



Study on Feasibility of Additional 4% Elective Pass-Through Entity-Level Excise

**Commonwealth of Massachusetts
Department of Revenue**

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This report is being issued pursuant to St. 2023, c. 50, § 44, which directs the Department of Revenue (DOR) to analyze and report on the potential impact of implementing an additional, elective entity-level excise of up to 4% on a portion of the Massachusetts income of eligible pass-through entities (PTEs) coupled with a refundable personal income tax credit.¹ The 4% elective PTE excise under consideration and any related personal income tax credit would be in addition to the existing 5% elective PTE excise and related personal income tax credit established in M.G.L. c. 63D. The existing PTE excise tax rate of 5% does not take into account the 4% surtax applicable to taxable income over a \$1 million inflation-adjusted threshold that applies in taxable years beginning on or after January 1, 2023.² The additional 4% PTE excise is being considered in order to adapt the PTE excise rate to the surtax.

This report includes the following:

- An overview of the existing 5% elective PTE excise and related personal income tax credit;
- A discussion of how a potential additional 4% elective PTE excise and related personal income tax credit might be applied;
- A discussion of the impact of the potential additional elective excise and related credit on the Commonwealth's taxpayers and tax revenue;
- A discussion of the feasibility of administering the additional 4% elective excise and credit, including application of Constitutional thresholds and administration of PTE and member elections; and
- A summary of the PTE tax regimes in other states

Existing Elective 5% PTE Excise and Related Personal Income Tax Credit

Effective for taxable years beginning on or after January 1, 2021, Massachusetts adopted an elective 5% PTE excise.³ The Massachusetts Legislature adopted the excise in response to the \$10,000 cap on the federal state and local tax (SALT) deduction passed by Congress in 2017 and made effective for tax years 2018 through 2025. After the federal limitation was passed, the Internal Revenue Service (IRS) issued Notice 2020-75, which announced that the federal limitation would not apply in determining the federal deduction for state taxes for members of PTEs where a tax is imposed at the PTE level and flows through to members, even if the tax is elective at the PTE level.⁴ The 5% rate was adopted because that was the personal income tax rate that applied to most PTE distributive income when the PTE excise was adopted, as the 4% surtax was not yet in effect.

S corporations, partnerships, and certain trusts (eligible PTEs) may make the election to pay the PTE excise on an annual basis.⁵ The excise is equal to 5% of the eligible PTE's distributive income that flows

¹ This report uses the terms "additional 4% PTE excise" or "4% PTE excise" to describe the additional excise under consideration.

² The 4% surtax applies to taxable income in excess of \$1 million, adjusted annually for inflation. A 5% rate applies to most income under that threshold. However, an 8.5% rate applies to short-term capital gains and a 6% effective rate applies to long-term gains on collectibles. See M.G.L. c. 62, § 4.

³ M.G.L. c. 63D, §§ 1, 2.

⁴ See IRS Notice 2020-75.

⁵ M.G.L. c. 63D, § 2.

to members that are natural persons (qualified members) for Massachusetts personal income tax purposes.⁶ Distributive income that flows to nonresident qualified members may be apportioned based on the PTE's Massachusetts apportionment factors.⁷ Qualified members are eligible for a Massachusetts personal income tax credit equal to 90% of the member's share of the excise paid by the PTE.⁸

If an election is made by an eligible PTE, it is binding on all qualified members.⁹ Once made, an election may not be revoked on an amended return or otherwise.¹⁰ The elective 5% PTE excise will expire if the federal SALT deduction limitation expires or is repealed.¹¹ The federal SALT limitation is set to expire for taxable years beginning on or after January 1, 2026.¹²

Potential Additional 4% PTE Excise and Related Personal income Tax Credit

There are a number of possible approaches to implement an additional 4% PTE excise election. This report examines a few plausible methods.

1. *Member-Level Election*

The approach that would allow PTEs and their members the most flexibility in determining the amount of the excise would be to permit each qualified member to make an election at the member level to have the PTE pay the additional 4% on each such member's share of distributive income that exceeds the income surtax threshold. Specifically, the PTE would determine its excise by adding (i) 5% of the distributive income of all eligible members plus (ii) 4% of electing members' share of distributive income that exceeds the income surtax threshold. A personal income tax credit could be allowed for the members' shares of the PTE excise, determined using the chosen tax rate. The Legislature would have to decide on allowing a credit and whether the credit should be a dollar-for-dollar credit or a limited credit similar to the 90% credit allowed with respect to the existing 5% PTE excise.

It would be possible for DOR to implement the approach described above. However, DOR would have to expend resources to develop a system to track member elections and to ensure that members' elections and the amounts reported on members' 3K-1s (Partner's Massachusetts Information), SK-1s (Shareholder's Massachusetts Information), and 2K-1s (Beneficiary's Massachusetts Information) match the PTE's elections and PTE excise reporting. A more important issue is whether the IRS would accept elections made at the member level. As noted below, no other state has used such an approach. Further, IRS Notice 2020-75 does not specifically apply to member elections. The IRS-approved approach is based on the theory that the PTE excise (even if elective at the PTE level) is a state tax on the PTE, which is binding on and flows through to the members. To the extent that a member is allowed an election, the PTE excise starts to look like a voluntary tax on the member. It is not clear that such a tax falls within the terms of the IRS Notice or if it would be considered deductible for federal purposes.

⁶ M.G.L. c. 63D, §§ 1, 2.

⁷ See Technical Information Release (TIR) 22-6.

⁸ M.G.L. c. 63D, § 2.

⁹ M.G.L. c. 63D, § 6.

¹⁰ *Id.*

¹¹ M.G.L. c. 63D, § 3.

¹² IRC § 164(b)(6).

2. *Entity-Level Election with an Optional Rate*

A simpler approach that would be easier to administer would be to require all elections to be made at the PTE level. Within such a framework, a PTE could be allowed to elect to pay the PTE excise at a rate of 5% or a rate between 5% and 9%, as set by legislation, depending on what the PTE perceives to be more beneficial for its members. No election would be allowed for members. Such a system would eliminate the need to track member elections. Specifically, DOR would be able to monitor members' share of PTE excise based only on PTE elections and reporting without having to track members' elections. However, eliminating member elections would make the PTE excise less adaptable to individual members' circumstances, resulting in situations in which some members' share of the PTE excise attributable to them is more or less than their personal income tax liability. Such "overpayments" could be recovered through a full or partial credit. Note that if the personal income tax credit were anything less than 100% of the PTE excise amount, as is the case with the current PTE excise, members not subject to the surtax may be economically harmed. "Underpayments" could result in additional liability that would have to be paid with the members' returns or through estimated tax payments.

3. *Entity-Level Election with a Single Rate*

Another simple approach would be to apply the PTE excise at a single rate of 9% (taking into account the generally applicable 5% tax and the 4% surtax) or a single blended rate somewhere between 5% and 9%, as set by legislation. As noted below, some other states adopt this approach.

Such an approach would be easier to administer given that there would be only one election. However, eliminating rate elections would make the PTE excise less adaptable to individual members' circumstances, resulting in even more circumstances in which some members' share of the PTE excise is more or less than their personal income tax liability. This increases the chance for the kinds of "overpayments" and "underpayments" described above.

4. *Entity-Level Election with a Variable Rate*

Rather than establishing a single PTE excise rate as described in (3), the excise could be calculated using the methodology described in (1), except with no individual member election allowed. In other words, every electing PTE would determine its excise by adding (i) 5% of the distributive income of all eligible members plus (ii) 4% of each members' share of distributive income that exceeds the income surtax threshold. Such an approach would eliminate the need to track individual member elections. Additionally, because such an election would be binding on a PTE's members, similar to the existing 5% elective PTE excise, this approach looks less like a voluntary tax on members than in (1) and, therefore, may be more acceptable to the IRS. Further, this approach may be more likely to accurately reflect individual members' circumstances than in (3), resulting in potentially fewer and/or smaller "overpayments" and "underpayments."

Impact on the Commonwealth's taxpayers and tax revenue

The existing 5% PTE excise provides qualified members of electing PTEs a basis to claim a federal SALT deduction for their share of the PTE excise paid by the PTE. The approaches described above would be structured to achieve the same result with respect to the additional 4% PTE excise. If the IRS sanctions a

member-level election approach, such an election would enable PTEs and their members greater latitude in determining the PTE excise attributable to members. Placing the election at the PTE level without a member election improves the prospect of the PTE excise being upheld by the IRS. However, it also increases the risk that a member's share of the PTE excise would be too high (e.g., if the PTE elects a 9% rate and the member is not subject to the 4% surtax) or too low (e.g., if the PTE elects a 5% rate and the member is subject to the 4% surtax). Note that such mismatches are possible under the existing 5% PTE (e.g., if the PTE elects to be subject to the excise and the member cannot benefit from the federal deduction because, for example, the member has losses or other deductions to reduce federal taxable income). The adverse effect of such "overpayments" is ameliorated if, and to the extent that, a personal income tax credit is allowed for members' share of the PTE excise. Thus, under the additional 4% PTE excise, as under the existing 5% excise, PTEs would have to evaluate the effect of the election on their members and make appropriate choices.

Any increased federal deduction occasioned by the additional 4% PTE excise would not result in a personal income tax revenue loss because the federal SALT deduction is not available for Massachusetts purposes. Further, to the extent that a dollar-for-dollar personal income tax credit is available for members' shares of the additional 4% PTE excise, the excise would be revenue-neutral. If a limited credit is allowed for the additional 4% PTE excise, the excise would result in increased revenue for the Commonwealth.

Administration, Including Administration of Elections and Application of Surtax Thresholds

None of the approaches to implementing an additional 4% PTE excise described above would be impossible from an administrative perspective. As noted above, an approach allowing elections at the member level would be more challenging to implement and may not be respected by the IRS. However, such an approach would provide PTEs and their members a better opportunity to achieve their desired outcomes. Approaches allowing PTEs to elect to pay the PTE excise at either 5% or a rate between 5% and 9% would be easier to administer, but would result in some "overpayments" and "underpayments" at the member level. Approaches using a single fixed PTE excise rate would be easiest to administer because it would be similar to the existing 5% PTE excise, but would be likely to cause even more "overpayments" and underpayments."

From DOR's perspective, implementation of the additional 4% PTE excise under any approach would require the assignment of additional resources. Processing systems would need to be updated to monitor elections and ensure that the correct amount of PTE excise is reflected on members' returns. Audits of PTEs and their members would become somewhat more complicated. However, it is not anticipated that any of these issues would be insurmountable. Nevertheless, these processes will take some time to implement. To ensure the smooth implementation of any legislation adopting an additional 4% PTE excise, the legislation should provide at least 6 months between enactment and the effective date of the legislation, and should apply prospectively.

PTE Tax Regimes in Other States

With three exceptions, every state that imposes a personal income tax has adopted an entity level tax on PTEs in response to the federal SALT limitation. The exceptions are D.C., Delaware, and North Dakota, all of which are considering legislation to adopt such a tax. The tax is elective in all of these

states except Connecticut. Connecticut's tax is mandatory for 2023 and earlier taxable years, but will be elective starting with tax year 2024.¹³

Most states that have an elective PTE tax allow PTE members a credit for the full amount of tax paid by the PTE that is attributable to a member's distributive income. However, Connecticut and Massachusetts limit the percentage of the credit available to members. In Connecticut, the credit is equal to 87.5% of the partner's share of tax,¹⁴ and in Massachusetts, 90% as noted above.

In contrast, several states treat the PTE effectively as a taxable C corporation, imposing all taxes at the entity level and allowing the partners to obtain an income exclusion for the amount taxed at the PTE level. Examples of states using this approach include Louisiana and Wisconsin.¹⁵

Certain states that provide an elective PTE tax have graduated income tax rates. California has a maximum individual income tax rate of 13.3%, but imposes its PTE tax at a blended rate of 9.3%.¹⁶ In New York, the PTE tax is imposed at graduated rates corresponding to the top four marginal rates for individuals (6.85 percent, 9.65 percent, 10.3 percent, and 10.9 percent), although the thresholds used in determining the rate are based on the entity's taxable income rather than the income of PTE members.¹⁷ Thus, in California and New York, the PTE tax attributable to members may be too high or too low to account for the state tax that ultimately will be due on their PTE income. These surpluses and deficiencies are reconciled on the members' returns through the PTE credit or additional payments.

Such discrepancies are inevitable in any PTE tax regime because typically members have other tax attributes that are taken into account on their individual tax returns but cannot be taken into account at the PTE level (e.g., losses from other business activities). However, the potential additional 4% PTE excise in Massachusetts could reduce discrepancies caused by rate differentials through the use of appropriate elections.¹⁸

¹³ See Conn. Gen. Stat. Sec. 12-699, as amended by Conn. P.A. No. 23-204, sections 360-364.

¹⁴ Conn. Gen. Stat. section 12-699(g)(1)(A).

¹⁵ See LA R.S. 47:287.732.2; Wis. Stats sec. 71.21(6)(a).

¹⁶ CAL. REV. & TAX. CODE § 19900(a)(1).

¹⁷ New York Laws, Article 24-A, sec. 862.

¹⁸ Smaller discrepancies would still occur as short-term capital gains are taxed at 8.5% and long-term capital gains on collectibles are taxed at an effective rate of 6%. See M.G.L. c. 62, § 4.