



# Accounting Treatment of State Pass-Through Entity Taxes

**By Ralph Nach, CPA**  
Principal, Epstein + Nach LLC  
Senior Faculty and Technical Advisor, 20-20 Services LLC  
Chief Auditor, Auvana Accountancy Corporation

January 2022

## Introduction and Background

The Tax Cuts and Jobs Act (“TCJA”) enacted on December 22, 2017 that became effective for tax years after December 31, 2017 and before January 1, 2026 included a provision that limited the annual federal personal income tax deduction for state and local taxes (“SALT”) to \$10,000. The taxes to which this limit applies are state and local income, sales, and property taxes paid by the individual taxpayer. Additionally, the TCJA also increased the standard deduction to \$12,000 for single tax filers and \$24,000 for joint filers.<sup>1</sup> These were significant increases from the prior standard deductions which were \$6,300 and \$12,600 for single and joint filers, respectively.

Considered in tandem, these two provisions of TCJA meant that many taxpayers, especially those that live in jurisdictions with high state and local tax rates would either get a partial SALT deduction if such taxes exceeded \$10,000 or no SALT deduction if the taxpayer did not have sufficient other itemized deductions that exceeded the standard deduction.

## State Workarounds

Nearly half of the states<sup>2</sup> whose citizens were disadvantaged by these limits have enacted or are proposing to enact state laws that provide a workaround to the limits for taxpayers that are owners of businesses that are pass-through entities (PTEs)<sup>3,4</sup>. These various states’ versions of the tax differ from each other and the practitioner must familiarize themselves with the details of how each applicable state’s system operates.

---

<sup>1</sup> These standard deductions were indexed to inflation and, for tax year 2021 are now \$12,550 for single filers and \$25,100 for joint filers.

<sup>2</sup> States enacting similar workaround taxes include Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Georgia, Idaho, Illinois, Louisiana, Maryland, Minnesota, New Jersey, New York, Oklahoma, Oregon, Rhode Island, South Carolina, and Wisconsin

<sup>3</sup> Applicable pass-through entities may include partnerships, S corporations, and limited liability companies taxed as partnerships depending on the provisions of each state’s law

<sup>4</sup> Several of the affected states’ laws will not be effective until tax year 2022.

The American Institute of Certified Public Accountants (“AICPA”) has published a color-coded map that provides a birds-eye view of the states that have enacted or are in the process of enacting such taxes.<sup>5</sup>

### **Example: State of Illinois Pass-Through Entity (“PTE”) Tax**

On August 27, 2021, Illinois enacted its “Pass-Through Entity Tax” (“PTE Tax”) that applies to taxable years ending on or after December 31, 2021, and prior to January 1, 2026. The Illinois PTE Tax works as follows:

- The PTE Tax is an entity-level income tax that partnerships and S corporations may elect to pay effective for tax years ending on or after December 31, 2021
- The election to pay the PTE Tax is required to be made annually and, is irrevocable once made
- The PTE Tax rate is equal to 4.95% of the Illinois net income of the PTE that is computed as Illinois base income for the tax year after apportionment or allocation.
- The 4.95% rate is the flat tax rate that applies to individual taxpayers in Illinois.
- A PTE making the election is liable for paying the PTE Tax to the Illinois Department of Revenue and, the PTE will, in later years, be required to pay estimated taxes on a quarterly basis if the expected tax due (including both the PTE Tax and state replacement tax) is more than \$500.00 or incur late estimated payment penalties.
  - If the annual Illinois tax liability, including PTE Tax, meets or exceeds \$20,000, the payments must be made electronically
- If the electing PTE does not pay the full amount of tax considered assessed, the partners or shareholders of the entity are personally liable to pay the tax assessed (including penalties and interest)
- PTE partners, members, and shareholders must add back to their Illinois income, on their personal Illinois return, their distributive share of the PTE Tax so that the Illinois tax liability at the partner, member, or shareholder level is computed on each individual owner’s distributive share of the entity’s taxable income *before* PTE Tax paid at the entity level
- PTE partners, members, and shareholders may claim a refundable Illinois credit equal to their distributive share of the Illinois PTE Tax paid by the PTE and may adjust their state estimated payments accordingly
- Illinois also explicitly allows a credit to resident PTE owners for “substantially similar” PTE Taxes imposed by other states that are based on the owner’s share of the PTE income allocated or apportioned to the other state.

---

<sup>5</sup> <https://bit.ly/3n8VMrg>

- In IRS Notice 2020-75<sup>6</sup>, the IRS announced its approval of the federal deduction of state PTE Taxes paid by the entity in circumstances where the partner, member, or shareholder receives a state tax credit, and the PTE Tax essentially is paid in lieu of the state income tax otherwise imposed upon the partner or S corporation shareholder.
- In order to claim the federal deduction for 2021, the PTE Tax must have been paid to the state during 2021.

---

<sup>6</sup> <https://www.irs.gov/pub/irs-drop/n-20-75.pdf>

### Example: Economic Substance of Tax for Financial Reporting Purposes

Haylee Home Stores LLC (“HHS”) operate a chain of household goods retail stores exclusively in Illinois. HHS is organized as a Limited Liability Company (“LLC”) and files its federal and state tax returns as a partnership. HHS has two members each of whom own 50% of the member interests:

Haylee J.	50%	Illinois resident
Aubree N.	50%	Illinois resident
	<u>100%</u>	

Since HHS operates a business, it reports its income for each member’s distributive share on the members’ respective forms K-1, Part III, Line 1 – Ordinary business income (loss). For 2021, HHS had aggregate ordinary income of \$200,000, prior to deducting any PTE Tax paid, half of which is allocable to each of the two members. HHS paid its estimated PTE Tax of \$9,900 ( $\$200,000 \times 4.95\% = \$9,900$ ) on December 31, 2021. Neither member has any dependents, taxable income from any other sources, or any subtractions or credits available on their Illinois tax returns.

Caption	Pass-Through Entity Tax Returns		Each Individual Tax Return (50%)	
	Federal	Illinois	Federal	Illinois
Ordinary business income before PTE Tax	\$200,000			
Federally deductible PTE Tax paid in 2021	9,900			
Ordinary business income to be reported on federal K-1s	190,100		\$95,050	\$ 95,050
State addition modification to add back distributive share of PTE Tax paid by HHS				4,950
State base income				100,000
2021 state exemption				2,375
Resident net income				97,625
Resident income tax (4.95%)				4,832
Refundable credit for PTE Tax paid by HHS				4,950
Illinois refund due to member				\$ (118) <sup>7</sup>

An analysis of the effects of the PTE Tax reveals that:

- The \$95,050 of ordinary business income that is passed through to each individual member is \$4,950 (50% of \$9,900 PTE Tax paid by HHS) less than it would have been if HHS had not elected to pay the PTE Tax. Thus, each member is receiving the same federal tax benefit they would have received if they had

<sup>7</sup> Refund is attributable to the 2021 state exemption of \$2,375 x the flat rate of 4.95% = \$118

been able to fully deduct personal Illinois income tax on the LLC's ordinary business income on their federal individual income tax returns.

- The state base income of each member is \$100,000, that is each member's distributable share of HHS's ordinary business income before PTE Tax. Consequently, individual state income tax of \$4,950 (4.95% of \$100,000) is assessed at the individual level. However, each member also is entitled to a \$4,950 refundable credit for their distributable share of PTE Tax paid by HHS that offsets that individual state income tax.
- The aggregate economic effects are that:
  - None of the income tax benefits that result from HHS paying the PTE Tax affect HHS as an entity since it is a pass-through entity whose taxable income for both federal and state tax purposes is attributed to its owners<sup>8</sup>
  - All of the income tax effects that arise from HHS paying the PTE Tax benefit its member-owners on their personal federal income tax returns, even if they don't itemize their deductions and take the standard deduction instead.

### **Recommended Treatment in US GAAP Financial Statements**

Based on the foregoing analysis, since the payment of the PTE Tax does not, in any way effect HHS as an entity but rather is entirely for the benefit of HHS's owners, each owner's distributable share of the payment of the PTE Tax should be reflected as a distribution (draw) to that owner. Thus, in the example above, each member's Form 1065, Schedule K-1 would reflect on line 19, code A, distributions of cash and marketable securities an increase of \$4,950.

This treatment is consistent with an example included in the FASB Accounting Standards Codification<sup>®</sup> at ASC 740-10-55-228 (Emphasis Added):

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

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.*

---

<sup>8</sup> Note that the PTE tax does not affect the computation of the Illinois Replacement Tax that is assessed to the entity.

## GAAP Presentation and Disclosure Considerations

A sample note to the financial statements of HHS is as follows:

### Note X – State Pass-Through Entity Tax (LLC Example)

We elected to pay a newly imposed Illinois Pass-Through Entity (“PTE”) tax (“PTE Tax”) on behalf of the members. This tax is assessed as 4.95% of our business income and is applied to reduce each member’s proportionate share of federal taxable income reportable on that member’s personal income tax return. Accordingly, each member recognizes a federal income tax benefit as if the member’s state income tax were fully deductible on the member’s personal federal income tax return. Since the income tax benefits associated with the PTE Tax exclusively benefit the members, each member’s proportionate share of the tax is recognized as a distribution to that member. Each of the member’s distributions include \$4,950 representing that member’s share of the PTE Tax paid on their behalf for the year ended December 31, 2021.

The statement of changes in members’ equity would appear as follows with each member’s distributable share of the PTE Tax included in that member’s distributions:

#### Haylee Home Stores LLC Statement of Changes in Members’ Equity Year Ended December 31, 2021

	50%	50%	
	<u>Member 1</u>	<u>Member 2</u>	<u>Total</u>
Balances, January 1, 2021	\$675,000	\$675,000	\$1,350,000
Net income for year ended December 31, 2021	100,000	100,000	200,000
Distributions	<u>(101,450)</u>	<u>(101,450)</u>	<u>(202,900)</u>
Balances, December 31, 2021	<u>\$673,550</u>	<u>\$673,550</u>	<u>\$1,347,100</u>

See accompanying notes and independent accountants’ report.

## Considerations with Respect to Electing Other States' Similar Taxes

Irrespective of the state or states in which a pass-through entity operates or that the entity's owners are residents of, the following matters should be considered before making an election in a particular state

- Do all pass-through entities doing business in the state qualify?
- What types of business owners are eligible to make the election in the state?
- Is consent of all the members required in order for the entity to elect to pay the tax?
- Will all members benefit from the PTE's election to pay the PTE tax?
- What is the timing of making the election?
- Can the election be revoked, and if so, how and when?
- Can the pass-through entity retroactively elect to pay the tax?
- How is the taxable base computed? (Guaranteed payments and other allocations may also be included in the taxable base)
- How are tax-exempt foreign members treated?
- Can members organized as corporations receive a credit for the PTE tax paid by the entity?
- How does a pass-through entity handle net operating losses ("NOLs")?
- Is depreciation arising from step-ups in basis deductible at the entity level in computing the taxable base?
- Is there a pass-through entity tax election available in every state in which the entity has nexus?<sup>9</sup>
- How does the apportioned tax base and the election itself affect the potential tax benefits to the entity's owners?
- Is a credit for tax paid to other states on behalf of an individual owner allowed in each individual owner's state of residence?
- Will the timing of estimated tax payments and other tax distributions affect the pass-through entity's federal S corporation election?
- Does the state have an alternative minimum tax that limits the amount of tax benefit?
- Will making the election change the filing group, causing a loss of other state tax benefits?

---

<sup>9</sup> Nexus describes the amount and degree of a taxpayer's business activity that must be present in a state for the taxpayer to become subject to the state's taxing jurisdiction of taxing power.

- Will maximizing the benefit require the PTE to adjust its legal or operating documents?
- Is a full credit for the tax paid by the entity available to the individual members (e.g., the Massachusetts elective tax provides a 90% credit)?

As of December 29, 2021, the following states have a substantially similar entity-level tax<sup>10</sup>:

Alabama	Ala. Code of 1975 § 40-18-24.4
Arizona	Ariz. Rev. Stat. § 43-1014
Arkansas	Ark. Code Ann. § 26-65-01
California	Cal. Rev. & Tax Code § 19900
Colorado	Colo. Rev. Stat. § 39-22-340
Connecticut	Conn. Gen. Stat. § 12-699
Georgia	GA. Code Ann. §§ 48-7-21(b)(7)(C) and 48-7-23(b)
Idaho	Idaho Code Ann. § 63-3026B
Louisiana	LA. Rev. Stat. Ann. § 47:287.732.2
Maryland	MD. Code Ann. Tax-Gen. § 10-102.1
Massachusetts	ALM GL ch. 63D, § 2
Michigan	MCL § 206.813
Minnesota	Minn. Stat. Ann. § 289A.08(7a)
New Jersey	N.J. Stat. Ann. § 54A: 12-3
New York	NY CLS Tax § 862
North Carolina	Sessions Law 2021-180, SB 105
Oklahoma	Okl. Stat. tit. 68, § 2355.1P-1
Oregon	2021 Or. Laws Ch. 589 § 3
Rhode Island	R.I. Gen. Laws § 44-11-2.3
South Carolina	S.C. Code Ann. § 12-6-545(G)
Wisconsin	Wis. Stat. §§ 71.21(6) and 71.365(4m)

<sup>10</sup> Source: <https://www2.illinois.gov/rev/research/publications/pubs/Pages/Pass-through-Information.aspx>

---

This publication has been prepared for general informational purposes and does not constitute professional advice on facts and circumstances specific to any person or entity. 20-20 Services LLC, Epstein + Nach LLC, Auvana Accountancy Corporation, and the author, by means of this publication, are not rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business or your clients' businesses. Before making any decision or taking or refraining from any action that may affect your business or your clients' businesses, you should consult with a professional advisor familiar with the specifics of your particular factual situation.

No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication. The information contained in this publication was not intended or written to be used, and cannot be used, for purposes of avoiding penalties or sanctions imposed by any government or other regulatory body. 20-20 Services LLC, Epstein + Nach LLC, Auvana Accountancy Corporation, their members, principals, owners, employees, contractors, and agents shall not be responsible for any loss sustained by any person or entity acting or refraining from action as a result of any material in this publication.

The content of this publication is based on information available as of January 8, 2022. Accordingly, certain aspects of this publication may be superseded as new guidance or interpretations are issued. Financial statement preparers and other users of this publication are therefore cautioned to stay abreast of and carefully evaluate authoritative and interpretative guidance issued subsequent to this publication.

© 2022 20-20 Services LLC, Epstein + Nach LLC, and Auvana Accountancy Corporation  
All rights reserved.