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Arizona Passthrough Entity Tax: Update and Overview

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Topics for Today

- SALT Workaround Passthrough Entity Taxes in General
- Arizona's Elective Passthrough Entity Tax
- Planning & Issues with Arizona's Passthrough Entity Tax
- FASB Meets the Passthrough Entity Taxes

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SALT Workaround Passthrough Entity Taxes

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Working Around the SALT Cap

- In the Tax Cuts and Jobs Act, Congress added the \$10,000 cap on most state and local taxes for individuals at IRC §164(b)(6)
- States began working on various ways to workaround that cap to allow taxpayers to claim benefits for state and local taxes in excess of \$10,000

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Working Around the SALT Cap

- Tax credits for charitable contributions to state controlled funds
 - CCA 201105010 had been issued in 2011 that “blessed” tax credits like Arizona’s various charitable tax credits
 - Did not find this was impermissible *quid pro quo* situation
 - Allowed a full deduction as a charitable contribution
 - New York & New Jersey adopted tax credit contributions to various state funds with a large portion becoming a tax credit
- IRS, arguing cap fundamentally changed the rules, reversed the position in TD 9864 in June 2019

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Working Around the SALT Cap

- New York had a payroll tax workaround
 - Gave credit to employees for payroll tax paid voluntarily by employer
 - In theory the employer would lower the wages paid to the employees (no way that would create any friction)
 - While it likely worked, virtually no one decided to use the program, and the payroll tax system was eventually scrapped by New York for the next solution.

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Working Around the SALT Cap

- Connecticut's passthrough entity tax-the golden workaround
 - Imposed a tax on the net income of partnerships and S corporations
 - Offered a refundable tax credit to partners/shareholders for their share of that entity level tax paid
 - Revenue Ruling 58-25 had found that a tax imposed on business income of a passthrough was deductible as a business tax and part of non-separately stated income
 - IRS originally announced was going to issue guidance to bar the deduction
 - So why would this be an advantage to equity holders of Connecticut passthroughs?

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Example (Page 5)

	No Passthrough Tax	Passthrough Tax Election
Federal income tax		
S corporation income	\$ 300,000	\$ 277,500
Total Adjusted Gross Income	300,000	277,500
Itemized Deductions		
Real estate taxes	20,000	20,000
Estimated taxes	20,000	0
Deductible taxes after TCJA cap	10,000	10,000
Net itemized deductions	10,000	10,000
Greater of standard deduction or itemized	25,900	25,900
Taxable income	\$ 274,100	\$ 251,600
Federal tax at 25%	\$ 68,525	\$ 62,900

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Example (Page 5)

	No Passthrough Tax	Passthrough Tax Election
State income tax		
Federal AGI	\$ 300,000	\$ 277,500
Add back state tax	0	22,500
State adjusted gross income	300,000	300,000
Standard Deduction	25,900	25,900
Taxable income	274,100	274,100
State personal income tax at 7.5%	20,558	20,558
Credit for PTET (refundable)	0	22,500
Net state personal income tax	\$ 20,558	\$ (1,942)

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Example (Page 5)

	No Passthrough Tax	Passthrough Tax Election
State passthrough entity tax		
Income		\$ 300,000
PTE Tax at 7.5%		22,500
Net income on federal K-1		\$ 277,500
Total Taxes Paid		
Federal tax	68,525	62,900
State income tax	20,558	(1,942)
State passthrough entity tax	0	22,500
Total Taxes	\$ 89,083	\$ 83,458
Net Tax Savings with PTET		\$ 5,625

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Working Around the SALT Cap

- Connecticut's passthrough entity tax-the golden workaround
 - IRS, despite shutting down the credit workarounds, says nothing about this credit after their initial threat
 - Other states take silence to indicate acceptance and begin enacting their own versions with changes
 - No other state makes the tax mandatory (is a voluntary tax really a tax was CT's initial concern)
 - Some states go for an exclusion from income rather than a credit (for example, Wisconsin)

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The IRS Surrender on Passthrough Entity Taxes

- Notice 2020-75, November 9, 2020
 - Stated proposed regulations will be released that will allow partnerships and S corporations to deduct state and local income taxes imposed on the entity
 - Provided interim guidance pending the issuance of those regulations (which still have not been issued)

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Notice 2020-75

.01 Purpose and scope. The Treasury Department and the IRS intend to issue proposed regulations to provide certainty to individual owners of partnerships and S corporations in calculating their SALT deduction limitations. Based on the statutory and administrative authorities described in section 2 of this notice, the forthcoming proposed regulations will clarify that Specified Income Tax Payments (as defined in section 3.02(1) of this notice) are deductible by partnerships and S corporations in computing their non-separately stated income or loss.⁶

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Federal Rule Under Notice 2020-75

- Important to note that all **benefits** take place on the federal income tax return
- Thus, if either the taxpayer or the law fails to comply with the Notice, there is no point in doing this
 - So must consider what must happen to get the federal benefit
 - Only then consider if and how to use the underlying state law to achieve that benefit
 - One potentially key example of this will be the timing of paying the Arizona tax
 - For sure an issue if on the overall cash basis of accounting
 - Accrual basis taxpayers will face uncertainty here

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Federal Rule Under Notice 2020-75

- What is deductible under federal law is a *specified income tax payment* as defined by Notice 2020-75

For purposes of section 3.02 of this notice, the term “Specified Income Tax Payment” means any amount paid by a partnership or an S corporation to a State, a political subdivision of a State, or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or the S corporation. This definition does not include income taxes imposed by U.S. territories or their political subdivisions.⁸

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(2) Deductibility of Specified Income Tax Payments. If a partnership or an S corporation makes a Specified Income Tax Payment during a taxable year, the partnership or S corporation is allowed a deduction for the Specified Income Tax Payment in computing its taxable income for the taxable year in which the payment is made.⁷

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Federal Rule Under Notice 2020-75

- Note that the rule talks about amounts paid during the tax year
 - Implies only amounts paid by the last day of the tax year can be deducted on the federal tax return (and thus obtain a current benefit), regardless of the overall method of accounting used by the entity
 - There have been indications that the IRS did not necessarily intend to draft a pure cash basis rule to govern the timing of deductions
 - However, without that rule there would also be a question under the “all events” test if it could be accrued before year end for any tax where the election to pay the tax can be made or revoked after year end (as is true for Arizona and most states)

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Notice 2020-75, Can an Elective Tax with a Credit Really Be a Tax?

For this purpose, a Specified Income Tax Payment includes any amount paid by a partnership or an S corporation to a Domestic Jurisdiction pursuant to a direct imposition of income tax by the Domestic Jurisdiction on the partnership or S corporation, without regard to whether the imposition of and liability for the income tax is the result of an election by the entity or whether the partners or shareholders receive a partial or full deduction, exclusion, credit, or other tax benefit that is based on their share of the amount paid by the partnership or S corporation to satisfy its income tax liability under the Domestic Jurisdiction’s tax law and which reduces the partners’ or shareholders’ own individual income tax liabilities under the Domestic Jurisdiction’s tax law.⁹

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Federal Rule Under Notice 2020-75

- IRS does not care if:
 - income tax is the result of an election by the entity
 - whether the partners or shareholders receive
 - a partial or full deduction,
 - exclusion,
 - credit,
 - or other tax benefit

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Federal Rule Under Notice 2020-75

- True even if those benefits
 - Are based on their share of the amount paid by the partnership or S corporation to satisfy its income tax liability under the Domestic Jurisdiction's tax law and
 - Which reduces the partners' or shareholders' own individual income tax liabilities under the Domestic Jurisdiction's tax law.

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Notice 2020-75, What is the Nature of the Deduction?

Any Specified Income Tax Payment made by a partnership or an S corporation during a taxable year does not constitute an item of deduction that a partner or an S corporation shareholder takes into account separately under section 702 or section 1366 in determining the partner's or S corporation shareholder's own Federal income tax liability for the taxable year. Instead, Specified Income Tax Payments will be reflected in a partner's or an S corporation shareholder's distributive or pro-rata share of nonseparately stated income or loss reported on a Schedule K-1 (or similar form).¹⁰

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Notice 2020-75, What is the Nature of the Deduction?

Any Specified Income Tax Payment made by a partnership or an S corporation is not taken into account in applying the SALT deduction limitation to any individual who is a partner in the partnership or a shareholder of the S corporation.¹¹

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Federal Rule Under Notice 2020-75

- Does it matter if the partnership has no §162 trade or business or a §212 rental or royalty activity?
 - Most state laws allow such partnerships to make the election in that case
 - AICPA has asked the IRS about this issue in particular:
 - Does the deduction still count in reducing adjusted gross income for the shareholder?
 - Is it still not limited?
 - IRS is not commenting on this issue at this point

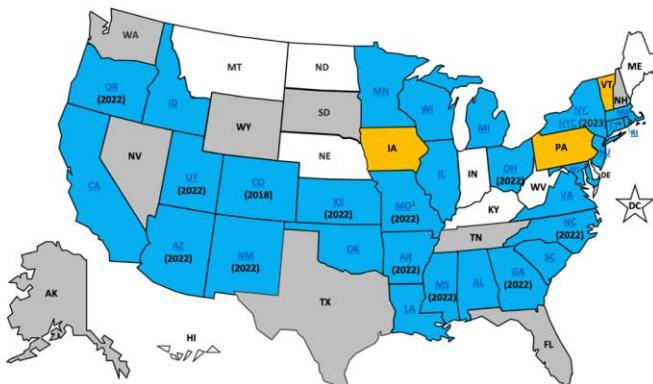
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AICPA Chart on PTEs

States with Enacted or Proposed Pass-Through Entity (PTE) Level Tax

As of July 19, 2022



29 states (8 & 1 locality) that enacted a PTE tax since TCJA SALT deduction limitation, effective for 2021 (or earlier) unless noted:

AL, AR¹, AZ¹, CA, CO², CT³, GA¹, ID, IL, KS², LA, MA, MI, MD, MN, MO³, MS³, NC¹, NJ, NM¹, NY, OH¹, OK, OR¹, RI, SC, UT¹, VA, WI, and NYC¹

¹ Effective in 2022 or later – on map (2022) or (2023)

² Retroactive to 2018

³ Mandatory

3 states with proposed PTE tax bills:

- IA - [HF 2087](#), session over, not enacted
- PA - [HB 1709](#), in committee
- VT - [H.0527](#), session over, not enacted

9 states with no owner-level personal income tax on PTE income:

AK, FL, NH, NV, SD, TN, TX, WA, WY

10 states with an owner-level personal income tax that have not yet proposed or enacted PTE taxes:

DE, HI, IN, KY, ME, MT, NE, ND, VT, WV



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State Tax Options

- Most states have enacted a credit based system, but a number have created an exclusion instead
- Most credit states allow any excess credit to be refunded (but not Arizona, California or Utah)
- All states except Connecticut allow the partnership or S corporation to choose if the tax applies, most often by due date of return
- States have now tended to exclude non-individual, non-trust equity holders
- Arizona and California have equity-holder level participation choice

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State Tax Options

- Colorado has added a new spin
 - Entities can make a retroactive election back to 2018
 - Now will need to see if other states make this choice - but not likely very useful if credit is not refundable for the state

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Arizona Elective Passthrough Entity Tax

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Arizona Entity Level Tax (ARS §43-1014)

- House Bill 2832, Chapter 425, signed into law on July 9, 2021
- Takes effect for tax years beginning from and after December 31, 2021
- Computation of the tax: imposed at a “a tax rate that is the same as the tax rate prescribed by section 43-1011” on:
 - The entire taxable income for the year that is attributable to its Arizona resident partners or shareholders and
 - The portion of its taxable income for the year derived from sources within Arizona that is attributable to its Arizona nonresident partners or shareholders.

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Arizona Entity Level Tax (ARS §43-1014)

- Rate problem with technical correction bill passed at end of 2022 session:
 - Originally the rate had been set at 4.5%, the maximum marginal tax rate imposed on Arizona taxable income of individuals prior to the passage in the 2021 Legislative session of SB 1828.
 - When SB 1828 removed from the ballot, maximum 2022 rate went down to 2.98%
 - There is not a singular *the rate* imposed (there are two rates, 2.55% and 2.98% that apply in 2022)
- Rory Wilson, Tax Policy Executive for the Arizona Department of Revenue confirmed at the Arizona Forum for Improvement of Taxation summer 2022 session that ADOR will treat the rate 2.98%

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EXAMPLE 1

ABC is an S corporation that is filing an Arizona S corporation income tax return. ABC has \$100,000 of income in 2022, \$75,000 of which is from Arizona sources and \$25,000 of which is not Arizona source.

There are two shareholders of ABC – Al, who is an Arizona resident holding 75% of the stock and Wilma who is not an Arizona resident and holds the other 25% of the stock.

The shareholder consent and ABC elects to pay the Arizona entity-level tax for 2022. The total income ABC will pay the entity level tax on is computed as follows:

100% of income allocated to Al, Arizona resident (75% of \$100,000) \$ 75,000

25% of Arizona source income allocated to Wilma, non-resident (25% of \$25,000) 18,750

Total taxable income for Arizona entity-level income tax \$ 93,750

ABC's Arizona entity-level income tax is 2.98% of \$93,750, or \$ 2,794.

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Arizona Entity Level Tax (ARS §43-1014)

- If the tax is not paid by the entity after the election is made, ADOR may collect proportionate amount from partners/shareholder(s)
- Rory Wilson also indicated at AFIT summer session that ADOR plans to have election made and tax paid on the Forms 165 and 120S
- Using the standard forms should end up with tax software vendors supporting the tax more quickly (unlike the SBI fiasco of the past year)

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Arizona Entity Level Tax (ARS §43-1014)

- Not offset at the S corporation level by the Business Contributions by an S Corporation to School Tuition Organizations for Displaced Students or Students with Disabilities
- But note that attempting to claim both credits can easily lead to excess (and wasted) credits that could work against net tax benefits, so will need to do detailed shareholder level planning to optimize the use of both credits

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Entity Level Tax Election

- The law seems to require two steps for this tax to apply:
 - The partners or shareholders must consent to be taxed at the entity level and
 - An election must be made by the entity on or before the due date (including extensions) of the business's Arizona income tax return.
- No information yet on
 - How consents are to be documented
 - If consents must be unanimous
 - If corporate and tax-exempt partners (to whom the tax would not apply) must consent nor
 - More detailed specifics on this election aside from it being on the tax forms

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Equity Holders to Whom the Election Does Not Apply

- Partners or shareholders that are not individuals, estates or trusts (such as corporations, partnerships, and tax-exempt entities) and
- Partners or shareholders who are individuals, estates or trusts and who opt out of the entity's election.
 - Original law had a drafting error that required those who wanted not to opt out not to tell the partnership or S corporation in writing that they waived their right to opt out
 - SB 1579, passed at the end of the 2022 session, corrected the language

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EXAMPLE 2

Continuing with the facts in Example 1, assume that Wilma decides to opt-out. In that case, the \$18,750 that represents her Arizona source income would not be included in taxable income in computing the entity's entity-level tax. Only the \$75,000 of income allocated to Al would be subject to the tax, resulting in an entity-level tax of \$3,375.

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Opting Out of the Election

- A partnership or S corporation that intends to make this election:
 - Shall notify all partners or shareholders who are individuals, estates or trusts that they have the right to opt out of the election for their share of the income and
 - Shall allow at least 60-days to each such partner or shareholder to make the opt-out election.
- If a partner or shareholder fails to respond within 60 days or waives the right to opt out, the partner or shareholder will be included in the election per ARS §43-1014.D.

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ANALYSIS

A partner or shareholder may wish to opt-out for various reasons. The equity holder may live in a state that does not allow for a credit for taxes to another state via a passthrough entity tax, which could more than negate the federal tax benefit due to paying full state income taxes effectively to both states on the income in question.

The credit for taxes paid to another state also becomes problematical if the taxpayer lives in a state where the credit for taxes paid on Arizona nonresident income would be claimed on the Arizona income tax return, resulting in extra state taxes being paid when there is no Arizona individual income tax to absorb the credit for taxes paid to the other state after the PTET credit is applied to reduce the Arizona nonresident income tax.

This particular problem impacts residents of California, Oregon and Virginia who own interests in partnerships or S corporations that elect to pay the Arizona PTET.

Similarly, an equity holder may not have enough Arizona income tax liability to be able to absorb the credit from the PTET and will not be able to absorb the credit in the carryover years.

The latter situation would be less of an issue if the tax credit was refundable, as it is for most states with this sort of program--but not in Arizona (or California for that matter).

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ANALYSIS

The law appears to first require a consent from the partners or shareholders to make the election, but then they must be offered the ability to opt-out. Hopefully the Department of Revenue will allow using a single form to consent to the entity's overall election and, at the same time, indicate if the individual equity holder plans to opt out.

Due to the 60 day rule, notices will need to be given by mid-January to equity holders of the entity's intent to make the election if the return is to be timely filed. A similar deadline for mid-July will apply for entities filing returns on extension who plan to make this election.

The Department of Revenue may allow partnerships and S corporations that provide the opt-out notice after these dates to still make the election if the entities have received waivers or opt-out notices from the partners or S shareholders by the due date, but it seems that the law would bar the entity from having any sort of requirement in its documents that the equity holder must provide a decision in less than 60 days..

For that reason, getting notices out early seems prudent for all entities planning to make this election. Otherwise an upset partner or shareholder who wants to punish the other shareholders could simply fail to respond before the due date to either opt out or waive the right to opt out if the notice is given less than 60 days before the filing deadline.

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Estimated Taxes for Electing Entities (ARS §43-581.C)

- Entities making the entity-level tax election will be required to have made payments of estimated taxes under the estimated tax rules found at ARS §43-581.
- Estimated taxes will be required for an entity making the entity-level election:
 - If the entity's taxable income exceeded \$150,000 in the prior year and
 - The payments shall be made in a manner that is consistent with rules that apply to individuals.

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Estimated Taxes for Electing Entities (ARS §43-581.C)

- The Arizona Department of Revenue announced early in March that it would waive penalties on the first two estimated tax payments due for the 2022 Arizona elective passthrough income tax.
- The agency expects to be able to receive such payments by September 15, 2022, the date the third estimated payment is due.
- Notice 2020-75 indicates that it will be safest to make sure all payments are made to Arizona by December 31, 2022

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Addition to Income of the Passthrough Entity Tax on the Individual Return

- The law provides for adding back the partner's or shareholder's share of the passthrough entity taxes deducted to Arizona gross income for Arizona income tax purposes
- Also requires adding back "similar" taxes imposed by other states—a concept that will appear again in the credit for taxes paid to other states

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ANALYSIS

The intent of that sentence is not completely clear. The Department of Revenue may shed some light on what impact that sentence would have on the amount that is added back to income.

As well, this add-back may serve to put the taxpayer in worse shape than without the election if the taxpayer is both able to itemize on the Arizona return and does not have other state and local taxes of at least \$10,000.

Prior to TCJA, the taxpayer would have gotten a deduction for all Arizona taxes paid as an itemized deduction. That would still be true if the taxpayer's total state and local taxes are less than \$10,000. In such a case, the taxpayer should consider opting-out of the election by giving notice to the entity during the 60-day period allowed for opting out.

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Credit for Entity-Level Tax Against Title 43 Taxes (ARS §43-1075)

- The credit is initially the amount of tax paid by the entity that is attributable to the partner's or shareholder's share of income taxable in Arizona
- The taxes potentially imposed that are apparently eligible to be offset with the credit would include:
 - The regular income tax (ARS §43-1011 for individuals, ARS §43-1301 for estates and trusts)
 - The small business income tax (ARS §43-1711)

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ANALYSIS

This provision is unlikely to have any practical effect unless the Legislature takes action to revise the small business income tax. After the 3.5% additional education tax was struck down by the courts and the flat tax referendum was removed from the 2022 ballot, allowing that rate reduction package to go into effect immediately, there would appear to be no circumstance where a taxpayer making the election to pay the small business income tax would reduce the taxpayer's total Arizona income taxes.

Assuming the revenue targets are met for all future years by the state to allow the scheduled rate reductions to take place in the first year each one could take effect, under current law the small business income tax flat rate will either be higher (3.0% vs. 2.98% in 2022) or the same as the highest Arizona marginal individual income tax rate in all future tax years.

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Credit for Entity-Level Tax Against Title 43 Taxes (ARS §43-1075)

- If the credit exceeds the taxes due under those provisions, the excess is carried forward for up to five years against the subsequent years' income tax liability.
- If the credit carryover is not absorbed by the taxpayer by end of the fifth year, the unused tax credit will be lost.

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ANALYSIS

Presumably the “income tax liability” refers to all of the taxes under Title 43, though it is interesting that previously the section referred to all taxes under this title (Title 43). Again, we will need to wait and see how the Department of Revenue interprets this provision.

The fact that the credit is not refundable and has a limited life of five years means care must be taken to opt-out by an equity holder who has insufficient tax due to be offset. Even if the credit could be used in later years, the taxpayer is accelerating the payment of the tax if they don't have a sufficiently large tax liability.

Given the large number of Arizona tax credits available, taxpayers should be asked about their intent to make tax credit donations and warned about the issues that can take place if they reduce the taxes too much.

Note that the passthrough entity produces a larger tax benefit to the taxpayer than the Arizona charitable tax credits generally do, as the passthrough tax is always deductible in computing federal taxable income along with offsetting the individual's Arizona income tax, while the charitable credits (such as those for school tuition organizations, qualified charitable organizations, etc.) only serve to offset Arizona income tax in most cases.

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Credit for Other States' Similar Passthrough Taxes

- A key issue that arose right after these came out was dealing with the issue of out of state equity holders
- Since taxes are paid by the passthrough entity, most states' credit for taxes paid to other states would fail to grant this credit
- So would end up paying full income tax to the state where the PTE tax was paid and to the taxpayers' home state
- Arizona, along with a number of other states, have now added an individual credit for taxes paid on another state's PTE tax

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EXAMPLE 3

Wayne, an Arizona resident, holds a minor interest in XYZ, Inc., an S corporation operating in New Jersey. All other shareholders are New Jersey residents. For 2021, the S corporation elects to participate in New Jersey's optional entity level tax, the Business Activity Income Tax (BAIT). Wayne's share of the income of the S corporation is \$100,000 and his share of the BAIT is \$10,000.

While Wayne gets a \$10,000 tax credit against his New Jersey income tax, he pays tax on the entire \$100,000 to Arizona with no tax credit for taxes paid to New Jersey. We will assume his New Jersey tax computed to be \$10,000, thus is entirely offset by the tax credit. Wayne pays a 4.5% tax rate to Arizona on the income (we'll assume he uses only the cap on combined rates), paying \$4,500 to Arizona.

Had the New Jersey S corporation not made this election, Wayne's income would have been \$110,000. We'll assume Wayne's tax to New Jersey would have still been \$10,000.

Given that the Arizona rate was well below New Jersey's, in this scenario Wayne would have likely received a full credit against the \$4,500 increase in Arizona tax. Even considering the extra benefit for the federal deduction at the 37% rate, Wayne is still \$800 worse off than if the New Jersey S corporation had not made the BAIT election. However, the other shareholders don't face this problem, so for them it's a major reduction in federal taxes with no negative state tax impact.

Wayne could not avoid this result by opting out of the New Jersey BAIT tax, as the New Jersey BAIT statute does not provide an option for individual shareholders to opt out of the BAIT tax/credit regime. The opt out option only appears in the California and Arizona passthrough entity tax statutes.

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Credit for Other States' Similar Passthrough Taxes

- Arizona law will now allow a credit for taxes that the Department of Revenue considers “similar” to that imposed under the Arizona elective entity-level tax found at ARS §43-1014 (such as the New Jersey BAIT) imposed on income that is subject to tax for Arizona individual income tax purposes.
- The credit will be no more than the credit that would have been allowed had the income been taxed at the individual level and not taxed at the entity level.

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Credit for Other States' Similar Passthrough Taxes

- Key question will be - what is a “similar” tax?
 - **States that Provide a 100% Credit for the Passthrough Tax** - these should have no problem with meeting this test
 - **States that Provide a Partial Credit for the Passthrough Tax** - most likely the Department will allow these taxes even though there’s not a full credit on the other state return
 - **Exclusion States** - these are the most likely to be rejected by states with a credit statute like Arizona

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Planning & Issues with Arizona's Passthrough Entity Tax

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Planning with Arizona's Entity Level Tax, Including Potential Troublesome Areas

- Decisions to be made:
 - Every Arizona passthrough is going to have to decide if the entity will or will not want to make the PTET election
 - Each equity holder will need to decide if he/she will opt-out if the entity does decide to make the election.
- Planning necessarily involves both understanding tax information from the passthrough entity and that of each equity holder.

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Planning with Arizona's Entity Level Tax, Including Potential Troublesome Areas

- Conflict of interest exposures
 - Potential problem if CPA is both advising the partnership/S corporation and the entity
 - Less of a problem in states with individual equity holder opt-in/opt-out (California and Arizona) but still a potential problem
 - Remember
 - Benefit will be determined at the individual level but
 - The partnership or S corporation must elect to participate and will incur additional costs of compliance

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Planning with Arizona's Entity Level Tax, Including Potential Troublesome Areas

- More likely to benefit all parties if entity only operates in Arizona and has only Arizona resident equity holders
- Also have to watch out if any equity holders opt-out or have resident and non-resident equity holders due to potentially different allocation of deduction vs. allocation of credit
 - Partnerships can solve this by having their partnership/operating agreement revised
 - S corporations may present a problem not easily solved unless the IRS carves out some relief
- We will look at a number of examples illustrating various issues

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Example 1- Taxpayer With Relatively Low Arizona Passthrough Income Compared to Overall Income

- S Corporation for 2022
 - Has \$100,000 of taxable business income before considering any passthrough entity tax
 - Exactly $\frac{1}{2}$ of the income (\$50,000) is Arizona source income
- Owners A (the client we are looking at, married couple filing a joint return) for 2022
 - Has income other than the passthrough of \$500,000 from wages, \$10,000 for interest income, and \$25,000 from an IRA
 - Has no medical deductions, paid \$3,500 in Arizona estimated taxes and withholdings, \$8,500 in real estate taxes in total on a principal residence and a vacation home and \$25,000 in charitable contributions

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Example 1 - A Federal Return Without the PTET election

	No PTET Cred.
Wages	\$ 500,000
Interest	10,000
IRA	25,000
Passthrough Entity Income (Loss)	50,000
Federal Adjusted Gross Income	585,000
Standard Deduction MFJ	25,900
Itemized Deductions	
Medical (total)	0
Less 7.5%	43,875
Net Medical	0
State income taxes	3,500
Real estate taxes	8,500
Deductible Taxes	10,000
Charitable Deductions	25,000
Total Itemized Deductions	35,000
Greater of Standard or Itemized	35,000
Taxable Income	550,000
Federal Tax	\$ 166,456

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Download slides at <https://edzollarscpa.com/azptet>**Example 1 - PTET Election Made - Calculation of PTET Tax****Arizona Passthrough Equity Tax**

	Total	Owner A	Owner B
Interest owned	100.00%	50.00%	50.00%
Resident?		Yes	Yes
Opt-Out		No	No
Arizona Source Income	50,000		
Federal Income Before PTET	100,000	50,000	50,000
Income subject to PTET Tax	100,000	50,000	50,000
Arizona PTET (2.98% Assumed)	2,980		
PTET Estimates Paid in 2022	2,980	1,490	1,490

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Download slides at <https://edzollarscpa.com/azptet>**Example 1 - Federal K-1s with PTET Election in Place****Federal K-1 - Nonseparately stated income**

	Total	Owner A	Owner B
Income before PTET	\$ 100,000	\$ 50,000	\$ 50,000
PTET Tax Deduction	2,980	1,490	1,490
Nonseparately stated income	\$ 97,020	\$ 48,510	\$ 48,510

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Download slides at <https://edzollarscpa.com/azptet>**Example 1 - Arizona PTET Credit Reported to Each Owner**

	Owner A	Owner B
PTET Nonrefundable Arizona Tax Credit	\$ 1,490	\$ 1,490

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Download slides at <https://edzollarscpa.com/azptet>**Example 1 - Benefit to Owner A on Federal Tax Return**

	No PTET Cred.	PTET Cred.
Wages	\$ 500,000	\$ 500,000
Interest	10,000	10,000
IRA	25,000	25,000
Passthrough Entity Income (Loss)	50,000	48,510
Federal Adjusted Gross Income	585,000	583,510
Standard Deduction MFJ	25,900	25,900
Itemized Deductions		
Medical (total)	0	0
Less 7.5%	43,875	43,763
Net Medical	0	0
State income taxes	3,500	2,010
Real estate taxes	8,500	8,500
Deductible Taxes	10,000	10,000
Charitable Deductions	25,000	25,000
Total Itemized Deductions	35,000	35,000
Greater of Standard or Itemized	35,000	35,000
Taxable Income	550,000	548,510
Federal Tax	\$ 166,456	\$ 165,905
Federal Tax Savings		\$ 551

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Download slides at <https://edzollarscpa.com/azpte>**Example 1 - Arizona Individual Return Comparison**

	No PTET Cred.	PTET Cred.
Federal Adjusted Gross Income	\$ 585,000	\$ 583,510
Small Business Income Tax Subtraction	0	0
Modified federal adjusted gross income	585,000	583,510
Passthrough entity taxes deducted on federal return	0	1,490
Subtotal	585,000	585,000
Total net long-term capital gain or (loss)	0	0
Multiply line 23 by 25%	0	0
Net capital gain derived from investment in qualified small business		
Subtract lines 24 through 34 from line 19	585,000	585,000
Other Subtractions		
Subtract line 36 from line 35. Enter the difference	585,000	585,000
Age 65 or over		
Blind		
Other exemptions		
Arizona Adjusted Gross Income	585,000	585,000
Itemized or standard deduction	35,000	35,000
Arizona taxable income	550,000	550,000
Tax	16,156	16,156
Dependent tax credit		
Other individual nonrefundable credits (STO, QCO, QFCO, etc.)		
PTET Credit		1,490
Balance of tax	\$ 16,156	\$ 14,666
Payments and withholding	0	0
Tax due (refund)	16,156	14,666

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Download slides at <https://edzollarscpa.com/azpte>**Example 1 - Comparison of Net Benefit/Cost to A****Net Benefit or Cost to A of PTE Election**

Assuming net income=cash flow which is distributed

	No PTET Cred.	PTET Cred.
Net distribution from entity of Line 1 income	\$ 50,000	\$ 48,510
Arizona PTET credit used to reduce Arizona tax	0	1,490
Federal income tax savings	0	551
Total	\$ 50,000	\$ 50,551

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Example 1

- Must also consider any additional compliance costs that would be involved:
 - Costs of tax planning calculations needed
 - Calculations by each equity holder to determine potential benefit
 - Detailed calculations by December 31 to tie down amount to pay
 - Additional costs of compliance in preparing year end returns, which may also include providing support to the equity holders to explain this tax/credit to the holder and their advisers
- So look at tax benefit reduced by any additional costs that would be incurred

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Example Case 2 - Shareholder Uses the Standard Deduction Rather Than Itemizing

- Let's assume A does not make any charitable contributions and only uses the standard deduction
- Since even without the SALT cap they wouldn't itemize, does that mean there is no possible benefit to a PTET election?
- No - now we get to deduct state income taxes related to the passthrough income plus the full standard deduction - Example 2 runs the numbers

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Example 2 - A Return Before PTET Election

	No PTET Cred.
Wages	\$ 500,000
Interest	10,000
IRA	25,000
Passthrough Entity Income (Loss)	50,000
Federal Adjusted Gross Income	585,000
Standard Deduction MFJ	25,900
Itemized Deductions	
Medical (total)	0
Less 7.5%	43,875
Net Medical	0
State income taxes	3,500
Real estate taxes	8,500
Deductible Taxes	10,000
Charitable Deductions	0
Total Itemized Deductions	10,000
Greater of Standard or Itemized	25,900
Taxable Income	559,100
Federal Tax	\$ 169,823

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Example 2 - Compare Federal Return With and Without PTET Election

	No PTET Cred.	PTET Cred.
Wages	\$ 500,000	\$ 500,000
Interest	10,000	10,000
IRA	25,000	25,000
Passthrough Entity Income (Loss)	50,000	48,510
Federal Adjusted Gross Income	585,000	583,510
Standard Deduction MFJ	25,900	25,900
Itemized Deductions		
Medical (total)	0	0
Less 7.5%	43,875	43,763
Net Medical	0	0
State income taxes	3,500	2,010
Real estate taxes	8,500	8,500
Deductible Taxes	10,000	10,000
Charitable Deductions	0	0
Total Itemized Deductions	10,000	10,000
Greater of Standard or Itemized	25,900	25,900
Taxable Income	559,100	557,610
Federal Tax	\$ 169,823	\$ 169,272
Federal Tax Savings	\$ 551	

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Download slides at <https://eddollarscpa.com/azptet>**Example 2 - Net Economic Benefit to A****Net Benefit or Cost to A of PTE Election**

Assuming net income=cash flow which is distributed

	No PTET Cred.	PTET Cred.
Net distribution from entity of Line 1 income	\$ 50,000	\$ 48,510
Arizona PTET credit used to reduce Arizona tax	0	1,490
Federal income tax savings	0	551
Total	\$ 50,000	\$ 50,551

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Example 2

- Note that A gets exactly the same benefit as was received in Example 1
- So even though it was clearly created as a SALT cap workaround, it can work even for those not directly impacted by the SALT cap

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Example Case 3 - All Income is Passthrough Income

- Things can get more complicated if all income the taxpayer has comes from passthrough income when the state does not give a refundable credit
- Arizona, California and Utah have nonrefundable credits with five year carryovers
 - Would there be a benefit even if the excess credit is never used (which could happen if facts don't change)
 - If the credit will be used, when will it be used? Time value of money issues may come into play in the analysis

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Example Case 3 - All Income is Passthrough Income

- Passthrough entity has \$1,000,000 of income before the PTET election
- A has no income other than from the passthrough entity

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Example 3 - Arizona PTET Calculation

	Total	Owner A	Owner B
Interest owned	100.00%	50.00%	50.00%
Resident?		Yes	Yes
Opt-Out		No	No
Arizona Source Income	500,000		
Federal Income Before PTET	1,000,000	500,000	500,000
Income subject to PTET Tax	1,000,000	500,000	500,000
Arizona PTET (2.98% Assumed)	29,800		
PTET Estimates Paid in 2022	29,800	14,900	14,900

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Example 3 - Federal K-1s

Federal K-1 - Nonseparately stated income	Total	Owner A	Owner B
Income before PTET	\$ 1,000,000	\$ 500,000	\$ 500,000
PTET Tax Deduction	29,800	14,900	14,900
Nonseparately stated income	\$ 970,200	\$ 485,100	\$ 485,100

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Example 3 - Arizona PTET Credits

	Owner A	Owner B
PTET Nonrefundable Arizona Tax Credit	\$ 14,900	\$ 14,900

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Example 3 - Federal Tax Savings to A

	No PTET Cred.	PTET Cred.
Wages	\$ 0	\$ 0
Interest	0	0
IRA	0	0
Passthrough Entity Income (Loss)	500,000	485,100
Federal Adjusted Gross Income	500,000	485,100
Standard Deduction MFJ	25,900	25,900
Itemized Deductions		
Medical (total)	0	0
Less 7.5%	37,500	36,383
Net Medical	0	0
State income taxes	14,900	0
Real estate taxes	8,500	8,500
Deductible Taxes	10,000	8,500
Charitable Deductions	0	0
Total Itemized Deductions	10,000	8,500
Greater of Standard or Itemized	25,900	25,900
Taxable Income	474,100	459,200
Federal Tax	\$ 139,689	\$ 134,474
Federal Tax Savings		\$ 5,215

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Example 3 - Arizona Income Taxes

	No PTET Cred.	PTET Cred.
Federal Adjusted Gross Income	\$ 500,000	\$ 485,100
Small Business Income Tax Subtraction	0	0
Modified federal adjusted gross income	500,000	485,100
Passthrough entity taxes deducted on federal return	0	14,900
Subtotal	500,000	500,000
Total net long-term capital gain or (loss)	0	0
Multiply line 23 by 25%	0	0
Net capital gain derived from investment in qualified small business		
Subtract lines 24 through 34 from line 19	500,000	500,000
Other Subtractions		
Subtract line 36 from line 35. Enter the difference	500,000	500,000
Age 65 or over		
Blind		
Other exemptions		
Arizona Adjusted Gross Income	500,000	500,000
Itemized or standard deduction	25,900	25,900
Arizona taxable income	474,100	474,100
Tax	13,894	13,894
Dependent tax credit		
Other individual nonrefundable credits (STO, QCO, QFCO, etc.)		
PTET Credit		14,900
Balance of tax	\$ 13,894	\$ 0
PTET Credit Carryover		\$ 1,006

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Example 3 - Economic Benefits to A Considering Only the Current Year
Net Benefit or Cost to A of PTE Election

Assuming net income=cash flow which is distributed

	No PTET Cred.	PTET Cred.
Net distribution from entity of Line 1 income	\$ 500,000	\$ 485,100
Arizona PTET credit used to reduce Arizona tax	0	13,894
Federal income tax savings	0	5,215
Total	\$ 500,000	\$ 504,209

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Example 3

- Note that A is better off with the election even if A is never able to use the carryover
- Some states with refundable credits are taking a piece of the tax benefit, recognizing that there is still a net tax benefit to the taxpayers even with a reduced credit

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Example 3

As an aside, this is why a few states (Connecticut and Massachusetts to be specific) are able to give a credit that is less than the passthrough tax paid and have the equity holders still be better off than if the tax did not apply, especially if the credit is refundable (as it is in both of those states). The state can simply "split" the federal tax savings with the individuals but still offer the individuals more than enough incentive to make the election worthwhile for them with the side effect that the state has managed to get the federal government to transfer funds indirectly to the state.

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Example Case 4 - Taxpayer Eliminates Arizona Tax Via Charitable Credits

- Many Arizona taxpayers have gotten used to greatly reducing or eliminating their Arizona tax by making various contributions to charitable organizations for which the state grants a credit
- But the PTET credit is generally more valuable since it both reduces the individual tax *and* generates a federal income tax deduction
- Clients will need to understand this tradeoff--too often they assume more credits are always better, so will try to do both (and end up poorer after tax and other money being paid to third parties)

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Example 4 - Arizona Charitable Credits

Contributions to Qualified Charitable Organizations	\$ 800
Contributions to Qualified Foster Care Organizations	1,000
Public School Tax Credits	400
Original Private School Tuition Organizations Credit	1,221
Switcher Individual Private School Tuition Organizations Credit	1,214
Arizona Military Family Relief Fund Credit	400
Total Offset	\$ 5,035

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Download slides at <https://eddollarscpa.com/mazptet>**Example 4 - Taxpayer's Federal Income Before PTET Credit**

	No PTET Cred.
Wages	\$ 0
Interest	0
IRA	11,840
Passthrough Entity Income (Loss)	200,000
Federal Adjusted Gross Income	211,840
Standard Deduction MFJ	25,900
Itemized Deductions	
Medical (total)	0
Less 7.5%	15,888
Net Medical	0
State income taxes	5,960
Real estate taxes	12,000
Deductible Taxes	10,000
Charitable Deductions	25,000
Total Itemized Deductions	35,000
Greater of Standard or Itemized	35,000
 Taxable Income	 176,840
 Federal Tax	 \$ 36,821

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Download slides at <https://eddollarscpa.com/mazptet>**Example 4 - Entity Level PTET Calculation****Arizona Passthrough Equity Tax**

	Total	Owner A	Owner B
Interest owned	100.00%	50.00%	50.00%
Resident?		Yes	Yes
Opt-Out		No	No
Arizona Source Income	50,000		
Federal Income Before PTET	400,000	200,000	200,000
Income subject to PTET Tax	400,000	200,000	200,000
Arizona PTET (2.98% Assumed)	11,920		
 PTET Estimates Paid in 2022	 11,920	 5,960	 5,960

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Example 4 - Federal K-1 and Arizona Credit

Federal K-1 - Nonseparately stated income	Total	Owner A	Owner B
Income before PTET	\$ 400,000	\$ 200,000	\$ 200,000
PTET Tax Deduction	11,920	5,960	5,960
Nonseparately stated income	\$ 388,080	\$ 194,040	\$ 194,040
		Owner A	Owner B
Arizona PTET Tax Credit		5,960	5,960

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Example 4 - Federal Taxes With and Without PTET Election

	No PTET Cred.	PTET Cred.
Wages	\$ 0	\$ 0
Interest	0	0
IRA	11,840	11,840
Passthrough Entity Income (Loss)	200,000	194,040
Federal Adjusted Gross Income	211,840	205,880
Standard Deduction MFJ	25,900	25,900
Itemized Deductions		
Medical (total)	0	0
Less 7.5%	15,888	15,441
Net Medical	0	0
State income taxes	5,960	0
Real estate taxes	12,000	12,000
Deductible Taxes	10,000	10,000
Charitable Deductions	25,000	25,000
Total Itemized Deductions	35,000	35,000
Greater of Standard or Itemized	35,000	35,000
 Taxable Income	176,840	170,880
 Federal Tax	\$ 36,821	\$ 34,914
 Federal Tax Savings		\$ 1,907

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Download slides at <https://edzollarscpa.com/azptet>**Example 4 - Arizona Return With and Without PTET Election**

Federal Adjusted Gross Income	\$ 211,840	\$ 205,880
Small Business Income Tax Subtraction	0	0
Modified federal adjusted gross income	211,840	205,880
Passthrough entity taxes deducted on federal return	0	5,960
Subtotal	211,840	211,840
Total net long-term capital gain or (loss)	0	0
Multiply line 23 by 25%	0	0
Net capital gain derived from investment in qualified small business		
Subtract lines 24 through 34 from line 19	211,840	211,840
Other Subtractions		
Subtract line 36 from line 35. Enter the difference	211,840	211,840
Age 65 or over		
Blind		
Other exemptions		
Arizona Adjusted Gross Income	211,840	211,840
Itemized or standard deduction	35,000	35,000
Arizona taxable income	176,840	176,840
Tax	5,035	5,035
Dependent tax credit		
Other individual nonrefundable credits (STO, QCO, QFCO, etc.)	5,035	5,035
PTET Credit		5,960
Tax due (refund)	0	0
Credit Carryovers		\$ 5,960

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Download slides at <https://edzollarscpa.com/azptet>**Example 4 - Net Cost or Benefit When Arizona Charitable Credit Contributions Made****Net Benefit or Cost to A of PTE Election**

Assuming net income=cash flow which is distributed

	No PTET Cred.	PTET Cred.
Net distribution from entity of Line 1 income	\$ 200,000	\$ 194,040
Arizona PTET credit used to reduce Arizona tax	0	0
Federal income tax savings	0	1,907
Total	\$ 200,000	\$ 195,947

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Example 4

- Because the charitable credits reduced the Arizona tax to zero, we don't have an Arizona tax reduction to "make up" for the reduction in eventual cash distribution from the passthrough entity
- We also have paid out \$5,035 (to the charities), which is cash out of pocket with no tax benefit
- Paying out the \$5,035 only makes sense if taxpayer has a truly disinterested interest in the charity--but if that is true, why did they limit the contributions to the maximum credit amount in the past???

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Example 4

- If the tax credit was from the S corporation PSTO credit *and* if the contribution qualified for a deduction (big if) under Reg. §1.162-15(a), only then is charitable credit equivalent to the PTET credit
- In that case, should either use the PSTO credit to wipe out the tax (assuming that remains a valid business expense) or use the PSTO only to "backfill" if the equity holders still have excess Arizona income tax after the PTET credit is applied

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Example 4

- After explaining this choice to my clients, I've found most would skip the Arizona charitable contributions in this situation (not surprising when they are only making contributions up to the Arizona credit amounts...)

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Example Case 5 - Opt-Out and Issues With Credit/Deduction Differences

- Now we move on to a significant issue that can arise if any of these apply:
 - Entity has ineligible partners along with those this tax applies to (say a corporation, partnership or tax exempt organization partner)
 - Entity has both Arizona resident and non-resident equity holders
 - Some of the equity-holders opt-out of the application of the PTET to their share of the flowthrough income

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Example Case 5 - Opt-Out and Issues With Credit/Deduction Differences

- Amount of tax deduction allocated to each equity holder governed by *federal law* which treats this as an entity-level tax
 - For S corporations allocated strictly on a per-share, per-day basis (or via a cut-off accounting that won't really change this problem if qualify to elect that treatment and make the election)
 - For a partnership, governed by §704(b) regulations and the operating agreement
 - Most operating agreements drafted before these taxes existed will allocate them much like property taxes or office supplies
 - However the agreement can be revised to bring the deduction and credit into line-- but the partnership needs to actually take this step

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Example Case 5 - Opt-Out and Issues With Credit/Deduction Differences

- Amount of the tax credit to each equity holder is governed by *state law*
 - Arizona provides your credit equals 2.98% of the flowthrough income allocable to you on which the PTE tax applied at the entity level
 - That will be zero if:
 - Partner is not a qualified entity (is a corporation, partnership or tax exempt organization)
 - Partner or shareholder has opted out under Arizona law
 - Not directly tied to the deduction allocated to the equity holder on the federal K-1 by Arizona law

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Example 5

- We have an S corporation again with 2 equal shareholders
- Shareholder B is going to opt out (so only A's flowthrough income will be subject to the PTE tax)
- Since it's an S corporation
 - Income is allocated on a per-share, per-day basis
 - All distribution rights must be the same on a per share basis for distributions that are both
 - Regular operating distributions and
 - Distributions in liquidation (the one class of stock rule - Reg. §1361(b)(1)(D))

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Example 5 - Owner A (Elected Owner) Return Before Election

	No PTET Cred.
Wages	\$ 100,000
Interest	10,000
IRA	17,000
Passthrough Entity Income (Loss)	200,000
Federal Adjusted Gross Income	327,000
Standard Deduction MFJ	25,900
Itemized Deductions	
Medical (total)	0
Less 7.5%	24,525
Net Medical	0
State income taxes	5,960
Real estate taxes	12,000
Deductible Taxes	10,000
Charitable Deductions	25,000
Total Itemized Deductions	35,000
Greater of Standard or Itemized	35,000
 Taxable Income	 292,000
 Federal Tax	 \$ 75,954

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Download slides at <https://edzollarscpa.com/azptet>**Example 5 - Entity PTET Tax When Owner B Opted Out****Arizona Passthrough Equity Tax**

	Total	Owner A	Owner B
Interest owned	100.00%	50.00%	50.00%
Resident?		Yes	Yes
Opt-Out		No	Yes
Arizona Source Income	50,000		
Federal Income Before PTET	400,000	200,000	200,000
Income subject to PTET Tax	200,000	200,000	0
Arizona PTET (2.98% Assumed)	5,960		
PTET Estimates Paid in 2022	5,960	2,980	2,980

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Example 5

- Note that the PTE is computed as 2.98% of *only the income flowing to Owner A*.
- However, the tax paid creates an expense that is split even between the 2 equal shareholders
- But it's different for the tax credit which is allocated based on whether someone opted in or not and the amount of their income on which the tax is based

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Example 5 - Allocation of the Deduction and Credit

Federal K-1 - Nonseparately stated income	Total	Owner A	Owner B
Income before PTET	\$ 400,000	\$ 200,000	\$ 200,000
PTET Tax Deduction	5,960	2,980	2,980
Nonseparately stated income	\$ 394,040	\$ 197,020	\$ 197,020
		Owner A	Owner B
Arizona PTET Tax Credit		\$ 5,960	\$ 0

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Example 5 - Federal Tax Benefit to Owner A

	No PTET Cred.	PTET Cred.
Wages	\$ 100,000	\$ 100,000
Interest	10,000	10,000
IRA	17,000	17,000
Passthrough Entity Income (Loss)	200,000	197,020
Federal Adjusted Gross Income	327,000	324,020
Standard Deduction MFJ	25,900	25,900
Itemized Deductions		
Medical (total)	0	0
Less 7.5%	24,525	24,302
Net Medical	0	0
State income taxes	5,960	2,980
Real estate taxes	12,000	12,000
Deductible Taxes	10,000	10,000
Charitable Deductions	25,000	25,000
Total Itemized Deductions	35,000	35,000
Greater of Standard or Itemized	35,000	35,000
 Taxable Income	292,000	289,020
 Federal Tax	\$ 75,954	\$ 74,911
 Federal Tax Savings		\$ 1,043

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Example 5

- If A & B have identical federal income, they each end up with a \$1,043 reduction in federal taxes
- However, they each saw a net reduction of cash to be distributed to them eventually from the S corporation of \$2,980 (it's in Arizona's treasury) but only all of the \$5,960 credit will go to A
- So B will transfer \$2,980 of wealth to be divided between A and the state of Arizona, and only get a net benefit of \$1,043 in a federal tax reduction

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Example 5 - In This Case A Gets It All...

	No PTET Cred.	PTET Cred.
Federal Adjusted Gross Income	\$ 327,000	\$ 324,020
Small Business Income Tax Subtraction	0	0
Modified federal adjusted gross income	327,000	324,020
Passthrough entity taxes deducted on federal return	0	2,980
Subtotal	327,000	327,000
Total net long-term capital gain or (loss)	0	0
Multiply line 23 by 25%	0	0
Net capital gain derived from investment in qualified small business		
Subtract lines 24 through 34 from line 19	327,000	327,000
Other Subtractions		
Subtract line 36 from line 35. Enter the difference	327,000	327,000
Age 65 or over		
Blind		
Other exemptions		
Arizona Adjusted Gross Income	327,000	327,000
Itemized or standard deduction	35,000	35,000
Arizona taxable income	292,000	292,000
Tax	8,467	8,467
Dependent tax credit		
Other individual nonrefundable credits (STO, QCO, QFCO, etc.)	0	0
PTET Credit		5,960
Tax due (refund)	8,467	2,507
Credit Carryovers		\$ 0

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Example 5

- Following the net cash to A's pocket, it's clear A got more than just the federal tax benefit out of this

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Example 5 - A Gets an Indirect (and Unintentional) Gift from B

Net Benefit or Cost to A of PTE Election

Assuming net income=cash flow which is distributed

	No PTET Cred.	PTET Cred.
Net distribution from entity of Line 1 income	\$ 200,000	\$ 197,020
Arizona PTET credit used to reduce Arizona tax	0	5,960
Federal income tax savings	0	1,043
Total	\$ 200,000	\$ 204,023

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Download slides at <https://edzollarscpa.com/azptet>**Example 5 - Not in Manual, But the Same Analysis for B**

How B Ends Up Shorted by the Election	No PTET Cred.	PTET Cred.
Net distribution from entity of Line 1 income	\$ 200,000	\$ 197,020
Arizona PTET credit used to reduce Arizona tax	0	0
Federal income tax savings	0	1,043
Total	\$ 200,000	\$ 198,063

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AICPA Seeks Fix for This for S Corporations

ANALYSIS

The AICPA Tax Executive Committee has written the IRS,⁴¹ asking the agency to apply the rules found at Reg. §1.1361-1(l)(2)(i) to the passthrough entity taxes to allow for “make-up” distributions, much as is allowed for taxes paid on composite returns. The IRS has not responded to this request, made in October of 2021, at the time this manual was written.

We’ll discuss this guidance in the section below dealing with general issues arising with Notice 2020-75 and the passthrough entity taxes as the AICPA commented on other items as well.

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Example Case 6 - Out of State Partners and Not All Income Arizona Source

- A similar problem with mismatching deductions and credits take place if there are a combination of in-state and out-of-state equity holders when not all income is Arizona source
 - For resident equity holder, it's 2.98% on *all* income passing out to the resident
 - For non-resident equity holders, it's 2.98% only on *Arizona source income* passing out to the non-resident

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Example Case 6 - Out of State Partners and Not All Income Arizona Source

- Facts for this example:
 - The S corporation has \$400,000 of income before the PTET tax
 - \$200,000 of that income is Arizona source
 - Owners A are Arizona residents
 - Owner B is a non-resident of Arizona

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Example 6 - PTET Calculation in This Case
Arizona Passthrough Equity Tax

	Total	Owner A	Owner B
Interest owned	100.00%	50.00%	50.00%
Resident?		Yes	No
Opt-Out		No	No
Arizona Source Income	200,000		
Federal Income Before PTET	400,000	200,000	200,000
Income subject to PTET Tax	300,000	200,000	100,000
Arizona PTET (2.98% Assumed)	8,940		
PTET Estimates Paid in 2022	8,940	4,470	4,470

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Example 6 - Federal K-1s to Each Shareholder

Federal K-1 - Nonseparately stated income	Total	Owner A	Owner B
Income before PTET	\$ 400,000	\$ 200,000	\$ 200,000
PTET Tax Deduction	8,940	4,470	4,470
Nonseparately stated income	\$ 391,060	\$ 195,530	\$ 195,530

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Download slides at <https://edzollarscpa.com/azptet>**Example 6 - Arizona Tax Credits to Each Shareholder**

	Owner A	Owner B
PTET Nonrefundable Arizona Tax Credit	\$ 5,960	\$ 2,980

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Example 6

- Same basic problem as prior example
 - Nonresident is going to transfer funds indirectly to resident
 - Resident doesn't get full benefit for tax paid, but considering money coming from the nonresident via the credit should not complain about this issue
- Again, AICPA request is in to give some relief for these cases for S corporations
- Partnerships can solve the problem with a modification to the partnership/operating agreement

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Issues for Taxpayers Who Do Not Get a State Tax Credit for Taxes Paid to Another State

- Will be important to know if nonresident equity holders will be given a credit for taxes paid via passthrough equity tax
- If there is not a tax credit granted, generally will be worse off if the PTET is elected

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Issues for Taxpayers Who Do Not Get a State Tax Credit for Taxes Paid to Another State

- Backward credit states create a problem as well
 - States that have this problem with each other are Arizona, California, Oregon and Virginia
 - When the credit shows up on the nonresident state, a PTET election on the nonresident state generally won't be captured
 - There will be only a reduced nonresident state tax on the individual return, but full tax paid on passthrough entity
 - When the PTET credit is nonrefundable makes a bad situation even worse
 - But due to federal tax reduction, it is possible the federal benefit could outweigh the additional state tax, so run the numbers for your particular situation

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Issues for Taxpayers Who Do Not Get a State Tax Credit for Taxes Paid to Another State

- Backward credit states create a problem as well
 - For Arizona/California problem, if entity files in both states consider having equity holder only opt-in for the resident state return
 - Hopefully both states will allow a credit on the nonresident state for PTET tax paid on the resident state return

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General Revenue Procedure 2020-75 Unresolved Issues

- S Corporations and Shareholders Who Are Allocated Credit That Does Not Agree With Their Share of the PTE Tax Expense
 - This problem is not unique to Arizona, though some Arizona features make it more of an issue than others
 - Keep your eye on AICPA request and any IRS response

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General Revenue Procedure 2020-75 Unresolved Issues

- Does a Shareholder/Partner Election to Participate in a PTE Tax Still Create Specified Income Tax Payments?
 - These options did not exist in the PTE taxes in existence in November 2020
 - AICPA concern is that this might be deemed one step too far and wants assurances that the IRS will not treat these states differently
 - Most likely the IRS will allow this due to political pressure from both sides of the aisle to allow these workarounds, but can't totally dismiss the possibility the regulations would treat these taxes differently

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General Revenue Procedure 2020-75 Unresolved Issues

- Non IRC §162 Activities in the Entity
 - Notice 2020-75 did not discuss whether the ruling was limited to partnerships/S corporations that had a §162 trade or business (or maybe also a §212 rental/royalty)
 - AICPA has asked if state taxes related to other activities would need to be separately stated and perhaps subject to the \$10,000 cap
 - IRS has not issued any comment on this issue, though they are aware of it
 - A married couple in Arizona (or any community property state) could form a single member LLC to hold brokerage accounts and elect to treat it as a partnership
 - Should advise client that the IRS may not accept this position and it should be disclosed on the return

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General Revenue Procedure 2020-75

Unresolved Issues

- Accrual Basis Partnerships and Timing of Deduction for Specified Income Tax Payments
 - Notice 2020-75 only discusses getting a deduction for taxes *paid* during the tax year
 - Did the IRS mean to create a special timing rule for these payments that apply regardless of overall method of accounting for the entity?
 - Will be an issue for entities reporting on overall accrual method of accounting

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General Revenue Procedure 2020-75

Unresolved Issues

- Accrual Basis Partnerships and Timing of Deduction for Specified Income Tax Payments
 - But accrual might now work as you expect due to the all events test
 - Most states (including Arizona) allows a taxpayer to make the election as late as the due date of the return (including extensions)
 - Under the all events test, item is deductible under accrual method when *all* of these are first met:
 - All events have occurred that establish the fact of the liability,
 - The amount of the liability can be determined with reasonable accuracy, and
 - Economic performance has occurred with respect to the liability.

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General Revenue Procedure 2020-75

Unresolved Issues

- Accrual Basis Partnerships and Timing of Deduction for Specified Income Tax Payments
 - But accrual might now work as you expect due to the all events test
 - Problem is establishing the fact of the liability as of December 31 - not really liable at that date
 - Some believe could have governing entity (managers, board of directors, etc.) adopt a binding resolution by December 31 to make the election (though in Arizona might also need to deal with opt-out by then)
 - If take this position, definitely will need to disclose the position on the return

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General Revenue Procedure 2020-75

Unresolved Issues

- Interest Paid on Debt/Liability Associated with PTE Tax
 - Issue involves interest paid on the tax (either borrowed funds or late payment) - is it deductible?
 - Answer is unclear
 - General rule is that interest paid on tax by a passthrough is not deductible
 - But...have an exception related to built-in gain and excess passive income tax, along with similar state tax
 - Note that the exception only covered S corporations

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General Revenue Procedure 2020-75

Unresolved Issues

- State and Local Tax Refunds and the Tax Benefit Rule of IRC §111
 - IRC §111 covers recovery of tax benefit items
 - If law does not grant a refundable credit, should have “standard” tax benefit rule, though appears to need to be separately disclosed so partner/shareholder can test
 - Do a with and without calculation for the refund
 - If, with the refunded amount not deducted in the prior year, either tax due went up or a carryover is changed, then there is at least a partial tax benefit
 - If credit is refundable, likely excess amount is taxable to the equity holder--see *Maines v. Commissioner*, 144 TC No. 8 (2015) and *Ginsburg v. Commissioner*, CA FC, Case No. No. 1:17-cv-00075-RHH (2019)

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General Revenue Procedure 2020-75

Unresolved Issues

- Net Passive Activity Income and PTE Taxes
 - The IRS, in Publication 925, *Passive Activity and At-Risk Rules* (2021), states that state and local income taxes related to a passive activity are not to be treated as passive activity expenses,
 - Nor is any state and local income tax refund related to such passive activity to be treated as passive activity income.
 - The entity would need to disclose the amount of such taxes paid on a per-activity basis to each partner or shareholder to allow the equity holders to properly compute their passive income and loss from each activity for their personal income tax returns

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General Revenue Procedure 2020-75

Unresolved Issues

- Net Passive Activity Income and PTE Taxes
 - Impact on Net Investment Income Under §1411
 - The PTE taxes would be allowed as a deduction to reduce net investment income to the extent they are allocable to any passive activity included as investment income under IRC §1411
 - Such taxes must be allocated to applicable passive activity income on a reasonable basis.
 - Assuming all activities of the entity were a single passive activity, treating the entire amount of PTE tax paid by the entity as related to the passive activity would seem reasonable, but if there is other income some allocation will need to be made.

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FASB Meets the Passthrough Entity Taxes

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Is a Passthrough Entity Tax an Income Tax per ASC 740?

- ASC 740-10-20 that defines income taxes as “[d]omestic and foreign federal (national), state, and local (including franchise) taxes based on income.”
- Is this a tax on:
 - The entity or
 - The owners?

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Is a Passthrough Entity Tax an Income Tax per ASC 740?

- Note that choice doesn't really solve this - a qualified corporation has a choice to be taxed as a C corporation or an S corporation
 - If a C choice is made, tax is reported on the corporation's financial statements
 - Did not question whether this isn't really just relieving the corporation's shareholders from their taxes

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Is a Passthrough Entity Tax an Income Tax per ASC 740?

- Potentially relevant guidance: In 2009, FASB issued Accounting Standards Update No. 2009-06, *Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities* (ASU 2009-06) that gave some additional implementation guidance related to the composite tax returns and similar structures.
- FASB never uses the term “composite returns” in the ASU, but in 2009 these were the principal types of returns that the specific implementation guidance was dealing with.

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Is a Passthrough Entity Tax an Income Tax per ASC 740?

- Only examples added - no new other text was added
- The examples themselves, found at ASC 740-10-55-226 to 740-10-55-228, provide that:
 - Before an income tax is accounted for using ASC 740's guidance, a determination must be made regarding whether the taxes are attributable to the entity or the owners and
 - The examples provide implied guidance on how the determination is to be made regarding whether the income tax in question is attributable to the entity or its owners.

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Is a Passthrough Entity Tax an Income Tax per ASC 740?

- In the Summary of ASU 2009-60, FASB stated:

If income taxes paid by the entity are attributable to the entity, the transaction should be accounted for consistent with the guidance for uncertainty in income taxes in Topic 740. If income taxes paid by the entity are attributable to the owners, the transaction should be recorded as a transaction with owners. The determination of attribution should be made for each jurisdiction where the entity is subject to income taxes and is determined on the basis of laws and regulations of the jurisdiction.

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Example 35: Attribution of Income Taxes to the Entity or Its Owners

740-10-55-226 Entity A, a partnership with two partners—Partner 1 and Partner 2—has nexus in Jurisdiction J. Jurisdiction J assesses an income tax on Entity A and allows Partners 1 and 2 to file a tax return and use their pro rata share of Entity A's income tax payment as a credit (that is, payment against the tax liability of the owners). Because the owners may file a tax return and utilize Entity A's payment as a payment against their personal income tax, the income tax would be attributed to the owners by Jurisdiction J's laws whether or not the owners file an income tax return. Because the income tax has been attributed to the owners, payments to Jurisdiction J for income taxes should be treated as a transaction with the owners. The result would not change even if there were an agreement between Entity A and its two partners requiring Entity A to reimburse Partners 1 and 2 for any taxes the partners may owe to Jurisdiction J. This is because attribution is based on the laws and regulations of the taxing authority rather than on obligations imposed by agreements between an entity and its owners.

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Example 36: Attribution of Income Taxes to the Entity or Its Owners

740-10-55-227 If the fact pattern in paragraph 740-10-55-226 changed such that Jurisdiction J has no provision for the owners to file tax returns and the laws and regulations of Jurisdiction J do not indicate that the payments are made on behalf of Partners 1 and 2, income taxes are attributed to Entity A on the basis of Jurisdiction J's laws and are accounted for based on the guidance in this Subtopic.

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Example 37: Attribution of Income Taxes to the Entity or Its Owners

740-10-55-228 Entity S, an S Corporation, files a tax return in Jurisdiction J. An analysis of the laws and regulations of Jurisdiction J indicates that Jurisdiction J can hold Entity S and its owners jointly and severally liable for payment of income taxes. The laws and regulations also indicate that if payment is made by Entity S, the payments are made on behalf of the owners. Because the laws and regulations attribute the income tax to the owners regardless of who pays the tax, any payments to Jurisdiction J for income taxes should be treated as a transaction with its owners.

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Is a Passthrough Entity Tax an Income Tax per ASC 740?

The ASU 2009-06 Summary also noted that it was issued solely to clarify the issue and was not expected to change existing practice.

The additional implementation guidance improves current accounting by helping to achieve consistent application of accounting for uncertainty in income taxes. The guidance is not intended to change practice. It has been issued to provide additional implementation guidance on accounting for uncertainty in income taxes and does not change other requirements of Topic 740.

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Is a Passthrough Entity Tax an Income Tax per ASC 740?

- From Example 35, it appears that a tax is attributable to the owners if:
 - A tax credit is offered to the taxpayers by the taxing entity where the credit may be used to offset the owners' income tax liabilities should the owners file state income tax returns. There is a parenthetical definition of what is meant by credit in this context as a "payment against the tax liability of the owners" that was added in response to a comment that not all credits should count for this purpose, but rather only items were like payments.
 - Agreements between the owners and the entity cannot change this result--only the laws and regulations of the taxing authorities are considered

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Is a Passthrough Entity Tax an Income Tax per ASC 740?

- Example 36 provides that a tax would be attributable to the entity if:
 - There is no option for the owners to file an income tax return under the laws and regulations of the taxing authority and
 - The law and regulations of the taxing authority do not provide that the payments are made on behalf of the owners

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Is a Passthrough Entity Tax an Income Tax per ASC 740?

- Finally, Example 37 provides the following additional case where the tax would be attributable to the owners and not the entity:
 - The entity and the owners are jointly and severally liable for the payment of the tax in question under the laws and regulations of the taxing authority and
 - The laws and regulations of the taxing authority indicate that the payments are made on behalf of the owners regardless of who pays the tax.

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AICPA Center for Plain English Accounting Report

- It Depends But It Probably Isn't An Entity Level Income Tax (Maybe)
- AICPA Center for Plain English Accounting issued a Report authored by Robert Durak titled "SALT Cap Workarounds: Accounting by Pass-Through Entities"
- Not surprisingly, the report turns to the guidance found in ASU 2009-06 and the examples that ASU added to ASC 740-10-55

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Report's Summary of Treatment, Looking at FASB 2009 ASU

Based on the guidance in FASB ASC 740 (see examples below), the accounting treatment for the taxes assessed on pass-through entities requires a determination about whether, based on the laws and regulations of each specific jurisdiction, the taxes paid by the entity are attributable to the owners or attributable to the entity. If attributable to the owners, the transaction would be accounted for as a transaction with an owner (i.e., accounted for as an equity transaction). If attributable to the entity, the transaction would be accounted for in accordance with the requirements in FASB *Accounting Standards Codification* (FASB ASC) 740, *Income Taxes*, similar to other income taxes.⁶³

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Shaded Commentary Suggests Most of These Should Not Be Entity Taxes

As of the writing of this report, approximately 20 states have SALT cap workarounds in place. These workarounds vary by jurisdiction. Even in cases where states have similar workarounds, slight differences among them may be present. Given the number and varied features of the workarounds, assessing how they apply to an entity can be challenging, especially for entities with multistate presences.

While we believe many of the new pass-through entity taxes are structured to be attributable to the owner, management and practitioners need to assess the tax laws and regulations in a specific jurisdiction to draw appropriate conclusions.⁶⁴

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Specific PTE Tax Issues and ASU 2009-06 Guidance

- Exclusion PTE States
 - The returns look a bit more like a C corporation structure, but only at the state level for taxation.
 - Neither of the two FASB examples that concluded the tax was attributable to the equity holder would appear to apply to such a passthrough entity tax
 - It seems most likely that these taxes should be treated as attributable to the entity.

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Specific PTE Tax Issues and ASU 2009-06 Guidance

- Tax Credit States - Dollar for Dollar Refundable Credits
 - If a state's passthrough entity tax provides a refundable tax credit to the equity holder based on the entirety of the equity holder's allocable share of the tax paid it likely is a tax attributable to the equity holders
 - Would be reported for GAAP (but not tax) purposes as a distribution to the equity holder as opposed to an expense of the entity.

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Specific PTE Tax Issues and ASU 2009-06 Guidance

- Tax Credit States - Dollar for Dollar Refundable Credits
 - But there are issues:
 - An S corporation where not every shareholder is allocated the same amount of deductible passthrough entity tax and refundable tax credit there will be a disconnect between distributions recorded for tax purposes and the legal distributions allowed to be taken by the equity holder.
 - Financial statements prepared as the Report suggests might tempt S corporations to make make-up distributions to shareholders who don't get a tax credit equal to their deduction to "make up" for the the unfair benefit received by other shareholders.

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Specific PTE Tax Issues and ASU 2009-06 Guidance

- Tax Credit States - Dollar for Dollar Refundable Credits
 - But there are issues:
 - Under the book capital account accounting required to comply with Section 704(b) regulations to deem allocations to have substantial economic effect and be respected for tax purposes, the payment will need to be treated as an expense of the entity and allocated as such by the agreement.
 - While an agreement could be crafted to work around this issue, so that the distribution and expense treatments lead to the same result, if that result is not achieved then there would be a problem with the GAAP capital accounts.

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Specific PTE Tax Issues and ASU 2009-06 Guidance

- Tax Credit States - Dollar for Dollar Refundable Credits
 - But there are issues:
 - Since under the partnership agreement, Section 704(b) capital accounts would govern distributions in liquidation, it would seem the GAAP account would need a "plug fix" much as the Tax Executive Committee suggested to deal with the S corporation AAA and tax basis issue in their letter to the IRS.
 - Some sort of "deemed distribution" would need to be taken into account to reflect the legal impact of the PTE tax allocations since they would govern the economic right of a partner to the net assets of the partnership.

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Specific PTE Tax Issues and ASU 2009-06 Guidance

- Tax Credits Where Either the Credit is Less Than 100% of the Tax Paid or the Credit is Not Refundable
 - Possible the guidance may suggest a tax that is both
 - Attributable to the equity holder to the extent it is available to the equity holder and
 - Attributable to the entity to the extent it is not.

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EXAMPLE

Dan's Phone Store, Inc. an S corporation located in Boston whose shares are all owned by Dan elects to pay the Massachusetts passthrough equity tax. The tax due is computed to be \$10,000. Under Massachusetts law, Dan gets a credit equal to 90% of his portion of the tax paid by the S corporation which is \$9,000 (90% of \$10,000).

\$9,000 of the tax paid appears to be attributable to Dan and, under the guidance found in ASC 740 and the AICPA Report, would seem to be properly reported on a GAAP financial statement as a distribution to Dan and not an income tax for the entity.

However, the \$1,000 paid in excess of the refund Dan can claim appears to be a tax attributable to Dan's Phone Store, Inc. as it imposed on the corporation's income and cannot be treated as a payment of Dan's individual tax. Thus, it would be reported as part of an income tax provision for Dan's Phone Store, Inc. on the store's GAAP financial statement, subject to the standard adjustments to the income tax imposed by the taxing entity for the year required under ASC 740.

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Specific PTE Tax Issues and ASU 2009-06 Guidance

- Tax Credits Where Either the Credit is Less Than 100% of the Tax Paid or the Credit is Not Refundable
 - If credit is nonrefundable, we have a credit that may not be fully able to be used by the equity holder
 - So how do we deal with this option?

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Nonrefundable Tax Credit - Conditional Entity Level Tax?

EXAMPLE

Dan's Phone Store, Inc. operates in California. Under California law, the PTE credit is not refundable. While unused credits can be carried forward for five years, if not used in five years any excess credit is lost. The corporation pays the PTE tax of \$10,000 for 2022 and Dan is allowed to claim a credit of the lesser of that \$10,000 or the tax before the credit on his 2022 return. Dan expects to be able to use \$9,000 of the \$10,000 credit.

Dan also expects the same situation to occur in all future years and presumes the SALT cap will be extended by Congress and the PTET tax and credit will be extended by the California Legislature when both are set to expire. Thus he never expects to be able to use any of the unused credit for future years. Both the cap and the PTE tax are set to expire for years beginning on or after January 1, 2026.

If, by chance, the PTE credit is not extended past January 1, 2026, Dan expects he would be able to use his unused credits at that point of \$4,000 (2022-2025) in full against his 2026 taxes.

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Arizona's Law Applied to ASC 740 Guidance Found in ASU 2009-06

- We have a number of indicators that suggest this tax should be treated as a distribution and not an income tax for GAAP purposes if you follow AICPA document.
- First, just like the tax in Example 35, Arizona provides for a tax credit that is available to be used against the various partners'/shareholders' Arizona income tax liability.
- Just like in Example 36, the law provides that the partners/shareholders are liable for the tax attributable to their share of the passthrough income.

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Arizona's Law Applied to ASC 740 Guidance Found in ASU 2009-06

- The partners/shareholders are eligible to file an income tax return for this income under Arizona.
- In Example 36 having no such option was found to be a reason why the tax was to be treated as an income tax under ASC 740.
- Not clear if this is a payment made on behalf of the shareholders

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Arizona's Law Applied to ASC 740 Guidance Found in ASU 2009-06

- But we have a *payment* terminology problem given FASB response to comment received

A respondent suggested that the Board avoid using the term credit in paragraph 740-10-55-226 because credit has a broader meaning than how it is used in proposed FSP FIN 48-d. That respondent stated that using the term credit could create confusion in applying the concept in this example. The respondent suggested substituting a description such as a *payment used against the tax liability of the owners* rather than the term *credit*.⁶⁸

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Arizona's Law Applied to ASC 740 Guidance Found in ASU 2009-06

But while indicating their agreement, the actual change was merely to add the suggested language as a parenthetical addition rather than removing the word credit and using the payment language as a substitute for the use of the word credit:

The Board agreed with the respondent's request because it believes that description does not alter the intent or meaning of paragraph 740-10-15-226 and it may help to avoid unintended consequences due to the broader meaning of the term credit. As a result, the Board parenthetically noted this distinction within paragraph 740-10-55-226.⁶⁹

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Arizona's Law Applied to ASC 740 Guidance Found in ASU 2009-06

- Unfortunately, FASB doesn't explain exactly how the reader is determine what is a "payment style credit" vs. "non-payment style credit" for these purposes.

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Issues That Arise from Treating as a Non-Entity Level Tax

- What is the Distribution Amount if the Tax Expense Allocation Differs from the Credit?
- Look back at Example 5

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Example 5 - PTET Calculation

	Total	Owner A	Owner B
Interest owned	100.00%	50.00%	50.00%
Resident?		Yes	Yes
Opt-Out		No	Yes
Arizona Source Income	50,000		
Federal Income Before PTET	400,000	200,000	200,000
Income subject to PTET Tax	200,000	200,000	0
Arizona PTET (2.98% Assumed)	5,960		
PTET Estimates Paid in 2022	5,960	2,980	2,980

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Example 5 - Federal K-1

Federal K-1 - Nonseparately stated income	Total	Owner A	Owner B
Income before PTET	\$ 400,000	\$ 200,000	\$ 200,000
PTET Tax Deduction	5,960	2,980	2,980
Nonseparately stated income	\$ 394,040	\$ 197,020	\$ 197,020

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Example 5 - Arizona Credit Allocation

		Owner A	Owner B
Arizona PTET Tax Credit		\$ 5,960	\$ 0

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Issues That Arise from Treating as a Non-Entity Level Tax

- It is the author's belief that, given FASB's concern with a credit that works like a payment, the impact on the owner's tax return is the key factor in determining the amount of distribution.
- Since Owners A will obtain a \$5,950 credit, Owner A should receive the entire \$5,950 distribution as only Owner A will receive a FASB defined payment for this Arizona taxes.

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Connecticut Example

Assuming the passthrough entity is an S corporation with one shareholder and \$100,000 of income before the tax. In that case we end up with these results:

Income Before Passthrough Tax	\$ 100,000
CT Tax at 6.99%	6,990
Net Taxable Federal	\$ 93,010
Shareholder Tax Credit (87.5% of the CT Tax)	\$ 6,116
Entity Tax Paid in Excess of Shareholder Credits	\$ 874

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Issues That Arise from Treating as a Non-Entity Level Tax

- S Corporation Per-Share Day Rule and One Class of Stock Rule
 - If it is determined that the financial statements should reflect the credit received by each shareholder as the amount distributed to that shareholder, as the author believes is closest to FASB's view of this as a payment and where the tax is attributable to, there are still issues.

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Example 5: Credit

Let's go back to our 50/50 shareholders from Example 5 under the Arizona tax where Owner B opted out. Our credit looked like this:

		Owner A	Owner B
Arizona PTET Tax Credit		\$ 5,960	\$ 0

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Issues That Arise from Treating as a Non-Entity Level Tax

- Partnership/Operating Agreements, §704(b) Language in Such Agreements and Partner's Capital
 - Legal documents incorporate §704(b) language in most agreements
 - Will govern payments made to liquidate the interest, so controls the *economic* capital accounts
 - Presumably GAAP means to reflect economics

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Example 5: PTET Allocation

	Total	Owner A	Owner B
Interest owned	100.00%	50.00%	50.00%
Resident?		Yes	Yes
Opt-Out		No	Yes
Arizona Source Income	50,000		
Federal Income Before PTET	400,000	200,000	200,000
Income subject to PTET Tax	200,000	200,000	0
Arizona PTET (2.98% Assumed)	5,960		
PTET Estimates Paid in 2022	5,960	2,980	2,980

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Example 5: Federal K-1

Federal K-1 - Nonseparately stated income	Total	Owner A	Owner B
Income before PTET	\$ 400,000	\$ 200,000	\$ 200,000
PTET Tax Deduction	5,960	2,980	2,980
Nonseparately stated income	\$ 394,040	\$ 197,020	\$ 197,020

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Example 5: Arizona Credits

		Owner A	Owner B
Arizona PTET Tax Credit		\$ 5,960	\$ 0

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Tax Basis Financial Statements - Is This Treatment Different?

- **Tax Basis:** A basis of accounting that the entity uses to file its tax return for the period covered by the financial statements.

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Tax Basis Financial Statements - Is This Treatment Different?

In a 2017 report, the AICPA Center for Plain English Accounting provided the following guidance on measurement principles for tax basis financial statements:

8. When preparing tax basis financial statements, how are differences between U.S. GAAP and IRS rules handled?

The general rule is that if the financial statements are being prepared on the tax basis, *the treatment on the tax return would trump the presentation under U.S. GAAP. (emphasis added)*⁷⁶

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Tax Basis Financial Statements - Is This Treatment Different?

- Since Notice 2020-75 treats these taxes as an entity-level expense, for tax basis financial statements, taxes qualifying under Notice 2020-75 should not be treated as a distribution.

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Arizona Passthrough Entity Tax: Update and Overview

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