



MULTISTATE INCOME/FRANCHISE TAX

Illinois enacts pass-through entity tax election

Tax Alert

Overview

On August 27, 2021, the Illinois Governor signed into law [Senate Bill 2531](#) (S.B. 2531) and it was enrolled as Public Act 102-0658. S.B. 2531 allows partnerships (other than a publicly traded partnership) and S corporations to elect to pay a 4.95% entity level state tax on income. The election may be made for taxable years ending on or after December 31, 2021 and beginning prior to January 1, 2026, provided that a \$10,000 limitation for the state and local tax deduction under IRC section 164(b)(6) still applies.

This Tax Alert summarizes the Illinois PTE tax election.

Pass-through entity tax election

Effective for tax years ending on or after December 31, 2021 and beginning prior to January 1, 2026, a partnership or S corporation can elect to pay an entity level tax in Illinois at the rate of 4.95% on its net income as defined in the proposed legislation. A separate election shall be made for each taxable year and once made is irrevocable for that year. The elective PTE tax is in addition to the existing Replacement Tax and does not impact the Replacement Tax calculation.

Pass-through entity tax considerations

The PTE tax base is calculated differently from the Replacement Tax which allows for many items disallowed under PTE tax. For the PTE tax, net income includes all income allocable to the state. Guaranteed payments and income distributable to all partners, including tax exempt partners, are included in the tax base.

Replacement Tax deductions that are disallowed for the PTE tax include:

- The deduction for income distributable to a shareholder/partner subject to Replacement Tax (i.e., the deduction found in 35 ILCS 5/203(b)(2)(S) and (d)(2)(I) is not allowed for the PTE tax)

- For partnerships, the deduction for the greater of personal service income or reasonable allowance for compensation paid for services rendered by the partners to the partnership (i.e., the deduction found in 35 ILCS 5/203(d)(2)(H) is not allowed for the PTE tax)
- Standard exemption (i.e., the deduction found in 35 ILCS 5/204 is not allowed for the PTE tax)
- Net loss deduction (i.e., the deduction found in 35 ILCS 5/207 is not allowed for the PTE tax)

An electing partnership or S corporation must make estimated tax payments if the PTE tax amount payable as estimated tax can reasonably be expected to exceed \$500. For a calendar year partnership, estimated tax payments are generally due on April 15, June 15, September 15 and January 15 of the following taxable year. For a calendar year S corporation, the first three payment dates are the same, but the fourth estimated payment is due on December 15. These estimated payment dates are a departure from the Replacement Tax, which does not have an estimated tax payment requirement for partnerships.

Entities making the election under S.B. 2531 are not required to make withholding payments for their owners, normally required under 35 ILCS 5/709.5. However, the estimated tax payments for the PTE tax are accelerated compared to the partnership and S corporation withholding payments, which are due at extension time.

Pass-through entity tax credit

Partners of an electing partnership or S corporation are allowed a credit against their Illinois Income Tax equal to 4.95% times the partner's distributive share of the net income of the electing partnership or S corporation. The credit cannot exceed the partner's share of tax actually paid by the partnership or S corporation. The credit can only be claimed against the Income Tax, not the Replacement Tax. Excess credit is treated as an overpayment and is refundable.

Credit for tax paid to other states

Under the new law, substantially similar taxes paid by a PTE, including PTEs that do not make this election, are considered tax paid by the partners for the purpose of credit for taxes paid to other states.

Other considerations

- Tax exempt partners: the PTE tax base includes all income distributable to tax exempt partners some of which may not be subject to Illinois tax.
- Nonbusiness income: nonbusiness income allocated to Illinois by the PTE is subject to PTE tax, even though nonbusiness income allocated to nonresident partners might otherwise be sourced outside Illinois. For example, nonbusiness interest, dividend and capital gains from intangible property is allocated to the taxpayer's commercial domicile. For purposes of the PTE tax the PTE is the taxpayer.
- Nonresident individual partners or shareholders of an entity making the election under S.B. 2531 may not be required to file an Illinois income tax return for the applicable tax year if the credit equals or exceeds their Income Tax liability. However, special or disproportionate allocations of partnership items of income may result in insufficient

PTE tax credit being allocated to partners required to satisfy their filing obligations.

- Some partners or shareholders may rely on nonresident withholding to satisfy their tax payments. Nonresident withholding will not apply to entities electing into the PTE tax. As a result, partners or shareholders of an electing entity who are separately subject to the Replacement Tax or have a higher Income Tax rate such as corporate partners, may need to make separate or additional tax payments when previously their share of withholding may have been sufficient.

Get in touch

[Gregory Bergmann](#)

[Brian Walsh](#)

[Ashley Rogale](#)

[Dan Daly](#)

[Donald Caplan](#)



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30 Rockefeller Plaza
New York, NY 10112-0015
United States

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