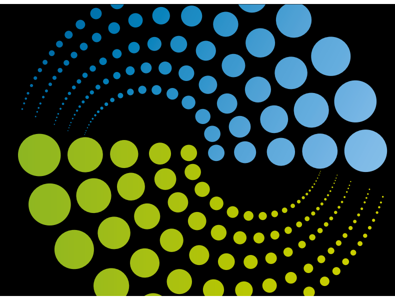
Deloitte.

State pass–through entity tax elections:
Strategic tax considerations in M&A transactions



State pass-through entity taxes (PTETs) have emerged as a state specific response to the limitation imposed on the state and local tax deduction under IRC section 164(b)(6) added by the Tax Cuts and Jobs Act of 2017, wherein individuals may only deduct $10,000 (or $5,000 if married filing separately) of state and local taxes (the "SALT Cap") for tax years 2018 through 2025.

Generally, without a PTET, an individual partner, member, or shareholder ("partner") of a pass-through entity would pay state and local income tax on their allocated share of income generated by the pass-through entity. For federal income tax purposes, the partner's deduction is limited by the SALT Cap, which may result in significantly less of a deduction than the amount of state and local tax actually paid.

Many states have adopted elective PTET regimes as a way for partners to receive the benefit of deducting state and local income tax indirectly through their pass-through entity interest(s). A PTET regime subjects the pass-through entity itself to an income tax in the state. Correspondingly, the partners receive a credit of their shares of the PTET paid or a deduction of their share of income subject to the PTET in the electing state. Since the SALT Cap does not apply at the entity level, in computing federal taxable income, the pass-through entity deducts the entire amount of PTET paid, such that the partners would be allocated less federal income. The PTET effectively converts all or a portion of the state income tax relating to the partner's share of the pass-through entity income to a federal entity-level tax deduction, thus, effectively working around the SALT Cap that would have been applicable if the state tax had been imposed on the individual partner directly.

Leveraging PTET elections in M&A transactions

Depending on the structuring and components of a transaction, PTETs may offer an opportunity for significant tax savings. For example, in a tax year where a significant realization event occurs, such as the sale of an underlying business or pass-through entity interest, electing into a PTET may preserve the full deductibility of state and local taxes at the federal level. This may lead to a significant reduction in the overall federal tax burden for the pass-through entity's partners.

Certain structuring alternatives involving S corporations may be beneficial in order to avail the S corporation of a PTET election. For example, a Section 338(h)(10) election or an F reorganization under IRC §368(a)(1)(F) result in the transaction being treated as an asset sale (or deemed asset sale) for tax purposes, which opens up the opportunity to subject any gain recognized on the sale of assets to a PTET regime since the gain is recognized at the entity level as opposed to if the transaction had been treated as a sale of stock. For buyers in a transaction, treating the transaction as an asset sale is attractive as it allows them a step-up in basis in the acquired assets. However, sellers generally prefer transactions to be treated as a sale of stock due to favorable capital gain rates. Oftentimes, as a result of treating a transaction as an asset sale, buyers will agree to make gross-up payments to the seller to compensate the seller for incremental tax costs associated with the transaction treatment. A PTET election helps to align the interests of the buyers and sellers, since the election results in potential tax savings for the sellers. Further, the gross-up payments may be reduced to reflect the decreased tax burden on the sellers as a result of PTET elections.

State-specific rules and their impact

Since each state with a PTET regime has its own set of rules, rates, and procedures, it is important for the entities involved in M&A transactions to thoroughly understand the specific requirements to determine whether the PTET election is available. Understanding these nuances is essential for ensuring that the PTET election aligns with the entity's broader tax planning objectives. Failing to understand the rules and mechanics of each state's PTET regime may lead to ineligibility to make an election.

For some states, the election is made annually, while in other states the election, once made, is binding for subsequent years until it is revoked. In states where the PTET election is binding for multiple years, entities should consider the long-term implications of the election, particularly if their operations or ownership structure is likely to change.

For some states, the election is due during the applicable tax year. For example, the New York State PTET election is made annually and is due by March 15 of the applicable tax year, at the same time the first-quarter estimated tax payment is due. As discussed further below, the timing of the election ultimately may impact the timing of the federal deduction of the PTET.

The tax calculation also varies by state. For example, in states like California and New York, the PTET taxable base includes a resident partner's entire share of pre-apportioned income and a nonresident partner's post-apportioned share of income. If a pass-through entity has a large number of residents partners of a state that imposes a PTET on a residents partner's entire share of income, there may be a significant tax saving opportunity. Conversely, in states where the PTET is only applied to state-sourced income, the benefit of making a PTET election may be less, unless the apportionment factor for that state is significant. Additionally, some states specifically exclude certain partner types from the tax base of the PTET, resulting in income allocated to pass-through or corporate parents being excluded from the tax base.

Private equity insights

In the context of private equity investors, it is important to evaluate the potential benefits related to making a PTET election for investments structured as operating partnerships. The benefits of making a PTET election for a private equity owned operating partnership can vary depending on the profile of the fund's investors and limited partners. For example, if a private equity fund's investors include a substantial number of tax-exempt entities not subject to U.S. federal or state income tax, the PTET election may not provide any benefit as any federal deduction for the share of the PTET paid would not benefit a tax-exempt entity and may even result in more taxes paid. In addition, if certain limited partners, such as non-U.S. investors, hold their interest in an operating partnership though a U.S. corporation, the PTET may similarly not provide any benefit as the SALT Cap does not apply to non-individual taxpayers. Depending on the private equity fund investor profile, the administrative complexity and compliance costs associated with making a PTET election may outweigh the potential tax savings to investors for some funds. Private equity investors should consult with their tax advisors to carefully evaluate the relevant considerations related to making a PTET election for operating partnerships by taking into account the profile of the fund investors and limited partners.

Timing considerations of PTET elections

The timing of the election and payments is another important consideration, particularly in the context of M&A transactions. The timing of the election and payments will impact the timing of the federal tax deduction, which could occur before or after the closing date of a transaction. There are a number of issues to consider in evaluating the timing of the deduction, including (but not limited to) the specific state's PTET laws and whether there is procedural guidance for taxpayers to make the PTET election during the applicable short tax year, the determination of whether the pass-through entity's PTET liability is fixed as of tax year-end for accrual-based taxpayers, and when payment is made.

Some of these issues may require the taxpayer to take affirmative actions in the tax year (including short tax year) in which it wants to claim the deduction, including making payments, notifying the states, and effectuating the election through a board resolution or shareholder agreement.

Interaction with nonresident withholding and composite returns

The interaction between a state's PTET election and other state tax obligation, such as nonresident withholding and composite tax returns, should also be considered. In states where nonresident withholding is required, the PTET election may affect the amount of nonresident withholding required or eliminate the requirement altogether. If an electing entity is still required to remit nonresident withholding, the availability of waivers should be analyzed to help identify and mitigate the unexpected tax liabilities from having to double pay the state income tax at the entity level.

In some states, the PTET election may satisfy the state tax filing obligations of nonresident partners, eliminating their need to file nonresident individual state tax returns. However, in other states, nonresident partners may still be required to file state returns if the entity has made a PTET election. If an electing pass-through entity is not able to file a composite return, claiming a PTET credit on behalf of the participating nonresident partners, this may create unexpected state filing obligations for individual partners.

Managing PTET payments and compliance risks

Another important consideration is the responsibility for PTET payments and the potential consequences of underpayment. Once a PTET election is made, it is typically binding for the tax year under state statutes, and the entity is responsible for ensuring that the correct amount of tax is paid. Errors in the calculation or payment of PTET could lead to significant penalties and interest for underpayments, as well as the risk of a state tax audit. As part of planning for a transaction, it is important to consider which party in the transaction will bear the risk and responsibility when it comes to potential underpayments and penalties/interest associated with a PTET elected as part of a transaction.

In addition to the potential for underpayment, entities should consider the possibility of overpayment. In the event of a PTET overpayment, entities may be entitled to a refund, but the process for obtaining refunds varies by state, and can be unclear due to lack of guidance from the state.

Preparing for state tax audits and legislative changes

One of the more significant risks associated with PTET elections is the potential for state tax audits. States with aggressive enforcement policies may closely scrutinize PTET elections, particularly in the context of large M&A transactions. Ensuring that all PTET payments are accurately calculated and timely made is essential to reducing the risk of an audit and the associated penalties. Additionally, given the evolving nature of PTET legislation, staying informed about ongoing legislative changes related to PTETs, such as recent amendments to state tax codes, is necessary for maintaining compliance.

Conclusion

As outlined above, there are several important considerations when analyzing whether a PTET election is available and beneficial. The planning around PTETs should always be analyzed in conjunction with other tax and non-tax considerations both at the entity level and individual partner level, as the benefit of a PTET is largely driven by the circumstances of each individual partner. However, in the context of M&A activities, a state PTET may create an opportunity for pass-through entities to reduce its partners' tax liability. By proactively analyzing the considerations and seeking assistance of M&A tax advisors, pass-through entities may enhance the benefits of PTET elections while mitigating unexpected consequences.

Interested in learning more?

Valerie Dickerson
Washington National Tax
Tax Partner
Deloitte Tax LLP
vdickerson@deloitte.com

Olivia Chatani
Washington National Tax
Tax Senior Manager
Deloitte Tax LLP
ochatani@deloitte.com

Jess Williams
Mergers & Acquisitions
Tax Partner
Deloitte Tax LLP
jrwilliams@deloitte.com

Megan Sullivan
Mergers & Acquisitions
Tax Senior Manager
Deloitte Tax LLP
megansullivan@deloitte.com

This communication contains general information only and Deloitte is not, by means of this article, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This article is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser. Deloitte shall not be responsible for any loss sustained by any person who relies on this article.

As used in this document, "Deloitte" means Deloitte Tax LLP and Deloitte Financial Advisory Services LLP, which are separate subsidiaries of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of our legal structure. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2024 Deloitte Development LLC. All rights reserved.