DEPARTMENT OF REVENUE

PASS THROUGH ENTITY TAX Modifications

March 15, 2023

	Yes	No
DOR Administrative Costs/Savings	X	

Department of Revenue
Analysis of H.F. 2256 (Davids) / S.F. 2443 (Klein)

	Fund Impact			
	F.Y. 2024	**F.Y. 2025**	**F.Y. 2026**	**F.Y. 2027**
	(000's)			
General Fund	(Unknown)	(Unknown)	(Unknown)	(Unknown)

Effective retroactively beginning with tax year 2022.

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 changes the tax and the credit in several ways. Under the bill, all of the income of a resident qualifying owner of a partnership or limited liability company taxed as a partnership would be allocated to Minnesota for purposes of the pass-through entity tax. The income of a nonresident and a resident qualifying owner of an S corporation would be allocated to the state as under current law.

The bill clarifies that limited liability companies are not qualified entities unless they are taxed as a partnership or S corporation and that a qualifying entity must have at least one qualifying owner.

Currently, multi-level partnerships, LLCs or corporations are not qualifying entities. The bill removes that restriction, although a publicly traded partnership would not be a qualifying entity.

A disregarded LLC with a qualifying owner as its single owner would be a qualifying owner.

EXPLANATION OF THE BILL (Cont.)

Currently, the election to pay the pass-through entity tax is binding on all owners of a qualifying entity. Under the bill, the election must exclude partners, members, shareholders, or owners who are not qualifying owners, and the election could be made by qualifying owners who hold more than 50% of the interest held by qualifying owners, rather than 50% of the total interest in the qualifying entity.

The bill removes the requirement that at least one owner be limited by the federal limit on state and local tax (SALT) deductions and adds a sunset provision so that the tax and credit expire at the same time as the federal limit on SALT deductions.

The bill specifies that if a partnership is subject to a federal audit, the entity must file an amended pass-through entity tax return for all direct partners who were included in the tax in the reviewed year and pay any additional amount owed.

REVENUE ANALYSIS DETAIL

- The estimate is based on information from tax year 2021, the first year the pass-through entity tax was in effect. In tax year 2021, about 27,500 entities paid $1,782.4 million in pass-through entity tax. Pass-through entity tax credits totaled $1,536.6 million on 35,000 returns.
- The bill will increase the tax and the credit for resident owners by allocating all of their income to Minnesota. Those owners will pay more tax and therefore be eligible for a higher credit.
- The bill also expands eligibility for the tax and the credit in several ways, including by removing the requirement that at least one qualifying owner be limited by the federal SALT cap, by allowing multi-level entities to be qualifying entities, and by allowing partial elections for qualifying owners only.
- Those provisions will increase the PTE tax and credits by an unknown amount. This estimate assumes a 15% increase in the tax and the credit.
- Because the PTE tax credit offsets the tax, the net effect will generally be revenue neutral. However, the PTE tax 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
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