paid or incurred on real property used in a trade or business are deductible but State taxes on net income are not deductible even though the taxpayer's income is derived from the conduct of a trade or business.

A general income tax has been held not deductible in computing adjusted gross income. See, for example, I. T. 3370, C. B. 1940-1, 32, and I. T. 3722, C. B. 1945, 78, relating to the treatment of the income tax imposed by the City of Philadelphia. See also I. T. 3753, C. B. 1945, 82, relating to the treatment of the New York temporary emergency tax on net incomes of unincorporated businesses.

However, certain State taxes pertaining to income have been held deductible in computing adjusted gross income in the case of an individual taxpayer engaged in a trade or business. See, for example, I. T. 3766, C. B. 1945, 83, as modified by I. T. 3829, C. B. 1946-2, 38, which involve the Indiana gross income tax. It was further stated in these published rulings that such tax paid by a partnership is deductible under section 23(c) of the 1939 Code in computing partnership income. Section 22(n) of the 1939 Code was not applicable since in the case of a partnership, no provision was made for the computation of adjusted gross income.

Similar conclusions were reached with respect to an annual license fee imposed by the City of Louisville, Ky., upon every person, association, corporation, or other entity engaged in an occupation, trade, profession, or other activity for the privilege of engaging in such activity. See Revenue Ruling 54-598, C. B. 1954-2, 121, which holds that any such tax paid by a partnership is deductible from partnership gross income but that such deduction shall not preclude the partners from claiming the

standard deduction. It further holds that any such tax imposed upon the profits of a sole proprietorship is deductible in computing the taxpayer's adjusted gross income since it is directly attributable to a trade or business carried on by taxpayer.

The earned income tax in the instant case is distinguishable from the Indiana gross income tax (I. T. 3766 and I. T. 3829, *supra*) inasmuch as such tax as respects businesses is imposed upon the net profits thereof rather than gross receipts. Similarly, it is distinguishable from the tax involved in Revenue Ruling 54-598, *supra,* because in that ruling the tax imposed was a license fee for the privilege **<Page 98>** of doing business within the city. See *J. D. Adams Manufacturing Co. v. Storen et al,* 304 U. S. 307; *Howard et al. v. Commissioners of the Sinking Fund of the City of Louisville et al.,* 344 U. S. 624; *Cook et al. v. Commissioners of the Sinking Fund of the City of Louisville et al* (Ky.), 226 S. W. (2d) 328, and *City of Louisville et al. v. Sebree et al.* (Ky.), 214 S. W. (2d) 248.

In view of the above, the instant tax imposed by the City of Cincinnati constitutes an income tax within the meaning of section 1.62-1 of the Income Tax Regulations. Accordingly, it is held (1) that any such tax imposed upon and paid by an individual on the net profits of a business owned by him and conducted in Cincinnati is not deductible by him in computing adjusted gross income, but is deductible in computing taxable income, provided that the taxpayer does not elect to claim the standard deduction; (2) that any tax imposed upon and paid by a partnership on the net profits of its business conducted in Cincinnati is deductible in computing the taxable income of the partnership and the partners are not precluded from claiming the standard deduction; and (3) that the tax imposed upon a resident's share of the net profits of an unincorporated business not attributable to Cincinnati and paid by such resident is allowable as a deduction provided that the taxpayer does not elect to use the standard deduction, but the tax may not be deducted from gross income in determining adjusted gross income.

I. T. 3829, C. B. 1946-2, 38, and Revenue Ruling 54- 598, C. B. 1954-2, 121, are distinguished from the instant case.

News Analysis: Could the IRS Identify SALT Workarounds as Listed Transactions?

POSTED ON OCT. 29, 2018

By

AMY HAMILTON

The American Institute of CPAs has published an issue paper discussing the potential benefits and risks raised by state workarounds to the $10,000 cap on the state and local tax deduction, though at first glance, the title of the paper — State Pass-Through Entity-Level Tax Implementation Issues — doesn't give that away.

While Treasury and the IRS have racked up nearly 8,000 comments on proposed regulations (REG-112176-18) addressing charitable contributions and state tax credits, the AICPA's October 4 paper moves one step beyond to focus primarily on SALT cap workarounds modeled after Connecticut's entity-level tax on passthroughs and offsetting personal income tax credit for entity members.

The 15-page paper provides a jumping-off point for debate about several aspects of the entity-level state tax approach, including whether the combination of provisions would even function as a SALT cap workaround — more on that later in this article. Another proposition meriting a double take is mentioned almost in passing:

> It is possible that the IRS could name any reliance on such state law tax provision enacted to avoid the federal limitation on the deduction for state and local taxes as a "listed transaction" that will require the taxpayer to disclose such transactions on the federal income tax returns. Preparers of tax returns claiming such deductions may have independent tax preparer reporting obligations.

The IRS defines listed transactions in its regulations (1.6011-4) addressing when taxpayers are required to disclose their participation in any one of several categories of reportable tax arrangements as follows: “A listed transaction is a transaction that is the same as or substantially similar to one of the types of transactions that the Internal Revenue Service

(IRS) has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction."

Treasury and the IRS currently recognize 35 listed transactions, but include this note in the instructions on the Form 8886 disclosure statement: "The fact that a transaction must be reported on this form does not mean the tax benefits from the transaction will be disallowed."

"Number one: No one in the IRS has said that there's going to be a listed transaction. In the literature, nobody's said that yet, either," according to Steve Wlodychak of EY, who participated in the development of the AICPA issue paper. "We just wanted to put it out there as the outlier of what the IRS could do within the arsenal of the various tools it has," he said.

The attorneys general of New York, New Jersey, and Connecticut — the states most aggressively adopting SALT cap workarounds and bringing legal challenges against the federal government — all declined to comment on a Big 4 accounting firm adviser implying that their states might be operating as tax shelter promoters.

"I think the AICPA is right to raise this possibility," said Duke University law professor Lawrence A. Zelenak, who added in an email to *Tax Notes* that listed transactions are not synonymous with abusive tax shelters. "Although one tends to think of listed transactions as necessarily 'abusive,' the relevant regulation gives the IRS the authority to list any transaction it determines to be a 'tax avoidance transaction,'" he added. "The 'tax avoidance' label — although not exactly a badge of honor — doesn't necessarily imply that the strategy is abusive or that it doesn't work."

Zelenak highlighted the opening paragraph of 1.6011-4(a), which says, "The fact that a transaction is a reportable transaction shall not affect the legal determination of whether the taxpayer's treatment of the transaction is proper."

"So, this isn't really a case of anyone implying that states are promoting abusive shelters," Zelenak said. But the optics could still be problematic for states adopting SALT cap

workarounds, he said, because "the distinction between a tax avoidance transaction and an abusive shelter may be lost on the general public."

New Assertion

The AICPA issue paper says it's an open question whether entity-level taxes enacted by states as part of a SALT cap workaround would, in fact, be deductible by a passthrough at the federal level. That's a new assertion.

The very idea behind the strategy of imposing state tax at the entity level and providing a corresponding credit for the entity's members is to take advantage of the Tax Cuts and Jobs Act's preservation of the deduction for state and local taxes paid or accrued in carrying on a trade or business. Proponents argue that by shifting the incidence of the state tax from the owners to the entity, the passthrough would be held harmless for the entity-level state tax — this is because, in theory, the entity-level state tax would be fully deductible for the passthrough at the federal level. The entity's owners, meanwhile, would get around the $10,000 federal limit on the SALT deduction by virtue of the state credit for their pro rata share of tax paid by the entity.

For example, under Connecticut's new law, the state will impose a 6.99 percent tax on the net income of partnerships, limited liability companies, and S corporations. Owners will receive a credit against their state income tax liability at a rate of 93.01 percent of their distributive share of tax paid at the entity level. "It works, and we can't see any way that there's any credible argument the federal government could make — IRS or otherwise — to disallow this," then-Revenue Commissioner Kevin Sullivan said in February.

The AICPA issue paper suggests otherwise, however. "Deductibility of such [passthrough entity-level] taxes for federal income tax purposes remains an open issue and partners, members and shareholders of PTEs could face challenges from the IRS as to the deductibility of overall income passed through to them from the PTE," the paper says, later adding, "As of now, no state has provided for financial indemnification for any such challenge by the IRS."

"The IRS could apply a *quid pro quo* challenge to the PTE-level tax approach, similar to that which it has made in proposed regulations challenging the state tax credits for charitable contributions," according to the paper. "Further, some commentators have suggested that if the IRS continues to challenge approaches to address the limitations on the state tax deduction, IRS may consider challenging the economic substance or substance over form of a transaction."

Wlodychak cited a footnote in the TCJA conference report that he believes casts doubt on whether the IRS would respect a workaround structure involving entity-level taxes and state credits. The conference report describes how, pre-TCJA, the SALT deduction worked. Individuals, for example, were allowed the deduction for property taxes, "if incurred in connection with property used in a trade or business; otherwise they are an itemized deduction."

"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," the TCJA conference report says. That sentence is followed by footnote 168, which directs readers to a House Report accompanying a 1944 individual income tax bill.

"Now, the tax geek that I am, I went back to look at it," Wlodychak said.

The 1944 tax law simplified the individual income tax by creating the standard deduction and "the new concept 'Adjusted gross income.'" In describing how AGI is computed, the 1944 conference report said that deductions made from gross income in arriving at AGI typically are limited to certain business expenses and losses that are treated as losses from sales or exchanges of property.

"The connection contemplated in this statute is a direct one rather than a remote one," the 1944 report said. "For example, property taxes paid or incurred on real property used in the trade or business would be deductible, whereas State income taxes, though incurred as a result of business profits, would not be deductible."

Wlodychak said that, read carefully, the TCJA conference report — via its reference to the 1944 report — is connecting old principles of tax law to distinguish between a tax on a passthrough entity that is truly related to business, and a tax on a passthrough entity that is related to personal income. As Wlodychak sees it, the TCJA conference report is making the point that the IRS's long-standing position is that an income-based tax is outside the realm of the business activity of a passthrough entity. Such a distinction suggests that a tax related to the income of the owners would be included within the TCJA's $10,000 cap on the SALT deduction, Wlodychak said, adding that he believes Connecticut's entity-level tax arrangement as a workaround would thus be suspect.

"I don't see any difference between the quid pro quo approach as it applies here," Wlodychak said. "Keep in mind, we are in uncharted territory, because we have never had a limitation on the SALT deduction. I don't know how the courts are going to approach this from a taxability analysis. But it seems very clear that the Congress intended the limitation to apply at the entity level with respect to income earned by taxpayers."

Treasury Secretary Steven Mnuchin and House Ways and Means Committee Chair Kevin Brady, R-Texas, earlier this year publicly called the SALT cap workaround involving state credits and charitable contributions "ridiculous" and "a gimmick," respectively. Treasury and the IRS in May also indicated that they are monitoring other SALT cap workaround proposals to ensure that federal law controls the characterization of deductions for federal income tax purposes.

"All of these are ominous signals to me that the IRS is going to aggressively pursue any of these arrangements that are intended to get around the SALT deduction, and I advise clients to be cautious until we have clear guidance," Wlodychak said.

Tax Shelter Schemes?

According to Wlodychak, Zelenak's writing influenced the panels that developed the AICPA issue paper. Specifically, Zelenak this summer called the SALT cap workaround strategy involving credits against state taxes for contributions to government organizations a "tax

shelter scheme" that converts taxes subject to the $10,000 limit to charitable contributions.

"The conversion strategy is a kind of tax shelter, and tax shelters that appear to work under a hypertechnical analysis often fail under one or more antiabuse rules, including the judge-made substance-over-form doctrine and the closely related economic substance doctrine," Zelenak wrote. His article was prompted in part by a widely circulated research paper by eight law professors — the lead author is Joseph Bankman of Stanford Law School — that argues the legality of taxpayers claiming the federal charitable contribution deduction for donations for which they've also received a state tax credit.

Bankman and Darien Shanske of the University of California, Davis, one of the coauthors of the original research paper, responded one month later.

"It can be argued that the states are in the position of tax shelter promoters, and benefits to promoters are ignored in determining whether a transaction has substance under common law doctrines," Bankman and Shanske wrote. "The analogy is not quite right, though."

It's not just that the states are not the same as the corporate tax shelter industry, they wrote — among other things, the states are sovereign, act on behalf of their citizens, and are not subject to tax. According to Bankman and Shanske, the primary reason it was necessary to apply doctrines like substance over form to corporate tax shelters was because the arrangements could not be addressed through legislation. "The shelters were developed in secret and often took years to come to the attention of the IRS, and still longer before legislation could prospectively reduce their benefits," they wrote.

That is not the case with the states, Bankman and Shanske wrote. The SALT cap workarounds involving charitable donations and state tax credits are based on existing programs, "and new donation credit proposals have received enormous publicity."

"The credit proposals at issue, unlike conventional tax shelters, were motivated by concern for the body politic and have been accompanied by public debate and analysis," Bankman and Shanske wrote. "We simply do not know how a benefit to the state, and corresponding benefit to its citizens, does or should fit into the substance leg of common law doctrines."

Another Take

After Connecticut adopted its entity-level tax arrangement, Parity for Main Street Employers — a coalition of businesses organized as passthroughs — released model state legislation for the SALT cap workaround.

"According to the Joint Committee on Taxation, the tax hike from the loss of the SALT deduction is significantly bigger than the benefit of the 20-percent pass-through deduction," Chris Smith, the coalition's executive director, said in May.

According to the AICPA issue paper, officials in at least three more states — New York, New Jersey, and Arkansas — have since indicated that they're also interested in such an approach. Now might be a good time to clarify in an aside that most of the AICPA issue paper has nothing to do with the question of whether the SALT cap workaround is a shelter or should be a listed transaction. For example, the paper lists several potential benefits of entity-level tax proposals, including a simplified determination of nexus at the entity level, rather than at the individual owner level, which also would reduce compliance costs for multi-tiered entities.

"The AICPA does not take any position on these state tax proposals, either as a concept or on any of the specific legislative drafts that some states have recently released," the issue paper says in bold letters. Wlodychak, meanwhile, described the paper as a collection of thoughts about the state and local tax deduction that might help guide CPAs in state societies when such passthrough entity-level tax arrangements are proposed.

Brian Reardon, president of the S Corporation Association, praised the AICPA's analysis of the 13 states and localities that already impose some type of entity-level tax on

passthrough businesses. “Nobody’s arguing that those taxes wouldn’t be deductible under the new tax reform regime,” he said.

Also, Treasury and the IRS have never mentioned the entity-level state tax strategy in their commentary on proposed SALT cap workarounds, even though Connecticut has already passed a version. “I feel like if there were a strong position for them to take against this, they would’ve already been making efforts and noises,” Reardon said.

Superficially, there might be a resemblance between an arrangement involving an entity-level tax and a corresponding credit for the owners on their pro rata share of tax paid by the passthrough, and SALT workarounds involving credits in exchange for contributions to government charities, Reardon said. “But I think we’re on much surer ground. You’re taking a tax payment made by an individual and making it a payment by an entity instead — so, it’s still a tax payment, you’re just changing the incidence of the tax.”

Reardon added that the law is clear that if the tax is paid by the entity, it’s deductible; if the tax is paid by the owners, then it’s subject to the new $10,000 cap. He cited footnote 172 in the TCJA conference report, which says: “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.”

Reardon also cited the clarification issued by Treasury and the IRS shortly after the release of the proposed regs addressing state tax credits and charitable contributions. “The business expense deduction is available to any business taxpayer, regardless of whether it is doing business as a sole proprietor, partnership or corporation, as long as the payment qualifies as an ordinary and necessary business expense,” the clarification says. “Therefore, businesses generally can still deduct business-related payments in full as a business expense on their federal income tax return."

“That clarification, in my mind, strengthened the case that we have,” Reardon said. “We’re not trying to pretend that a tax is a charitable contribution. We’re simply saying that if the

new rule is that entity-level taxes are deductible and shareholder taxes are not, then states should look to impose these taxes at the entity level and make them deductible."

Reardon added that it's patently unfair that under the TCJA, C corporations can continue to deduct state and local taxes, but an S corporation cannot.

"There's no reasonable, underlying policy rationale for that," Reardon said. "Until we can fix this at the federal level, I think it's perfectly appropriate for states to address it on their own."

Section 11042

¶ 5016 Limitation on deduction for state and local, etc. taxes.

Code Sec. 164

Conference Report

Present Law

Individuals are permitted a deduction for certain taxes paid or accrued, whether or not incurred in a taxpayer's trade or business. These taxes are: (i) State and local real and foreign property taxes; **164** (ii) State and local personal property taxes; **165** (iii) State, local, and foreign income, war profits, and excess profits taxes. **166** At the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction for State and local income taxes. **167**

164 Sec. 164(a)(1) .

165 Sec. 164(a)(2) .

166 Sec. 164(a)(3) . A foreign tax credit, in lieu of a deduction, is allowable for foreign taxes if the taxpayer so elects.

167 Sec. 164(b)(5) .

Property taxes may be allowed as a deduction in computing adjusted gross income if incurred in connection with property used in a trade or business; otherwise they are an itemized deduction. 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. **168**

168 See H. Rep. No. 1365 to accompany Individual Income Tax Bill of 1944 (78th Cong., 2d. Sess.), reprinted at 19 C.B. 839 (1944).

Individuals also are permitted a deduction for Federal and State generation skipping transfer tax ("GST tax") imposed on certain income distributions that are included in the gross income of the distributee. 169

169 Sec. 164(a)(4) .

In determining a taxpayer's alternative minimum taxable income, no itemized deduction for property, income, or sales tax is allowed.

House Bill

Under the provision, in the case of an individual, as a general matter, State, local, and foreign property taxes and State and local sales taxes are allowed as a deduction only when paid or accrued in carrying on a trade or business, or an activity described in section 212 (relating to expenses for the production of income). 170 Thus, the provision allows only those deductions for State, local, and foreign property taxes, and sales taxes, that are presently deductible in computing income on an individual's Schedule C, Schedule E, or Schedule F on such individual's tax return. Thus, for instance, in the case of property taxes, an individual may deduct such items only if these taxes were imposed on business assets (such as residential rental property).

170 The proposal does not modify the deductibility of GST tax imposed on certain income distributions. 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.

The provision contains an exception to the above-stated rule in the case of real property taxes. Under this exception, an individual may claim an itemized deduction of up to $10,000 ($5,000 for married taxpayer filing a separate return) for property taxes paid or accrued in the taxable year, in addition to any property taxes deducted in carrying on a trade or business or an activity described in section 212. Foreign real property taxes may not be deducted under this exception.

Under the provision, in the case of an individual, State and local income, war profits, and excess profits taxes are not allowable as a deduction.

It is intended that persons required to report refunds of State and local income taxes under section 6050E should no longer be required to report such refunds of tax relating to taxable years beginning after December 31, 2017. A technical amendment may be needed to reflect this intent.

Effective date

The provision is effective for taxable years beginning after December 31, 2017.

Senate Amendment

The Senate amendment follows the House bill. However, under the Senate amendment, the suspension of the deduction for State and local taxes expires for taxable years beginning after December 31, 2025.

Effective date

The provision is effective for taxable years beginning after December 31, 2017.

Conference Agreement

The conference agreement provides that in the case of an individual, **171** as a general matter, State, local, and foreign property taxes and State and local sales taxes are allowed as a deduction only when paid or accrued in carrying on a trade or business, or an activity described in section 212 (relating to expenses for the production of income). **172** Thus, the provision allows only those deductions for State, local, and foreign property taxes, and sales taxes, that are presently deductible in computing income on an individual's Schedule C, Schedule E, or Schedule F on such individual's tax return. Thus, for instance, in the case of property taxes, an individual may deduct such items only if these taxes were imposed on business assets (such as residential rental property).

171 See **sec. 641(b)** regarding the computation of taxable income of an estate or trust in the same manner as an individual.

172 The proposal does not modify the deductibility of GST tax imposed on certain income distributions. 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.

Under the provision, in the case of an individual, State and local income, war profits, and excess profits taxes are not allowable as a deduction.

The provision contains an exception to the above-stated rule. Under the provision a taxpayer may claim an itemized deduction of up to $10,000 ($5,000 for married taxpayer filing a separate return) for the aggregate of (i) State and local property taxes not paid or accrued in carrying on a trade or business, or an activity described in section 212, and (ii) State and local income, war profits, and excess profits taxes (or sales taxes in lieu of income, etc. taxes) paid or accrued in the taxable year. Foreign real property

taxes may not be deducted under this exception.

The above rules apply to taxable years beginning after December 31, 2017, and beginning before January 1, 2026.

The conference agreement also provides that, in the case of an amount paid in a taxable year beginning before January 1, 2018, with respect to a State or local income tax imposed for a taxable year beginning after December 31, 2017, the payment shall be treated as paid on the last day of the taxable year for which such tax is so imposed for purposes of applying the provision limiting the dollar amount of the deduction. Thus, under the provision, an individual may not claim an itemized deduction in 2017 on a pre-payment of income tax for a future taxable year in order to avoid the dollar limitation applicable for taxable years beginning after 2017.

Effective date

The provision is effective for taxable years beginning after December 31, 2016.

Approved August 2014

Code of Ethics and Rules of Professional Conduct

Code of Ethics

1. Members and associates will, in personal and public life, strive to enhance the status of enrolled agents (EA) and promote their qualifications to serve the public.
2. Members and associates will demonstrate honesty, integrity, and objectivity in all their professional actions and relationships.
3. Members and associates will continually strive to improve upon their competence to practice by keeping informed and educated about tax practice and representation.
4. Members and associates will maintain the confidentiality of professional relationships.
5. Members and associates will support efforts to advance the reputation and prestige of the EA license.
6. Members and associates will comply with the most current provisions of Treasury Department Circular 230 and the NAEA Code of Ethics and Rules of Professional Conduct.
7. Members and associates will not knowingly misrepresent or omit information when preparing or approving and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service (IRS) matters. If a client insists on the misrepresentation or omission, the Member or Associate should withdraw and refuse to prepare the return or other documents.

Rules of Professional Conduct

1. Members and associates will adhere to all laws and regulations that provide equal opportunity for all clients and employees regardless of race, color, religion, gender, national origin, age, handicap, sexual orientation, or any other legally protected class.
2. Members and associates will maintain a confidential relationship between themselves and their clients or former clients, disclosing confidential information only when authorized or legally obligated to do so. Members and associates will instruct employees that information acquired in their duties is confidential and will ensure that confidentiality is maintained.
3. Members and associates will promptly submit requested information to the IRS and will not interfere with lawful efforts by the IRS to obtain any record or information, unless the member or associate believes, in good faith and on reasonable grounds, that the information is privileged.
4. Only members may designate themselves “Member(s) of the National Association of Enrolled Agents.” Only associates may designate themselves as “Associate(s) of the National Association of Enrolled Agents.”
5. Members and associates will not represent conflicting interests without express written consent of all parties after full disclosure.

6. Members and associates will not allow their related business interests to affect representation of a client and must immediately disclose their interests when referring a client to another firm or enterprise for services.
7. Members and associates will refuse any gift, favor, or hospitality that would influence or appear to influence their actions.
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.
9. Members and associates will not knowingly, directly or indirectly, professionally associate with an individual who has been suspended or disbarred.
10. Members and associates will avoid any appearance of impropriety when paying or accepting a commission to obtain a client, or to refer products or services.
11. Members and associates who are engaged simultaneously in another occupation will conduct themselves in such a manner that no conflict of interest exists when rendering professional tax service or professional advice. No member or associate will accept or pay a commission for the sale or referral of products or services to a client unless they are properly licensed and all facts are fully disclosed in writing to the client. No member or associate will pay a commission or referral fee to an employee for the sale or referral of products or services to a client unless the employee is properly licensed and the facts are fully disclosed in writing to the client.
12. Members and associates will not solicit clients in any manner prohibited by the most current provisions of Circular 230, including advertising or other forms of solicitation that present a false, misleading, or deceptive appearance.
13. Members and associates will undertake only those tax matters which the member or associate, or the member's or associate's firm, can reasonably expect to complete with professional competence. Members and associates will obtain sufficient relevant data to provide a reasonable basis for conclusions or recommendations as required to complete the task.
14. Members and associates should be considerate and courteous in dealing with representatives of governmental agencies. In practice, members and associates are required to provide all information required by a statute or regulations when formally requested by the authorized governmental agency.
15. Members and associates will not suggest or give the impression they can obtain special consideration from governmental agencies or their representatives because of prior IRS employment.
16. Members and associates will advise a client, preferably in writing, if they suspect the client may not have complied with the revenue laws or may have made an error in, or omission from, a return, document, affidavit, or other paper the client is required by law to execute.

17. Members and associates will not represent a client, or will withdraw from client representation that has commenced, if:

    a. The representation will result in the violation of the rules of professional conduct or the law,
    b. The member's or associate's physical or mental condition materially impairs his/her ability to represent the client,
    c. The client persists in a course of action involving the member's or associate's services that the member or associate believes is criminal or fraudulent,
    d. The client has used the member's or associate's services to perpetrate a crime or fraud, or
    e. The member or associate is discharged.
18. Members and associates may withdraw from representing a client if:
    a. The client insists on pursuing an objective that the member or associate considers imprudent,
    b. The client fails substantially to fulfill an obligation to the member or associate regarding the member's or associate's services and has been given reasonable warning that the member or associate will withdraw unless the obligation is fulfilled,
    c. The representation will result in an unreasonable financial burden on the member or associate,
    d. The representation has been rendered unreasonably difficult by the client, or
    e. Other good cause for withdrawal exists.
19. If representation is terminated, a member or associate will take reasonable steps to protect the former client's interests including providing reasonable notice to allow retention of another practitioner, surrendering papers and property to which the client is entitled, and refunding unearned advance fees.
20. Members and associates will return to the client or former client all records or other data the client provided.
21. Tax preparation or representation services will be offered as authorized by the most current provisions of Circular 230.

APPENDIX A

I. GENERAL

The Association is obligated to prescribe and enforce standards for its members and associates. Complaint procedures are outlined in Section III. Investigations and hearings may be held to determine if members and associates adhered to these standards. The respondent may resign at any stage of proceedings discussed below but NAEA has no obligation to suggest or accept such resignation.

II. DEFINITIONS

A. Censure: The mildest form of discipline, this action is a warning or reprimand.

B. Preponderance of Evidence: This is evidence that is more likely true than not.

C. Complaint: A written statement that must contain a clear and concise statement of facts that a member or associate (now referred to as respondent respondent) violated the ethical standards set forth by this Association. The complaint must include pertinent dates of the alleged unethical practice and be signed by the complainant(s), who may or may not be a member or associate of the Association.

D. Conflict of Interest: A conflict of interest arises when any person involved in a disciplinary proceeding (other than the complainant or respondent respondent) has competing professional or personal interests. Such competing interests can make it difficult to fulfill the disciplinary duties impartially. A conflict of interest exists even if no unethical or improper act results from it and can create an appearance of impropriety that can undermine confidence in the process. Any conflict of interest will not deprive a party or witness the opportunity to be heard, but the conflict may be considered when evaluating the evidence.

E. Expulsion: This includes loss of NAEA member or associate rights and privileges. Should proceedings result in expulsion, NAEA may disclose only that a person is no longer a member or associate.

F. Fraud: This is a deliberate misrepresentation, by words or conduct that causes another person to suffer damages, usually monetary damages. Fraud can also be committed by false or misleading allegations or by concealing something that should be disclosed.

G. Suspension: This is an intermediate form of discipline between censure and expulsion. A person who is suspended loses all rights and privileges of membership or association with NAEA for the period of suspension.

H. Continuing Education (CE): Instruction that meets the IRS requirement for Ethics education.

III. COMPLAINT PROCEDURES

A. Initial Handling and Review

1. The Association's executive vice president (EVP) receives all initial complaints. If a complaint is first received by a state affiliate's leadership or Ethics Committee, the complaint must be forwarded within ten (10) days to the NAEA EVP. The complaints will be reviewed for required information described in II. C. above. The EVP will acknowledge receipt of the complaint to the complainant within thirty (30) days. A complete log or diary must be maintained by the chair of the Ethics & Professional Conduct Committee (E&PC). This log is open for inspection by E&PC Committee members and the NAEA EVP or NAEA's president upon written request.

2. Every complaint will be reviewed and evaluated by the E&PC chair. The chair and/or the E&PC Committee are not obligated to act on every

complaint received. The chair will report disposition of all complaints to the NAEA EVP.

3. The NAEA E&PC Committee chair will refer the complaint to the president of the relevant state affiliate. At any time the state affiliate can request that the NAEA E&PC Committee process the complaint.
4. If the respondent is an officer or director of the National Association of Enrolled Agents, the NAEA E&PC Committee alone will process the complaint.
5. If the respondent is an associate with no state affiliation, the NAEA E&PC Committee alone will process the complaint.

B. Investigation

1. The state affiliate president or the NAEA E&PC Committee chair will notify the respondent in writing within thirty (30) days of receiving the complaint. The notice will advise the nature of the charge, the allegations supporting the charge, and will advise the respondent of his/her rights under the disciplinary procedure. The notice will request a response within thirty (30) days.
2. The state affiliate president or NAEA E&PC chair will appoint one NAEA member to investigate the charge. The investigating member will report to the president or chair with a recommendation within sixty (60) days.

C. Hearing

1. Upon receipt of the investigative file, the state affiliate E&PC Committee or NAEA E&PC Committee will notify the respondent the investigation is complete and offer a hearing before the NAEA E&PC Committee. The respondent must request a hearing within ten (10) days.
2. If the respondent declines a hearing, or if the respondent fails to reply within ten (10) days, the committee will issue findings of fact and a recommended decision as described in Section III.
3. If the respondent requests a hearing, advance notice of the date, time, and place of the hearing will be provided at least thirty (30) days before the hearing.
4. Only members of the state affiliate E&PC Committee or the NAEA E&PC Committee will hear the matter. A Hearing Committee, consisting of at least three members, will select a chair to preside at the hearing. The hearing can be transferred to the NAEA E&PC Committee upon written request within fifteen (15) days of receipt of the respondent's hearing request if the affiliate E&PC Committee is unable or unwilling to conduct the hearing. Hearing attendance is restricted to Hearing Committee members, the respondent, the respondent's counsel (if applicable), the state affiliate or national counsel (if applicable), and a transcriber. Other persons may be allowed to attend only by agreement with the E&PC Committee and the respondent. Witnesses, including the complainant, will not be allowed to attend any part of the hearing in which they are not

directly involved. Evidence will be considered informally and hearsay evidence will be heard, but the Hearing Committee chair will exclude irrelevant or unduly repetitive testimony. The Hearing Committee chair may restrict speakers' time if restrictions are stated in advance of the hearing opening.

5. The respondent will have the right to appear before the Hearing Committee in person, to be represented by counsel, to present witnesses, to make an opening statement, to examine and rebut unfavorable evidence, and to make a closing argument.
6. The hearing will be recorded using a tape recorder or other recording device. The verbatim transcription will be made by a person who is not a member or associate of NAEA. All documents accepted by the Hearing Committee chair will be made an official part of the hearing record.
7. The Hearing Committee will deliberate in executive session with no non-committee member present including the transcriber or any party to the hearing
8. All rulings and decisions of the Hearing Committee chair that concern these proceedings will be final and binding.

IV. FINDINGS AND RECOMMENDATIONS

A. Findings

1. The only disciplinary actions that can be recommended are: dismissal, censure, suspension, or expulsion.
2. When making a recommendation the E&PC Committee should consider all facts and circumstances it deems relevant, including but not limited to the following (where applicable):
    a. The extent of the seriousness of the offense, including whether it was intentional fraud, negligent misrepresentation, or an innocent mistake.
    b. Whether this is the first offense or complaint. If it is not the first complaint, the E&PC Committee will also consider the date of the last offense and the nature of that offense.
    c. Whether, and to what extent, others were harmed by the actions, including monetary loss or if there is physical injury, harm to reputation, loss of income, etc.
    d. Whether the respondent may be subject to other liability or punishment.
    e. Whether, and to what extent, the respondent has been responsive to and cooperative with the investigation and hearing.
    f. Whether, and to what extent, the respondent made restitution to complainant(s).

g. Whether, and to what extent, the respondent has been subject to previous discipline by NAEA (or a state affiliate).

h. Previous handlings of similar cases.

i. Whether there are any mitigating circumstances.

B. Dismissal

1. After initial review of the complaint as set forth in III.A.2 above, the NAEA E&PC Committee chair may dismiss a complaint after consulting with legal counsel or whomever is deemed appropriate.

2. For purposes of illustration only and not intended to be a complete or exhaustive list, a complaint may be dismissed for the following reasons:

   a. Failure to state a claim on which relief can be granted.

   b. Basing a complaint on matters which are already covered by another authority, jurisdiction, or regulated by law.

   c. Knowledge that the same acts or omissions alleged in the complaint are already the subject of another body's investigation, discipline, or prosecution.

   d. Failure to allege a violation with specificity and/or with sufficient facts, evidence, or detail to support the charge.

   e. Failure to comply with the requirements for a proper complaint, including complainant's identity and signature.

   f. Legal counsel advises no further action should be taken on the complaint.

3. A complaint may be deferred pending the action of another authority or jurisdiction the respondent is subject to.

4. At any time during the investigative process, the state affiliate president or NAEA E&PC Committee chair may dismiss the complaint if the chair believes it is appropriate to do so under the same reasons given in IV.B.2. above.

5. In the event the chair of the NAEA E&PC Committee or the state affiliate president dismisses the complaint, the NAEA E&PC Committee chair will notify the complainant of such decision. Unless legal counsel recommends dismissal of the complaint, the complainant will be notified that the decision to dismiss may be appealed to the president of the Association, who after consulting with the E&PC Committee chair may sustain or overrule the decision.

6. If the E& PC Committee decides to dismiss the complaint, the decision is final. Notification of the complaint's dismissal will be mailed to the state affiliate president, the respondent, the complainant and the NAEA EVP within ten (10) days.

C. Continuing Education

1. In the event of any finding of a breach in Ethics and Professional Conduct by a member, a remedy for the offense will be two additional hours, annually, of ethics CE. The CE requirement will be for a three year period, beginning after the board determination of violation for the offense.
2. This CE will be in addition to the IRS requirement of two hours of ethics CE annually.
3. This requirement will be in addition to possible censure or suspension
4. The EVP shall review the member's adherence to this requirement and in the event the additional CE responsibility is not met, the EVP will recommend expulsion to the board.

D. Censure

1. If the E&PC Committee recommends censure, a copy of the finding of fact and recommendation will be mailed to the respondent within fifteen (15) days.
2. A censure must be in writing and clearly outline the consequences in the event of a recurrence of the conduct.

E. Suspension or Expulsion

1. If the E&PC Committee recommends suspension or expulsion, a copy of its finding of fact and recommendation will be mailed to the respondent at least fifteen (15) days prior to the effective date of suspension or expulsion.
2. Upon receipt of a state affiliate's or NAEA E&PC Committee's findings and recommendation for suspension or expulsion of a member or associate, the NAEA President will call a meeting of the NAEA Board of Directors unless a regularly scheduled meeting is to be held within ninety (90) days to review the state affiliate's or NAEA E&PC Committee's findings and recommendation. Excluded from this review will be all officers and directors from the state affiliate who participated in processing the case at the state level. The respondent may be heard at this session, if so desired. All disciplinary action hearings will be held in closed executive session.
3. The NAEA Board, upon reviewing the investigative file and recommendation, will confirm, modify, or dismiss the recommendation of the state affiliate or NAEA E&PC Committee. In reviewing the findings and recommendation, the NAEA Board of Directors will consider the facts and circumstances as identified in Section III. A. 2. above. The decision of the NAEA Board is the final appeal of a decision to suspend or expel a member or associate.
4. Suspension or expulsion will be done in good faith and in a fair and reasonable manner. A procedure is deemed fair and reasonable when it is

carried out according to the California Corporate Code for Nonprofits Section 5340-5342 and:

a. It is done according to the NAEA bylaws.

b. The respondent is given notice of the suspension and the reasons for the action at least fifteen (15) days before the suspension or expulsion takes place.

c. The respondent has an opportunity to be heard by a body or person authorized to reverse the proposed suspension or expulsion. The opportunity to be heard can be orally or in writing and must occur not less than five days before the effective date of the suspension or expulsion.

V. ADMINISTRATIVE DEMANDS

A. Documents sent to the complainant or respondent as required by this Code must be mailed by USPS or sent by a private delivery service that provides confirmation of delivery.

B. No postponements or delays will be granted in the processing of a case unless unusual circumstances arise.

C. Any inspection or receipt of tax return information as a part of these procedures will be in accordance with existing laws, rules, and regulations.

D. Confidentiality will be established and maintained throughout the processing of a complaint.

E. The investigative file, including the hearing record, findings of fact, and recommendation, will be mailed to the state affiliate president and the NAEA EVP within fifteen (15) days of the hearing. If no hearing is held, the investigative file will be mailed within thirty (30) days of the investigation's completion. All duplicate records will be destroyed.

F. Records of all proceedings under this Code will be sealed and retained at the NAEA national office and state affiliate headquarters for five (5) years from the date of the final decision of the highest body to hear the matter. If no state affiliate headquarters exist, the NAEA national office will serve as custodian. If no legal action has been instituted for reinstatement within that time, all records will be destroyed by the EVP. No records will be destroyed while any legal action is pending.

G. In the event of a conflict of interest or bias among any person serving in any capacity in a proceeding, that person will recuse him/herself from participation.

H. No E&PC Committee member or state affiliate E&PC committee member will be compensated for their time in this service. The respective convening authority will be responsible for charges incurred during conduct of its business. NAEA will reimburse NAEA E&PC Committee members for travel, lodging, and mailing in accordance with NAEA policies and procedures. The state affiliate will reimburse its E&PC Committee members in accordance with its own standing rules and procedures.

I. Any state affiliate board of directors that wishes to have a standing committee for ethics and professional conduct must adopt the NAEA Code of Ethics and Rules of Professional Conduct or ethics and professional conduct rules that are at least as comprehensive as NAEA's, and "fair and reasonable" procedures. This "fair and reasonable" criterion requires the code, rules and procedures to be either set forth in the state affiliate bylaws, adopted by reference in the state affiliate bylaws, or sent annually to all members or associates within the state affiliate.

LEVELS OF CONFIDENCE FOR TAX RETURN POSITIONS

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	Disregard of regs.	Tax shelter	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 at the time 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. 1.6662-4(d)(3)(ii). *[Regs. Sec. 1.6664-4(f)(2)(B)]*	✓	✓	△	✓ [3]	✓	✓
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. 1.6662-4(d)]*	✓	✓	△	⊘ [3]	✓	△ [4]
Realistic Possibility of Success (at least 33%): 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. *[AICPA SSTS No. 1]*	✓	△	△	⊘	△	⊘
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.1.6662-3(b)(3); Joint Committee on Taxation Interest and Penalty Study (JCS-3-99)]*	✓	△	△	⊘	△	⊘
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. 1.6662-4(d)(3)(iii) and AICPA U.S. Federal Tax Law Hierarchy Quick Reference Chart.
2. In rendering tax advice for a return position, it's advisable to use the terminology in the Code and regulations to describe the level of confidence. Exercise care in using terms "should" or "will" because a client may misinterpret the 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 Notice 2009-5, Sec. 6694, and Sec. 6707A.

REVIEWED MAY 12, 2017

STATE PASS-THROUGH ENTITY-LEVEL TAX IMPLEMENTATION ISSUES

BACKGROUND

One of the provisions of the 2017 federal tax reform (Pub. Law No. 115-97, commonly referred to as the *Tax Cuts and Jobs Act* (TCJA)) was a limit on the amount of state and local taxes an individual can deduct for regular federal income tax purposes. Congress amended section 164 by imposing a $10,000 limit for most individuals and married couples filing a joint return and a $5,000 limit on married individuals filing separately.[1] There were no changes to the provision in section 164 that allows for the deduction for taxes paid in connection with a trade or business that are imposed on the business directly.[2] There were also no additional limitations placed on the deductibility of charitable contributions under section 170, but section 170 was expanded.[3]

The TCJA legislative history,[4] as well as comments made by federal tax officials, indicate that the deduction for state and local income taxes paid by corporations was retained, but no similar deduction was retained for entities other than C corporations. The individual owners of pass-through entities (PTEs) report their proportionate share of business income on their individual income tax returns and are subject to the $10,000/$5,000 annual limit of section 164(b) for state and local income taxes paid. PTEs include entities taxed under subchapters K and S of the Internal Revenue Code. These PTEs include S-corporations, partnerships, limited partnerships, limited liability partnerships (LLPs), and limited liability companies (LLCs).

ISSUE

In response to these new federal limitations, many state tax policy makers are proposing, and several state legislatures have enacted, various approaches to assist their taxpayers in mitigating this new limitation on the federal income tax deduction for state and local taxes.

One state legislative approach that several states have proposed, and one state already has enacted, is intended to **shift the tax on PTE income from the owner to the PTE**. Such an approach, its proponents believe, would allow the PTE to deduct the entity's state and local income taxes as a

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[1] All section references in this document are to the Internal Revenue Code of 1986, as amended, (IRC) or the Treasury regulations promulgated thereunder, unless otherwise specified.
[2] TCJA, Sec. 11042(a) (amending IRC section 164(b).
[3] TCJA, Sec. 11023 increased the adjusted gross income (AGI) limitation for individual donors' cash contributions to operating charities from 50 percent to 60 percent. In addition, the Pease limitation, which phased out as much as 80 percent of the benefits of charitable and other itemized deductions for higher income taxpayers, was repealed. These changes will sunset after 2025.
[4] See section 164(a) ("…In addition, there shall be allowed as a deduction State and local, and foreign, taxes not described in the preceding sentence [which lists the various taxes for which a deduction under section 164 is permitted] which are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for production of income)"). See e.g., House Rpt. 115-466, *Tax Cuts and Jobs Act: Conference Report to Accompany H.R. 1*, pg. 259 to 261.

tax on the business at the federal level, followed by a deduction for the PTE tax in the distributive share of the PTE owners' income. These state proposals also would provide that the owner is permitted to claim a credit on the owner's state income tax return for the amount of the owner's distributive share of the taxes paid by the PTE.

A PTE state-level tax was recently enacted in Connecticut,[5] and other states are considering similar proposals. As states consider enacting PTE-level taxes, states and state CPA societies should consider various perspectives and implementation issues regarding this approach.

The multitude of methodologies that states employ to impose tax on income and capital, the potential lack of guidance from state authorities, and the variety of taxpayer-specific fact patterns will likely result in added compliance complexities. In addition, it is uncertain whether federal tax officials will respect or challenge these approaches.

IMPORTANCE TO CPAs

Given the number of PTEs and the novelty of the recently enacted federal limitations on the deductibility of state and local taxes for PTE owners, we anticipate some states will consider enacting an entity-level tax with a corresponding credit to the PTE owners. PTE-level taxes will have broad federal and state tax consequences. CPAs regularly assist PTEs and their owners with tax compliance and planning, and interact with state tax authorities on their behalf. In addition, many CPA firms are formed as PTEs.

CPAs are interested in working with state tax authorities and legislatures as they consider possible entity-level taxes on PTEs. Entity-level taxes have implications regarding both state tax revenues and state taxpayers, including PTEs and individual taxpayers.

RECENT STATE ACTIVITY

On May 31, 2018, the Governor of Connecticut signed into law Public Act 18-49 (Act) that contains a PTE-level tax. The Act imposes a 6.99% entity-level income tax on most PTEs in Connecticut. Owners of PTEs are entitled to a credit against their Connecticut personal income tax equal to 93.01% of the PTE owner's pro rata share of the PTE-level tax paid by their PTE. The state law grants a Connecticut resident owner of a PTE with a credit for any entity-level tax imposed by other states that the Connecticut Department of Revenue Services (CDRS) determines is similar to the Connecticut PTE-level tax.

The Act also provides that PTEs subject to the Connecticut PTE-level tax are required to make quarterly estimated tax payments. On June 6, 2018, the CDRS issued guidance regarding the Connecticut PTE-level tax and the estimated payment requirements thereunder.[6] In addition,

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[5] See *Entity-Level Income Taxes on Pass-Through Businesses*, Connecticut General Assembly, Office of Legislative Research, Heather Poole, Associate Analyst, 2018-R-0090, March 8, 2018.

[6] SN 2018-4, issued June 6, 2018, provides guidance on estimate payment installments. Any owner and PTE may re-characterize their individual estimated payments to apply against the 2018 PTE estimated tax requirement.

CDRS issued additional guidance in OCG-6 (June 19, 2018) and OCG-7 (August 21, 2018).[7] The Act and the Connecticut PTE-level tax is applicable for taxable years beginning on or after January 1, 2018. Under the Connecticut PTE-level tax, however, the PTE may elect to carve out the pro rata share of PTE income allocated to corporate owners from the calculation of the Connecticut PTE-level tax. The Act does not affect the taxation of publicly-traded partnerships, sole proprietorships, or single-member limited liability companies (SMLLCs) that are treated as disregarded entities for federal income tax purposes.

Other states, such as New York, New Jersey and Arkansas, have announced that they are considering whether to enact their own PTE-level tax similar to Connecticut's. Specifically, the New York Department of Taxation and Finance released its own draft of a proposed Unincorporated Business Tax (UBT), which, similar to the Connecticut tax, would provide a credit for PTE owners against their corresponding New York state personal income tax liabilities.[8]

AICPA POSITION

The AICPA encourages state CPA societies to advocate for fair, reasonable, and administrable tax rules that minimize the complexities and burdens to taxpayers and state tax authorities alike.

The AICPA does not take any position on these state tax proposals, either as a concept or on any of the specific legislative drafts that some states have recently released.

To assist state CPA societies, the AICPA identified the following list of issues for consideration in evaluating any proposed state PTE-level tax.[9] This list is not intended to support or oppose any proposal, but to provide a guide for discussion of any such proposal. Each state CPA society will need to make its own determination on whether such a regime will represent an overall benefit or detriment to their members, their members' clients, and the state's taxpayers in general. Each state CPA society should also consider whether such a regime represents overall good tax policy.

The AICPA does not express any opinion on the relative importance of the items identified below nor is the order in which the issues are listed below any indication of the AICPA's view of the significance of these issues.

[7] The guidance addresses various details, including the calculations for: how a PTE distributes and reports the credit to owners, what happens if the credit exceeds an owner's tax liability, how tiered PTEs report and distribute the credit, how combined groups of corporations that own a PTE can distribute the credit, how trusts report and distribute the credit, and whether nonresident individuals who receive a credit must otherwise file a Connecticut personal income tax return.

[8] See the New York Department of Taxation and Finance discussion draft and summary for a state PTE level tax.

[9] In addition to the AICPA State Pass-Through Entity-Level Tax Task Force, the AICPA State and Local Tax, Partnership, and S Corporation Tax Technical Resource Panels, as well as the AICPA Tax Executive Committee approved this paper.

Potential Benefits

Simplified Nexus for All PTEs, Including Multi-Tiered Entities, Which will Also Have Reduced Administrative Burdens

1. Determination of nexus is simplified by requiring testing solely at the PTE–level (and not at the individual owner level).

2. Compliance costs for multi-tiered PTEs are reduced because state income tax nexus is limited to the entity level, and nexus determinations do not apply at upper tiers of a multi-tiered PTE (i.e., including hedge funds).

3. Administrative burdens are reduced because multiple tiers will not have a requirement for state purposes to separately calculate combined apportionment factors at each tier of a multiple tier PTE structure.

Other Administrative Simplification and Burden Reduction

4. Elimination of composite returns and filing requirements for non-resident owners of PTEs provides administrative simplification.

5. Administrative simplification for corporate partners and other partnership owners of a PTE is promoted if there is no requirement for upper-tiered owners to file state tax returns.

6. A PTE-level tax could reduce the administrative burden on states as the states may not have to expend resources to collect from non-residents with state source income (and can thus focus their collection efforts only on the PTE).

7. There is the possibility that non-residents with income from multiple PTEs would no longer need to file a separate individual income tax return in the non-resident state that has a PTE-level tax.

Potential Challenges and Complexities

Double Taxation Potential and Individual Level State Credits for Taxes Paid

1. PTE-level taxes present a potential for double taxation or an unintended increase in individual income taxes. States may levy a second layer of income tax if all the individual-level state income tax credits are not equal to all of the entity-level state income tax paid. To avoid double taxation, all states would need to provide a full credit to their residents for all states' PTE-level taxes.

    a. Each state may or may not provide a full credit against the owner's resident state income tax for the owner's share of PTE-level taxes paid in a non-resident state.

        i. The state may or may not provide a PTE owner-level credit that is fully refundable.

ii. If the credit is not fully refundable, the state may or may not allow a carryforward of the balance of the credit, or the taxpayer might not have the ability to utilize a carryforward.

b. The individual-level tax credit treatment is relevant to both residents and non-residents and may involve both the Commerce Clause and Due Process Clause of the U.S. Constitution as well as potential state constitution or statutory counterparts.

i. Regarding resident owners, the state imposing the entity-level tax will need to permit its residents to apply credit for income taxes paid to another state by the entity. It is possible that resident owners may not continue to claim a credit for taxes paid to other states. Because a resident individual is not personally paying the PTE-level tax (and residents receive a credit from the resident state to offset the PTE-level tax), it is possible that residents may lose their credits for taxes paid to other states.

ii. Regarding non-resident owners, other states will need to determine whether, and how, they will permit their residents to receive credit for the non-resident PTE-level tax imposed on pass-through income in another state.[10] A possible result is different treatment for non-residents in different states, involving the U.S. Constitution and recent U.S. Supreme Court cases.[11]

Determination of Tax or Credits to Owners

c. Details are needed regarding the determination of the tax or credit for:

i. Separately-stated income of a partnership or S corporation.

ii. Special allocations of income reported by a partnership to specific partners.

iii. Guaranteed payments made to specific partners, particularly non-residents.

d. Because there are different methods for calculating a partner's ownership percentage of partnership capital or profits, etc., a particular method that is used to allocate the tax paid or credit available may create unexpected or disparate results. Substantial economic effect rules could come into play.

[10] The failure to provide a state tax credit would result in the taxpayer subject to double taxation, a result that the Supreme Court precedent historically appears to avoid. However, states have differentiated between a tax at the entity level and a tax at the individual level. For example, California only provides a credit for other state taxes paid at the individual level. California does not provide a credit for the Texas margins tax. The state would have to distinguish the Texas margins tax from the Connecticut PTE tax to provide a credit for the Connecticut PTE tax and other similar PTE-level taxes.

[11] See *Comptroller of the Treasury of Maryland v. Wynne et. ux.*, Dkt. No. 13-485 (May 18, 2015), 575 U.S. _(2015), 135 S.Ct. 1787.

Treatment of Credits Otherwise Creditable to Owners

e. It is possible a state may not provide for the treatment of state tax credits, such as research and development credits, that are otherwise creditable to PTE owners. States will need to consider whether the credit is allowed against the PTE-level tax.

Treatment of PTE Credits for Taxes Paid to Non-Resident States by the Entity

f. The state in which the PTE files returns and pays PTE-level taxes may not allow the PTE to claim a credit for other states' PTE-level taxes paid by the PTE to a non-resident state.

Tax Rate Disparity

g. A disparity (and greater tax payment) potentially exists between a flat-rate PTE-level tax versus the typical graduated tax rates imposed by states on individuals, including the possible exemption from taxation of specific categories of income (i.e., investment income, capital gains, etc.).

Sourcing Rules, Determination of In-state Source Income, and Treatment of Investment Partnerships

h. Differences may exist between the sourcing rules applied to determine the PTE-level tax and the sourcing rules applied at the owner level. Such differences may create taxpayer confusion and could result in significant differences (potential increases and decreases) in the amount of tax imposed by the state on the PTE, as well as its owners.

i. Details are needed regarding the determination of in-state source income at the entity-level. The legislation may provide for the use of:

    i. Corporate-type apportionment and allocation rules.

    ii. Individual taxpayer residency type rules, clarifying whether the rules are based on the PTE's organizational or corporate domicile.

    iii. "Special allocation" rules for specific types of income, such as investment income. Most states source certain specified types of income entirely based upon the taxpayer's residence. The state may treat all investment income for an in-state PTE as sourced to the resident state of its partners, members or shareholders and might treat such income as in-state income of the PTE based upon its business situs or corporate domicile, regardless of owner residency.

    iv. It is possible that a state may consider the mere formation or registration of a PTE as minimal contact with a state for a PTE-level tax. It is possible that the PTE-level tax may apply to all PTEs, including investment partnerships. For investment partnerships, states will need to clarify how to determine which state's PTE-level tax applies for purposes of deducting the tax.

De Minimis Exception

j. Details are needed regarding whether there is a *de minimis* exception.

Mandatory or Elective Tax

k. Details are needed regarding whether the PTE-level tax is mandatory or elective. If it is elective, details are needed regarding whether the election is required only once or annually on a timely filed return, with extensions, who makes the election (the PTE or its owners), and if the election is irrevocable once it is made.

Separately Stated Form 1040 Schedule K-1 Items

l. Details are needed regarding the PTE-level tax and state individual income tax treatment of separately stated Form 1040 Schedule K items. Below are a few examples needing guidance.

    i. Whether charitable donations made by the PTE are deductible by the PTE. If charitable donations are deductible, what limitations apply.

    ii. Whether the insolvency exception for cancellation of debt income applies at the individual level or PTE-level.

Basis Step-Up Adjustments

m. Details are needed regarding the treatment of any basis adjustments (i.e., whether depreciation from basis step-up adjustments is deductible at the entity level, reducing the PTE-level tax).

Net Operating Loss Treatment

n. Details are needed on the treatment of net operating losses (NOLs) to address whether losses are carried forward at the PTE level.

SMLLCs and Other Disregarded Entities

o. The PTE level assessment may cover SMLLCs and other disregarded entities.

    i. If the legislation covers SMLLCs, the legislation should clarify the process for collecting from the entity and granting credit to the owner.

    ii. The legislation should include a clear definition whether an owner who is itself a SMLLC or grantor trust is considered a natural person if owned by a natural person.

    iii. The legislation should clarify whether all in-state SMLLCs are subject to the PTE-level tax, or if there are exceptions (e.g., investment SMLLCs).

p. Disparate tax treatment of business income generated through a partnership or S corporation is possible compared to business income generated through a disregarded entity (such as a SMLLC or qualified subchapter S subsidiary (Q-sub)) or a sole proprietor (who files a Form 1040 Schedule C). The form of an entity should not result in different state tax treatment.

Unreimbursed Business Expenses

q. Whether and how unreimbursed business expenses deducted by a shareholder owner on the owner's individual return (Form 1040 Schedule E) may affect the state tax credit allowed.

Treatment of Pass-Through Income from Other PTEs and Treatment of Compensation

r. The treatment of pass-through income from other PTEs and how that income received by a PTE is treated in determining the PTE-level tax will create complexities. Specific, detailed guidelines on how to handle these calculations are a necessary element of any proposal.

s. An incentive may exist for the active shareholders of S corporations to further reduce their salary income and instead increase distributions from the business to reduce state tax paid by the owner. The reduced salary could create an IRS challenge as not enough for reasonable compensation.

Capital Accounts

t. An incentive may exist to skew section 704(b) capital accounts, particularly if corporate or tax-exempt partners exist. If corporate partners are not receiving a payment on their behalf, it may affect their share of the proceeds on the liquidation of their partnership.

Tax-Exempt and Foreign Partners and Shareholders

u. States may not provide appropriate treatment of a PTE-level tax imposed on the income allocated to tax-exempt and foreign partners and shareholders.

Corporate Partners

v. Corporate partners may not receive credit for their share of the PTE-level taxes paid by the PTE to another state.

w. The state may subject C corporations doing business in the state to additional liability solely due to their ownership of interests in PTEs and the state applying the tax to entities owned either directly or indirectly by C corporations.

Administrative Burdens of Tracking, Reporting, and Payments Increased

2. New administrative burdens could apply with respect to the tracking and reporting of state tax payments.

    a. All owners of a PTE paying a PTE-level tax will need to track their respective share of PTE-level taxes paid, the amount of credits provided by the resident state, and the credit for taxes paid to other (non-resident) states.

    b. Taxpayers and state revenue departments may have different sourcing rules to determine the PTE-level tax and at the owner level.

    c. The PTE will have direct liability for paying estimated tax payments. Some PTEs might face cash-flow issues that would require cash infusions from their owners as either capital contributions or loans.

    d. The states will need to consider how a PTE-level tax system will interact with or need to change regarding:

        i. Existing non-resident owner composite and withholding filing, reporting and payment systems.

        ii. Existing filing, reporting, and payment procedures for unitary corporate partners.

        iii. State unitary combined filings and whether such filings will include PTEs.

    e. Tiered PTE structures present the possibility of even more complex, additional administrative tracking and reporting issues because tax payments and associated credits are flowed through multiple layers.

    f. If the proposal affects Publicly Traded Partnerships, they may face new and complex additional administrative burdens and securities law issues.

Different Federal and State Tax Treatment and Potential Impact on Federal Calculations

3. A PTE-level tax would not follow the traditional pass-through treatment of partnerships and S corporations under the Internal Revenue Code (notably, IRC Subchapters K and S).

    a. Thus, the federal and state tax systems in effect would apply different tax treatment of the same entity. The federal tax system would not treat a partnership or S corporation as a taxable entity, but the state would treat the entity as taxable.

    b. Non-resident owners would no longer have the ability to offset income and losses from investments held in different legal entities for state tax purposes. Individuals may lose the ability to use losses from one PTE to offset income from another PTE, particularly for section 469 passive activities.

c. The state's implementation of a PTE-level tax could affect the amount of income eligible for the new federal 20% deduction for qualified business income (QBI) of PTEs under section 199A. A state PTE-level tax that is deducted by the PTE for federal income tax purposes will reduce the owner's distributive share of QBI and, therefore, result in a smaller federal deduction than if there was no PTE-level tax.

d. A reduction in owners' self-employment income may occur, thereby resulting in a possible reduction in their credited earnings for Social Security purposes.

Federal Deductibility of Individual State Income Taxes

4. Deductibility of such PTE-level taxes for federal income tax purposes remains an open issue and partners, members and shareholders of PTEs could face challenges from the IRS as to the deductibility of overall income passed through to them from the PTE.

   a. Treasury and IRS officials have publicly stated that the IRS will apply "substance over form" principles in interpreting the $10,000 state and local tax deduction limitation.[12]

      i. Texas views the margin tax paid by a PTE as imposed only on the income of the "trade or business" for federal income tax purposes because it only applies to business income and the state does not impose a personal income tax.

      ii. The Connecticut PTE-level tax is similarly imposed on the income at the PTE level, but by contrast, each partner, member or shareholder receives a full tax credit against the owner's state tax liability for a state income tax that the owner would otherwise owe on the owner's distributive or pro rata share of the PTE's income.

      iii. The Connecticut PTE-level tax law allows an election to carve out the distributive share of the PTE's income allocated to corporate partners in computing the PTE-level tax that results in the PTE only paying tax on income allocated to owners who are natural persons. The mere existence of this election may provide credence to a challenge that the new PTE-level tax is, and the federal government should treat as, similar to a withholding regime.

      iv. Treasury Secretary Mnuchin, then-Acting IRS Commissioner Kautter, as well as members of Congress instrumental in enacting the limitation on the federal deduction for state and local taxes have stated that the IRS may challenge state or local government provisions enacted to avoid the federal limitation on the deduction for state and local taxes. As of now, no state has provided for financial indemnification for any such challenge by the IRS. The IRS could apply a *quid pro quo* challenge to the PTE-level tax approach, similar to that which it has made in proposed regulations

[12] IRS Notice 2018-54 (5/23/18).

challenging the state tax credits for charitable contributions in Prop. Reg. §1.170A-1.[13] Further, some commentators have suggested that if the IRS continues to challenge approaches to address the limitations on the state tax deduction, IRS may consider challenging the economic substance or substance over form of a transaction. It is possible that the IRS could name any reliance on such state law tax provision enacted to avoid the federal limitation on the deduction for state and local taxes as a "listed transaction" that will require the taxpayer to disclose such transactions on the federal income tax returns. Preparers of tax returns claiming such deductions may have independent tax preparer reporting obligations.

5. Additional considerations and concerns with adopting a state PTE-level tax include:

   a. The TCJA section 11042 that imposes the state and local tax deduction limitation is scheduled to sunset after 2025. The adoption of a PTE-level tax, however, may remain a permanent transformation of a state's business tax system.

   b. After the enactment of a PTE-level tax, the state may modify or curtail the individual-level credits. This situation could result in a double taxing regime on PTEs that formerly never existed.

   c. Some taxpayers may not realize the minimal impact of the state and local tax deduction limitation for high income taxpayers in many states. Prior to the TCJA, the state and local tax deduction was limited for many middle and high income individuals because it was disallowed (and the tax rules continue to disallow it) under the federal alternative minimum tax (AMT). The TCJA limitation may not affect the state and local tax deduction for these high income individuals. While the TCJA increased the AMT exemption and threshold amount, decreasing the number of taxpayers subject to the AMT, taxpayers in the higher earning brackets could have expected continuing liability for AMT. This AMT result would negate any limitation imposed under the regular income tax for the state and local tax deduction.

PRESENT LAW

For federal purposes, Subchapter K and Subchapter S of the Internal Revenue Code are considered pass-through tax regimes. Income is calculated and reported at the entity level, but the income tax is imposed on the owners based on their allocable share of the entity's income.

[13] The IRS issued proposed regulations (REG-112176-18), effective on August 27, 2018, limiting charitable contributions in exchange for state or local tax credits. The proposed regulations apply the *quid pro quo* principle to limit the charitable deduction generally to the net contribution after subtracting the value of state tax credits the taxpayer receives or expects to receive. On September 5, 2018, the IRS clarified in an information release (IR-2018-178) that taxpayers who make business-related payments to charities or government entities in exchange for state or local tax credits can generally deduct the payments as business expenses as long as the payment qualifies as an ordinary and necessary business expense. This general deductibility rule is unaffected by the recent proposed regulations (REG-112176-18) that require taxpayers to reduce their charitable contribution deduction by the amount of any state or local tax credit they receive.

For the most part, states have adopted the same tax regime as the federal tax regime for these types of PTEs. As detailed in the chart below, a few state and local taxing jurisdictions, notably New York City (NYC) and the District of Columbia (DC), impose tax on income earned at both at the entity and the owner level with minimal offsetting credits allowed. However, in NYC and DC, residents are provided a credit for the entity-level tax against their personal income tax.

Most entity-level taxes currently imposed by states on PTEs are considered gross receipts or business activity taxes, as contrasted with income taxes. Roughly half of the states that impose such taxes are notable for having no individual income tax regime.

Specifically, as detailed in the chart below, at least eleven states, plus NYC and DC, impose an entity-level income tax on PTEs. Five of these states do not levy an individual income tax (i.e., Nevada, New Hampshire, Tennessee, Texas, and Washington) and three states (i.e., Connecticut, Kentucky, and Ohio) and DC and NYC provide some type of partial offsetting personal income tax credit or deduction. Other states impose annual fees or flat taxes on PTEs, such as annual filing fees or partnership fees.[14]

Currently, the below thirteen states or jurisdictions have some form of a state PTE-level tax.

	State or Jurisdiction	**Type of Tax**	**Legislation**	**Details of the Tax**
1	Alabama	Business privilege tax	Ala. Code §40-14A-22	The tax applies to corporations, limited liability entities, and entities considered disregarded for federal tax purposes. In general, the rate is: $0.25 per $1,000 for taxable incomes less than $1, $1 per $1,000 for incomes of at least $1 but less than $200,000, $1.25 per $1,000 for incomes of at least $200,000 but less than $500,000, $1.50 per $1000 for incomes of at least $500,000 but less than $2,500,000, and $1.75 per $1000 for incomes of $2,500,000 or higher. In general, the minimum tax is $100, and the maximum tax is $15,000. No offsetting credit or deduction is provided.
2	California	Franchise tax on S corporations	RTC §23802(b)	A 1.5% franchise tax (or $800 minimum if greater) is imposed on the net income of S corporations. No credit is provided to owners. It is an entity-level tax allowable above-the-line. It is deducted on the Form 1040 Schedule E and is not subject to the $10,000 limit for the shareholders. Each shareholder is responsible for paying taxes on their pro rata share of the S corporation's items of income, deductions, and credits. S corporations are subject to the annual $800 minimum franchise tax.
3	Connecticut	Pass-through entity tax	CT Public Act 18-49	The tax is imposed at a rate of 6.99% on entity-level income of most PTEs in Connecticut. Owners of PTEs are entitled to a credit against their Connecticut personal income tax equal to 93.01% of the PTE owner's pro rata share of the PTE-level tax paid by their PTE. Connecticut resident owners of a PTE may claim a

[14] See *An Update on State Tax Treatment of LLCs and LLPs*, State Tax Notes, Bruce P. Ely, Christopher R. Grissom, and William T. Thistle II, January 8, 2018, p. 155.

				credit for any entity-level tax imposed by other states that is similar to the Connecticut PTE-level tax. PTEs subject to the Connecticut PTE-level tax are required to make quarterly estimated tax payments. The Connecticut PTE-level tax is applicable for taxable years beginning on or after January 1, 2018. A PTE may elect to carve out the pro rata share of PTE income allocated to corporate owners from the calculation of the Connecticut PTE-level tax. The tax does not affect the taxation of publicly-traded partnerships, sole proprietorships, or single-member limited liability companies (SMLLCs) that are treated as disregarded entities for federal income tax purposes.
4	District of Columbia	Unincorporated business franchise tax	DC ST §47-1808.03	Business income is taxed at the entity level, but it is subtracted from income of resident-owners for personal income tax purposes. The District is prohibited by an act of Congress from imposing a direct tax on the income of non-residents. S corporations are treated as C corporations for purposes of their corporate income taxes, and thus, an S corporation is not respected for DC tax purposes. The tax generally applies to any trade or business conducted by an individual or entity, other than a corporation; exempt businesses include professional firms (1) with gross income which is at least 80% derived from personal services rendered by members of the entity, and (2) for which capital is not a material income-producing factor. The rate is 8.25% of taxable income. The minimum tax is (1) $250 if DC gross receipts are $1 million or less, and (2) $1,000 if DC gross receipts are greater than $1 million.
5	Illinois	Personal property replacement tax	35 ILCS 5/201	The tax applies to corporations, partnerships, trusts, S corporations, and public utilities. The rate is 1.5% of net income for partnerships and S corporations. There is no minimum tax. No offsetting credit or deduction is provided.
6	Kentucky	Limited liability entity tax	KRS § 141.0401	Owners are generally allowed a personal income tax credit or corporate income tax credit for limited liability entity taxes paid. The tax applies to corporations and limited liability PTEs (e.g., LLCs and LLPs) with gross receipts or gross profits greater than $3 million. In general, the tax is the lesser of (1) $0.095 per $100 of Kentucky gross receipts or (2) $0.75 per $100 of Kentucky gross profits; taxpayers with gross receipts or gross profits between $3 million and $ 6 million may reduce their taxes by a specified formula. The minimum tax is $175.
7	Nevada	Commerce tax	N.R.S. 363C	The tax generally applies to all business entities with at least $4 million in annual gross revenue apportioned to the state. The rate varies from 0.051% to 0.331% of gross revenue, depending on industry. There is no minimum tax, and there is no individual income tax.
8	New Hampshire	Business enterprise tax; business profits tax; and interest	N.H. Rev. Stat. § 77-E:2; N.H. Rev. Stat. § 77-A:2; (N.H.	The New Hampshire business enterprise tax applies to all business entities (including disregarded entities, such as sole proprietors and SMLLCs) with more than $208,000 in gross receipts or an enterprise value tax base greater than $104,000. The rate is 0.675% of the

		and dividends tax	Rev. Stat. § 77:4)	enterprise value tax base (i.e., the sum of all compensation paid or accrued, interest paid or accrued, and dividends paid by the enterprise, after adjustments and apportionment). There is no minimum tax. The New Hampshire business profits tax applies to all business entities organized for gain or profit with at least $50,000 in gross receipts. The rate is 7.9% of taxable business profits; there is no minimum tax. The New Hampshire interest and dividends tax applies to New Hampshire residents, fiduciaries, LLCs, partnerships, and associations with non-transferable shares whose gross interest and dividend income exceeds $2,400. The rate is 5% of interest and dividend income; there is no minimum tax. There is no broad-based individual income tax (state taxes interest and dividend income).
9	New York City (NYC)	Unincorporated business tax (UBT)	NYC Admin. Code 11-501 – 11-540	Individual city residents may claim a credit against their NYC personal income tax for a portion of UBT payments made. New York state law prohibits NYC from imposing a direct income tax on non-resident individuals. S corporations are treated as C corporations for purposes of their corporate income taxes, and thus, an S corporation is not respected for NYC tax purposes. The UBT generally applies to individuals and unincorporated entities engaged in any trade, profession, or business; exceptions include performing services as an employee. The rate is 4% of taxable income allocated to New York City; there is no minimum tax. Businesses with liabilities less than $5,400 may receive a full or partial UBT tax credit.
10	Ohio	Commercial activity tax	Ohio Rev Code § 5751.03	The first $250,000 (joint filers) or $125,000 (single filers) of business income is deductible for personal income tax purposes. The Ohio commercial activity tax generally applies to all business entities with gross receipts greater than $150,000. The rate equals (1) an annual minimum tax of $150 to $26,000, depending on gross receipts plus (2) 0.26% of gross receipts in excess of $1 million.
11	Tennessee	Franchise and excise tax; and interest and dividends tax	Tenn. Code Ann. § 67-4-2007; Tenn. Code Ann. § 67-2-102	The Tennessee franchise and excise tax applies to any individual or entity doing business in the state. The franchise tax rate is $0.25 per $100 of net worth (i.e., the difference between total assets and total liabilities); minimum tax is $100. The excise tax rate equals 6.5% of net earnings. The Tennessee interest and dividend taxes applies to individuals and partnerships whose taxable interest and dividend income exceeds $1,250. The tax equals 5% of dividend and interest income. There is no broad based individual income tax (tax on interest and dividend income only).
12	Texas	Franchise and margin tax	T.C.A., Tax Code § 171.001	The Texas franchise tax generally applies to any business entity formed in or doing business in Texas; exceptions include sole proprietors and general partnerships owned entirely by natural persons. The base is the lesser of (1) 70% of total revenue, (2) total revenue minus the costs of goods sold, (3) total revenue minus total compensation, or (4) total revenue minus $1

				million. The tax rate is 0.375% for retailers or wholesalers and 0.75% for other types of businesses. There is no minimum tax, and there is no individual income tax.
13	Washington	Business and occupation tax	RCWA 82.04.220	The tax applies to any individual or entity engaged in business. The rate is 0.138% to 3.3% of gross receipts, depending on industry. There is no individual income tax.

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Oklahoma Pass-Through Entity Tax Equity Act of 2019

Example 1

Simple Example With & Without Election

	No PTE Election			PTE Election		
Pass-Through Entity	Individual	Corporate	Entity	Individual	Corporate	Entity
Schedule K-1, Line Item	Owner	Owner	Totals	Owner	Owner	Totals
Ordinary Income	100,000	150,000	250,000	94,800	140,640	235,440
Interest	5,000	7,500	12,500	5,000	7,500	12,500
Charitable Contribution	(1,000)	(1,500)	(2,500)	(1,000)	(1,500)	(2,500)
Federal K-1 Totals	104,000	156,000	260,000	98,800	146,640	245,440
Add back Oklahoma Tax				5,200	9,360	14,560
Oklahoma Net Entity Income				104,000	156,000	260,000
Oklahoma Tax Rate				5.0%	6.0%	
Oklahoma Tax				5,200	9,360	14,560
Oklahoma K-1 Adjustment: state tax				5,200	9,360	
Oklahoma K-1 Adjustment: Oklahoma net entity income				(104,000)	(156,000)	

Owner's Tax Returns	No PTE Election		PTE Election	
Federal				
Other items of gross income	500,000	1,000,000	500,000	1,000,000
Ordinary Income (from K-1)	100,000	150,000	94,800	140,640
Interest (from K-1)	5,000	7,500	5,000	7,500
Adjusted Gross Income	605,000		599,800	
State income taxes	(30,000)	(70,000)	(30,000)	(70,000)
Deduction limited to $10,000	(10,000)	N/A	(10,000)	N/A
Charitable (from K-1)	(1,000)	(1,500)	(1,000)	(1,500)
Taxable Income	594,000	1,086,000	588,800	1,076,640
Tax Rate	37.0%	21.0%	37.0%	21.0%
Federal Tax	219,780	228,060	217,856	226,094
Oklahoma				
Adjusted Gross Income / Taxable Income	605,000	1,086,000	599,800	1,076,640
Oklahoma Adjustments				
State income tax		70,000		70,000
State income tax (from K-1)			5,200	9,360
PTE Adjustment			(104,000)	(156,000)
Charitable	(1,000)		(1,000)	
Oklahoma Taxable Income	604,000	1,156,000	500,000	1,000,000
Tax Rate	5.0%	6.0%	5.0%	6.0%
Oklahoma Tax	30,200	69,360	25,000	60,000
Federal Tax Savings			1,924	1,966
			1.850%	1.260%
Oklahoma Tax Liability of PTE	-	-	5,200	9,360
Oklahoma Tax Liability of Owner	30,200	69,360	25,000	60,000
Total Oklahoma Tax Liability	30,200	69,360	30,200	69,360

§ 2358(A)(11): 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,

Oklahoma Pass-Through Entity Tax Equity Act of 2019

Example 2

Positive and Negative Net Taxable Income Owners

	No PTE Election			PTE Election		
Pass-Through Entity	Individual	Corporate	Entity	Individual	Corporate	Entity
Schedule K-1, Line Item	Owner	Owner	Totals	Owner	Owner	Totals
Ordinary Income	100,000	(150,000)	(50,000)	94,800	(150,000)	(55,200)
Interest	5,000	7,500	12,500	5,000	7,500	12,500
Charitable Contribution	(1,000)	(1,500)	(2,500)	(1,000)	(1,500)	(2,500)
Federal K-1 Totals	104,000	(144,000)	(40,000)	98,800	(144,000)	(45,200)
Add back Oklahoma Tax				5,200	-	5,200
Oklahoma Net Entity Income				104,000	(144,000)	(40,000)
Oklahoma Tax Rate				5.0%	6.0%	
Oklahoma Tax				5,200	-	5,200
Oklahoma net entity income (loss) carried forward						(40,000)
Oklahoma K-1 Adjustment: state tax				5,200	-	
Oklahoma K-1 Adjustment: Oklahoma net entity income				(104,000)	144,000	

Appears to be a disconnect in the statute between the aggregate method of calculating the tax (owner-by-owner), and the net entity method for calculating "Oklahoma net entity loss." Further, consider what happens in the carry forward tax year: the Oklahoma net entity loss is a component of "Oklahoma net entity income" that is divided between the owners according to the "Distributive Share" rule of § 2355.1P-2.

Owner's Tax Returns	No PTE Election		PTE Election	
Federal				
Other items of gross income	500,000	1,000,000	500,000	1,000,000
Ordinary Income (from K-1)	100,000	(150,000)	94,800	(150,000)
Interest (from K-1)	5,000	7,500	5,000	7,500
Adjusted Gross Income	605,000		599,800	
State income taxes	(30,000)	(70,000)	(30,000)	(70,000)
Deduction limited to $10,000	(10,000)	N/A	(10,000)	N/A
Charitable (from K-1)	(1,000)	(1,500)	(1,000)	(1,500)
Taxable Income	594,000	786,000	588,800	786,000
Tax Rate	37.0%	21.0%	37.0%	21.0%
Federal Tax	219,780	165,060	217,856	165,060
Oklahoma				
Adjusted Gross Income / Taxable Income	605,000	786,000	599,800	786,000
Oklahoma Adjustments				
State income tax		70,000		70,000
State income tax (from K-1)			5,200	-
PTE Adjustment			(104,000)	144,000
Charitable	(1,000)		(1,000)	
Oklahoma Taxable Income	604,000	856,000	500,000	1,000,000
Tax Rate	5.0%	6.0%	5.0%	6.0%
Oklahoma Tax	30,200	51,360	25,000	60,000
Federal Tax Savings			1,924	-
			1.850%	0.000%
Oklahoma Tax Liability of PTE	-	-	5,200	-
Oklahoma Tax Liability of Owner	30,200	51,360	25,000	60,000
Total Oklahoma Tax Liability	30,200	51,360	30,200	60,000