

March 29, 2022

Revised based on Additional Information

	Yes	No
DOR Administrative Costs/Savings	X	

Department of Revenue
 Analysis of H.F. 3967 (Davids) As Proposed to be Amended (H3967A1)

	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	(Unknown)	(Unknown)	(Unknown)

Effective retroactively beginning tax year 2021.

EXPLANATION OF THE BILL

Current Law: Pass-through entities such as S corporations and partnerships do not generally pay state or federal income taxes directly. Their income is passed to shareholders, who report the income on their individual income tax returns.

Beginning in tax year 2021, Minnesota created a pass-through entity tax that allows a partnership, S corporation, or limited liability company to file and compute tax liability at the entity level. The pass-through entity tax is equal to the sum of the tax liability of each qualifying owner. Each qualifying owner's tax by determining the owner's Minnesota source income from the entity. The income of both resident and nonresident owners is allocated to Minnesota in the same way as for nonresident partners and shareholders. The resulting income amount then multiplied by 9.85%.

Certain nonresident owners may have their Minnesota income tax filing requirement satisfied by the entity's Schedule PTE similar to composite income tax. The other owners will receive a refundable income tax credit for their portion of the PTE tax paid by the entity.

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. To qualify, at least one owner of the entity must be limited by the federal limit on state and local tax deductions.

Proposed Law: The bill makes several changes to the pass-through entity tax.

Currently, the income of resident partners or shareholders is allocated to Minnesota in the same way as for nonresident partners and shareholders. Under the bill, all of the income of resident partners in a partnership would be allocated to Minnesota. This would increase the amount of income attributed to the partnership.

The bill clarifies that single member limited liability companies are not qualified entities unless they are taxed as a partnership or S corporation.

EXPLANATION OF THE BILL (Cont.)

As proposed to be amended, the bill allows a multi-tiered entity to be a qualified entity under certain circumstances. The second-tier entities must be excluded from the qualifying entity's tax return, the entity must be taxed as a partnership, limited liability company, or S corporation, and may not be a publicly traded partnership.

Currently, a qualifying owner must be an individual or estate, or a trust that is a shareholder of an S corporation. The bill expands the definition of qualifying owner to include all trusts, an entity taxed as a partnership, or a disregarded entity with a qualifying owner as its single owner.

If a partnership is subject to a federal audit, the bill requires the entity to file an amended pass-through entity tax for all direct partners who were included in the tax in the reviewed year.

REVENUE ANALYSIS DETAIL

- The bill will expand the number of qualifying entities and owners who are eligible for the pass-through entity tax and may change the amount of tax due for some partnerships with resident partners.
- The pass-through entity tax may reduce a shareholder's federal adjusted gross income and may affect the shareholder's Minnesota tax liability and eligibility for tax credits. For example, the standard deduction and itemized deductions are phased out by adjusted gross income over a certain threshold. The reduction in FAGI may increase a taxpayer's standard deduction. Credits such as the working family credit also depend on FAGI.
- Because the bill expands the pass-through entity tax, it will reduce Minnesota tax liability by an unknown amount.

Minnesota Department of Revenue
Tax Research Division
[https://www.revenue.state.mn.us/
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