



## Federal Tax ADVISORY ■

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### PTET Elections: Don't Let Them "Pass" By Unnoticed in M&A Transactions

The Tax Cuts and Jobs Act of 2017 (TCJA) limits an individual taxpayer's potential itemized deductions for certain state and local taxes to \$10,000 (or \$5,000 for a married individual filing a separate return) for taxable years beginning after December 31, 2017 and before January 1, 2026. Several states have enacted workarounds to this so-called "SALT cap" in the form of a "pass-through entity tax" (PTET) for partnerships or S corporations that may be mandatory or require a voluntary, annual "PTET" election.

In general, a state PTET election allows a partnership or S corporation with income derived from or sourced to that state to elect to pay income taxes at the entity level, often with a corresponding owner-level benefit in the form of a full or partial credit or offset against the owner's income tax liability in the state. As entity-level state income taxes, these taxes should not be subject to the federal SALT cap applicable to individuals. In November 2020, the IRS released [Notice 2020-75](#) indicating proposed regulations would be issued generally blessing PTET election workarounds. As a result, PTET elections have become an important planning tool in acquisitions.

#### **PTET Election Considerations in Common Acquisition Structures**

A common structure for an acquisition of an S corporation involves a pre-closing F reorganization, followed by a deemed asset sale for federal income tax purposes. In order to complete a pre-closing F reorganization, consistent with Revenue Ruling 2008-18, the S corporation shareholders will often form a new corporation (Newco), contribute their shares of the existing S corporation (Old S) to Newco in exchange for shares in Newco in the same proportions as their ownership of Old S, then file an election on IRS Form 8869 electing for Old S to be treated as a "qualified Subchapter S subsidiary" (QSub). Sometimes, a "protective" S corporation election on IRS Form 2553 is also filed for Newco, but based on Rev. Rul. 2008-18, the contribution and QSub election should be treated as an F reorganization, with Newco treated as a continuation of Old S (and

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consequently an S corporation), and Old S treated as a QSub of Newco. Depending on Old S's state-law classification, Old S can then covert to an LLC for state-law purposes, merge into an LLC, or file a check-the-box election if Old S was previously an LLC that elected S corporation status, in each case so that Old S may be classified as a disregarded entity before the sale. After Old S is classified as a disregarded entity, the acquisition of Old S should be treated as a purchase of assets for federal income tax purposes.

This structure is often the preferred approach for buyers (short of an actual asset sale, which often has commercial impracticalities) —buyers desire a step-up in tax basis of the target's assets and can mitigate potential entity-level liability for any defect in the S corporation status of Old S. This structure also facilitates tax-deferred rollovers.

In certain cases, however, this structure can result in incremental tax cost to the sellers, compared with a sale of the S corporation stock directly to the buyer. Usually, the incremental tax is attributable to items in the deemed asset sale such as accounts receivable, inventory, and certain recapture items triggering incremental ordinary income, but also entity-level state and local taxes (for example, Massachusetts imposes an excise tax on S corporations, and California imposes an income tax on certain S corporations), as well as incremental state and local income taxes imposed on the S corporation owners. Nevertheless, buyers and sellers may be surprised to find that, in certain circumstances, if Newco makes a PTET election after the F reorganization, the deemed asset sale may result in an incremental tax *benefit* compared with a direct sale of Old S stock.

PTET elections should also be considered by sellers purporting to sell assets for tax purposes, whether as an actual sale of assets or as a sale of interests in an already disregarded LLC. In such cases, an individual seller should consider transferring the assets or disregarded LLC interests into a new entity taxed as a partnership or S corporation, which becomes the seller and could be eligible to make PTET elections. There is limited guidance on entitlement to federal deductions resulting from PTET elections beyond Notice 2020-75. As a result, the parties to these transactions, and their advisors, should consider as part of their planning relating to PTET elections the potential application of general tax principles (for example, when a newly formed partnership is used, the partnership anti-abuse rules under Section 1.701-2 of the Treasury Regulations) based on their particular facts and circumstances.

## Potential Complexities

Using PTET elections as a planning tool can introduce some interpretative and administrative complexity, particularly given their limited history (most were only recently enacted). Each state PTET regime is different and may introduce its own complexities and considerations, but the regime enacted in California serves as a helpful example of some uncertainties taxpayers face.

Under the California PTET regime, for tax years beginning on or after January 1, 2022, qualifying entities are required to pay an amount equal to the higher of 50% of the elective tax paid the prior year or \$1,000 on or before June 15 of the taxable year they intend to make a PTET election. The remainder of the tax is then paid on or before the due date of the entity's original return without regard to extensions. The PTET election is irrevocable, and the California statute provides that for taxable years beginning after January 1, 2022 and before January 1, 2026, taxpayers are ineligible to make the PTET election if they do not make the required June 15 payment.

Qualifying entities for purposes of the California PTET regime include S corporations and partnerships, but not disregarded entities. Therefore, following the above example, the PTET election can be made by Old S before its conversion to a disregarded entity or by Newco once it is formed. The statute does not indicate whether Old S or Newco is the appropriate entity to make the election and make the June 15 payment, and it does not specifically address elections made in connection with F reorganizations. In most cases, Newco's treatment as a continuation of Old S's status as a valid S corporation for federal income tax purposes should be respected for most state income tax purposes, and taxpayers might assume any election or payment made by the target before the F reorganization will automatically carry over with the S corporation status.

However, absent affirmative guidance, this interpretation is not entirely clear. Where possible, and given this uncertainty, taxpayers should consider completing the F reorganization and then having Newco make the election and payment, rather than Old S. Under this framework, an eligible entity makes the election, and any benefit from an overpayment or liability for an underpayment of the applicable taxes should follow the correct legal entity. In some situations, following this practice will not be possible, and the S corporation target may make the June 15 payment—for example, when the F reorganization cannot be completed by June 15.

The states with mid-year PTET payment deadlines also create uncertainty about the status of entities formed after the deadline, and at least one state ([New York](#)) has issued guidance that an entity formed after its opt-in / initial payment deadline is ineligible to make a PTET election. Certain states may not invalidate a PTET election when the PTET payment is late but instead could charge interest and penalties. When the proper application of a PTET election is unclear, communication with the relevant state or local tax authorities and contractual protections may be required to ensure the election is respected and the benefits and burdens of the election follow the correct legal entity. For instance, taxpayers may specify which party bears the burden of an underpayment or the benefit of a refund associated with the applicable taxes. Given the increased popularity of PTET elections and their use in acquisitive transactions, we expect states will begin to offer guidance and procedures for taxpayers faced with these circumstances in the coming months and years, but we also caution that close scrutiny of state PTET regimes is needed in the meantime.

For more information, please contact [John Baron](#), [Danny Reach](#), [Scott Harty](#), [Clark Calhoun](#), or [Terence McAllister](#).

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