

**CONFIDENTIAL MEMORANDUM**

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**TO** Pass-Through Entity Clients (and their CPAs) Interested in New Elective PTE Tax Proposal

**FROM** Bruce P. Ely

**DATE** March 4, 2020

**SUBJECT** Overview of the TCJA Task Force's PTE Tax Proposal

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Several of our pass-through entity (PTE) clients or their CPAs have asked about the proposed elective PTE Tax proposal contained in Section 3 of the Tax Cuts and Jobs Act (TCJA) Task Force's implementing legislation, HB 353/SB 250. I hope the following unofficial summary will help clarify:

1. The Alabama PTE Tax proposal generally follows the Wisconsin PTE tax statute by being purely elective, meaning that the PTE could elect-in one tax year, then elect-out the following tax year if for example Congress eventually repeals or substantially increases the SALT deduction cap, or if it's allowed to sunset after 2025. However, once the PTE elects-out, it cannot re-elect for the next four tax years.
2. The tax rate is pegged at 3.95% of the PTE's deemed corporate taxable income, apportioned and allocated to Alabama as if the PTE was a C corporation. The sponsors chose that tax rate as somewhat of a compromise between the proposed 4.75% C corp. rate (lowered from 6.5% to reflect the repeal of the corporate Federal income tax deduction) and the average *effective* tax rate if individuals own the PTE, factoring-in their FIT deduction. It is also a result of multiplying the 5% individual tax rate by  $(1 - 21\%)(\text{federal corporate tax rate}) = 3.95$ .
3. Neither the individual tax rates nor the individual FIT deduction are being altered by this bill or the accompanying constitutional amendment. The proposed constitutional amendment *only affects* the 6.5% corporate income tax rate and the corporate and bank FIT deduction.
4. The essence of the proposal is that the Alabama income tax liability of the PTE is paid by the PTE itself and the income/expenses (including SALT) of the PTE never show up on the Alabama tax returns of its owners. We think this is the most defensible way to defeat any potential challenge by the IRS that this is some sort of nefarious "SALT cap workaround" and should be denied or disregarded. To date, the IRS has not challenged this approach.
5. Also, the Joint Committee's Explanation of the TCJA (known as the "Blue Book") specifically mentions taxes levied on the PTE itself as not being subject to challenge by the IRS as a SALT cap workaround. There is no distinction made in the Blue Book between, e.g., state and local property taxes and state income taxes.

6. There are now 6 states with PTE taxes, including Louisiana and most recently New Jersey, and the S Corporation Association of America predicts that perhaps as many as 5-6 or more states may follow suit this year. The S Corp. Association is backing the Task Force's PTE tax proposal and engaged me to draft it, with assistance from their national experts.
7. We inserted language to protect the PTE from any sort of adverse tax consequences either when it elects-in or when it elects-out so that, for example, there is no deemed liquidation or depreciation recapture for Alabama income tax purposes. We also inserted language to confirm that the owner's basis in their S corp. stock or partnership/membership interest will continue to be "stepped up" for any income taxed at the corporate level during the time the PTE election is in place. See Sections 3(h) and (i), pages 51-52 of the House Bill.
8. Finally, we made it clear that the PTE will continue to receive an Alabama income tax credit for net income taxes it pays to other states on behalf of itself or its owners (e.g., as a composite return payment) with respect to income taxed at the entity level. See Section 3(g) of the bill.

Hopefully this very unofficial summary has been useful. If you have any further questions about the proposal or suggestions for change, feel free to contact me at [bely@bradley.com](mailto:bely@bradley.com).