



INDIVIDUAL INCOME TAX Pass Through Entity Tax

March 10, 2021

	Yes	No
DOR Administrative Costs/Savings	X	

Department of Revenue
Analysis of H.F. 1909 (Davids) As Proposed to be Amended (H1909A1)

	Fund Impact			
	<u>F.Y. 2022</u>	<u>F.Y. 2023</u>	<u>F.Y. 2024</u>	<u>F.Y. 2025</u>
	(000's)			
General Fund	\$0	\$0	\$0	\$0

Effective beginning with tax year 2021.

EXPLANATION OF THE BILL

Current Law: Flow-through entities such as S corporations and partnerships do not pay state or federal income taxes directly. Their income is passed to shareholders, who report the income on their individual income tax returns. There is no election to allow a partnership, S corporation, or limited liability company to file and pay their tax liability as an entity.

For individuals, federal deductions for state and local taxes paid are subject to the federal cap on state and local tax deductions. The cap is \$10,000 (\$5,000 for married separate filers). The limitation expires after tax year 2025.

Proposed Law: The bill creates an option that allows a partnership, S corporation, or limited liability company to file and compute tax liability as opposed to passing all the income to its owners. A pass-through entity would elect to pay a pass-through entity (PTE) tax. It is assumed when the PTE tax is paid at the entity level that the federal government will allow the taxes to be deductible as part of the income flowing out of the pass-through entity.

The income subject to tax under the PTE tax would be an apportioned amount. Under current law, nonresidents have income apportioned to Minnesota. In contrast, under current law residents have 100% of their income assigned to Minnesota.

Income under the PTE tax would be taxed at 9.85%, the highest individual rate.

If the election is made by the majority owners of the qualifying entity (having more than 50% ownership interest), the election is binding on every owner of the entity. The election must be made by the date the return is due or the extended due date. A shareholder's basis in the entity is not affected by the election to pay the PTE tax.

Under the A1 amendment, the owners of the qualifying entity would claim a refundable credit on the individual income tax return equal to the amount of PTE tax.

Mechanics of the PTE Tax Calculation

Taxpayers choosing to pay the PTE tax would calculate their taxes in a three-step process which differs from the one under current law. First, each partner/shareholder would compute their tax on flow-through income as done under current law. Next, information from the individual income tax calculation would be used in the process of computing a PTE tax. Last, the PTE tax would be claimed as a tax credit on the individual income tax return.

REVENUE ANALYSIS DETAIL

- The number of qualifying entities that would select PTE tax is unknown.
- In tax year 2018, about 179,300 full-year resident returns reported income from an S corporation, partnership, or limited liability corporation.
- Of those, about 42,500 returns had state and local taxes over the deduction limit (\$10,000 or \$5,000 for married separate filers).
- About 21,800 of those returns had at least some income in the highest income tax bracket. Those are most likely to elect to use the PTE tax option, which would have all its income taxed at the highest income tax rate.
- It is unknown how many of those taxpayers have more than 50% ownership in the qualifying entities.
- It is assumed that an entity would only use the PTE tax option if the majority shareholders benefit from the election with a reduced combined federal and state tax liability.
- Because the amount of income reported on the individual income tax return is the same as under current law, the same amount of tax will be collected under the bill as under current law. The tax paid by the PTE will be offset by the refundable credit claimed by the shareholder, resulting in no change in revenue.

Minnesota Department of Revenue
Tax Research Division
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