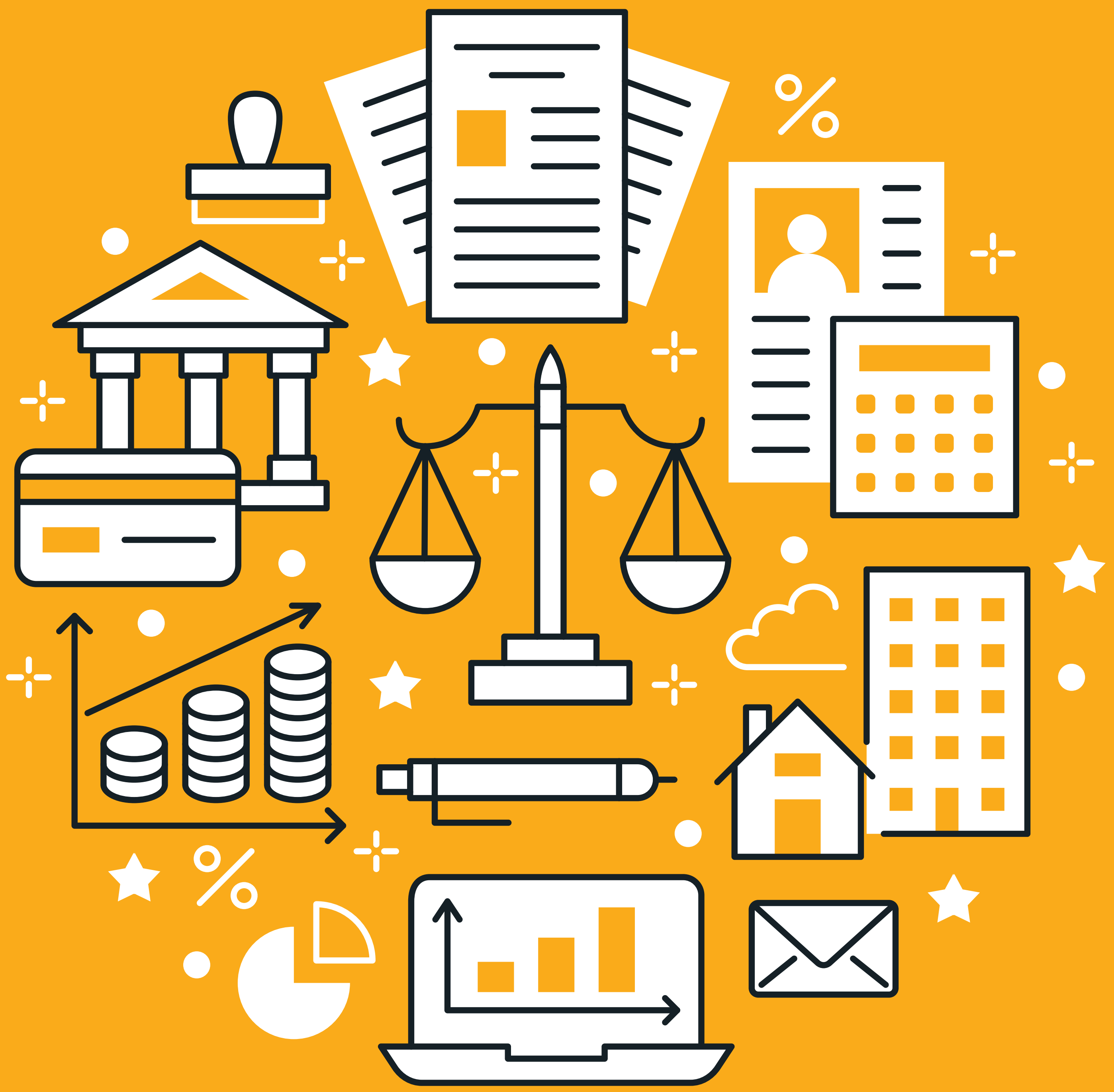


WHERE ARE WE ON THE NEW ELECTIVE PTE TAX REGIME?

WILLIAM T. THISTLE, II AND BRUCE P. ELY

Earlier this year, Alabama became one of 19 or so states to enact a pass-through entity tax as a workaround to the so-called "SALT Cap" enacted as part of the Tax Cuts and Jobs Act of 2017, which limits the deductibility of state and local taxes to $10,000 (MFJ) annually.

Background

The Alabama Electing Pass-Through Entity Tax Act (Act 2021-1) established a new alternate state income tax applicable only to electing partnerships/LLCs treated as pass-through entities and to S corporations (collectively, "PTE's"). For tax years beginning on or after **January 1, 2021**, a PTE can elect annually to be taxed at the entity level for Alabama income tax purposes at the highest marginal individual income tax rate (currently 5%) calculated in accordance with the Subchapter K or Subchapter S rules, as appropriate, and apportioned in accordance with Alabama's multistate corporation apportionment rules.

Initially, the PTE owners' pro rata or distributive shares of income were to be excluded from their Alabama taxable income, but the Legislature quickly amended the law through Act 2021-423 to provide that the PTE's income still flows through to its owners. In return, the owners are each entitled to claim a **refundable credit** in an amount equal to their pro rata or distributive share of the Alabama income tax paid by the electing PTE. The credit mechanism is intended to allow PTE owners to take full advantage of their federal income tax deduction. This way, the PTE Tax will work much like the composite return regime, but with a SALT Cap workaround that can provide a tax benefit at the federal level.

Act 2021-423 also authorized the Alabama Department of Revenue (ADOR) to waive interest and penalties resulting from the underpayment or the electing PTE's failure to pay the estimated tax due on April 15, 2021. Shortly after the PTE Tax was amended, the ADOR provided guidance that if the underpayment is $500 or less, then penalties and interest will not be incurred. If the underpayment is greater than $500 and is due to the retroactive effect of Act 2021-423, then taxpayers will be eligible for penalty and interest waivers as well.

ADOR's Proposed Rule on the PTE Tax

On August 31, the ADOR issued Proposed Rule 810-3-36-.01 (the "Proposed Rule") implementing the PTE Tax. The Proposed Rule primarily focused on the mechanical requirements to make the election and pay the tax.

According to the Proposed Rule, to make the PTE Tax election, the PTE must file Form PTE-E, *Pass-Through Entity Election Form*, electronically via the ADOR's My Alabama Taxes website "on or before the fifteenth day of the third months following the close of the tax year for which the entity elects to be taxed as an Electing Pass-Through Entity." The election is binding for the tax year to which it relates and all subsequent tax years "until a request to revoke the election is [timely] made." Thus, once the election is properly made, the PTE must affirmatively *opt-out* to terminate the election. There are certain voting requirements both for making the election and for opting out.

The Proposed Rule further provides that an entity making the election must file Alabama Form EPT, *Electing Pass-Through Entity Payment Return*, in addition to a complete Form 20S, *S-Corporation Information/Tax Return*, or Form 65, Alabama Partnership/Limited Liability Company Return of Income, for the applicable taxable year for which the election was made and all taxable years thereafter unless the election is terminated.

The Proposed Rule also addresses quarterly estimated payments. Specifically, the Proposed Rule tracks previous informal guidance from the ADOR by defining the "required annual payment" as the lesser of 100% of the tax shown on the return for the taxable year or 100% of the tax shown on the return for the preceding year. Although the Proposed Rule doesn't include this, previous guidance from the ADOR provided that if the entity was a PTE during the previous year and therefore didn't owe income tax for that year – the previous year's tax safe harbor is calculated as if the PTE was a C corporation.

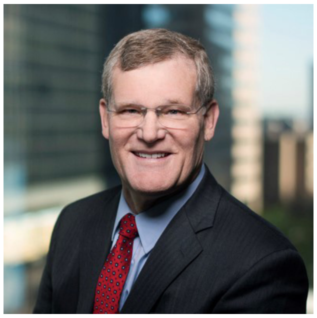
Although the Proposed Rule provides much insight regarding the mechanics of the new PTE Tax, much remains unclear. To that end, our law firm and the Alabama Society of CPAs separately filed extensive comment letters with the ADOR, proposing revisions to and requesting clarifications on the Proposed Rule. [For a copy of those comment letters, please contact Jeannine Birmingham at jbirmingham@ascpa.org.]

Issues We Hope the ADOR Clarifies

Certain areas that we requested clarification on included confirming that PTEs electing to pay the PTE Tax are not required to file composite returns with respect to their nonresident members. Additionally, we proposed revising the Proposed Rule to expressly provide that a nonresident owner of an electing PTE will not be required to file an Alabama income tax return to report its respective share of the income from the PTE, unless (1) the owner is a resident of Alabama, (2) the owner has Alabama income from sources other than the electing PTE and thus separately has an Alabama income tax filing obligation, or (3) it seeks to claim the refundable PTE Tax credit. Both of those topics were addressed in informal guidance issued by the ADOR on June 14, 2021.

Other areas of concern focused on the ability of electing PTEs to utilize net operating losses and claim tax credits. The Proposed Rule limits the income tax credits available to the electing PTE to just the Alabama Historic Rehabilitation Tax Credit and the Railroad Modernization Act Credit. "All other tax credits shall pass through to and may be claimed by an eligible taxpayer under the provisions applicable to that credit." The comment letter we filed on behalf of several scholarship-granting organizations (SGOs) asked for clarification that if the PTE makes a donation to a qualified SGO, the credit from that donation will indeed pass-through to the owners and will not affect the 50%-of-tax limitation on donors.

The public hearing on this proposal was held October 5, 2021 and we now await the hearing officer's report and hopefully a final rule that reflects the input of the ASCPA and our clients. If you have any questions about the Alabama PTE Tax or the ADOR's Proposed Rule, please feel free to contact Bruce or Will.



Bruce Ely

William Thistle