

5 KEY TAKEAWAYS

Pass-Through Entity Tax: Drafting Agreements to Take Advantage of State PTET Regimes and Federal Deduction Opportunities

Kilpatrick's [Kylan Memminger](#) recently participated on a panel discussion at the **ABA Tax Section May Tax Meeting** where they discussed the topic of **“Pass-Through Entity Tax: Drafting Agreements to Take Advantage of State PTET Regimes and Federal Deduction Opportunities.”**

Kylan offers the following key takeaways from the discussion:

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PTET Regimes Provide a Workaround to the SALT Deduction Limit

The Pass-Through Entity Tax (PTET) was enacted by many states as a workaround to the federal limit on itemized deductions for state and local taxes (SALT). By taxing income at the entity level, PTET allows owners of pass-through entities to effectively bypass the SALT limitation, as the PTET is treated as a business expense and reduces pass-through income for federal tax purposes, resulting in an unlimited deduction for state tax attributable to PTE ownership at no extra out-of-pocket cost for owners.

PTET Elections Offer Significant Planning Opportunities but Require Careful Compliance

PTET elections can align interests between buyers and sellers, particularly in M&A contexts where asset sale treatment is sought. However, multistate entities must assess each state's rules for compliance and the actual benefit of the PTET regime, especially considering differences in state-specific rates, credit limitations (e.g., Connecticut's 87.5% cap), and additional complexities with tiered partnerships.

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Taxpayers and Practitioners Face Multiple Legal and Operational Challenges

Entities considering PTET elections must address several issues, including:

- Reviewing and potentially amending operating agreements to account for PTET elections.
- Determining eligibility under state statutes.
- Ensuring proper documentation and authorization of elections.
- Monitoring ongoing state law changes and guidance.
- Deciding which states to pay PTET when operating in multiple jurisdictions.

These challenges highlight the need for legal counsel and careful operational planning.

PTET Landscape Is Highly Variable Across States and Continues to Evolve

PTET regimes are now widespread, with 38 states plus New York City adopting entity-level tax workarounds. However, the focus has shifted from whether a state has PTET to how each state's PTET works. Key differences include election timing, statute mechanics, sourcing, and owner eligibility.

For example:

- Maryland allows elective application of PTET to all resident income, not just Maryland-source income, with recent legislative changes.
- Virginia has nuanced credit treatment for taxes paid to other states, requiring careful planning for multistate owners.
- California, Illinois, Louisiana, New York, Michigan, Oklahoma, and Minnesota each have unique rules and recent changes that impact transactional planning and agreement drafting.

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Transaction Structure and State-Specific Rules Can Materially Affect PTET Benefits

The timing and mechanics of PTET elections (including deadlines and sunset provisions), as well as state-specific rules regarding asset vs. stock sales, apportionment, and credit treatment, can significantly influence the federal deduction benefit and after-tax proceeds in transactions. For example:

- Asset sales may unlock PTET benefits by allowing entity-level tax to apply to gain, whereas stock/equity sales often do not.
- State differences in sourcing and apportionment (e.g., Illinois sourcing gain based on entity apportionment, California's credit reduction for late election).
- Sunset risks must be considered in transactional agreements and due diligence.