

PASS THROUGH ENTITY TAX ELECTION

Deducting Mississippi State Income Tax Liability



CONSULTING GROUP

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\$10,000/year

What happened?

In response to the Tax Cuts and Jobs Act of 2017 (TCJA 2017), which limits the federal income tax deduction for state and local tax payments to \$10,000 per year (and limits some other itemized deductions), the Mississippi legislature passed House Bill 1691 into law effective for tax returns due after January 1, 2023. Subsequently, the legislation just passed House Bill 1668, which corrected several drafting errors in the original bill. It allows for any partnership, S corporation or similar pass-through entity (PTE) to elect to be taxed at the entity level, rather than at the individual level, for state income tax purposes. This means that PTE's are now able to fully deduct state income taxes paid in a given tax year, **unlike individuals**.

What is required?

An electing PTE must submit **Form 84-381**, Pass-Through Entity Election Form, to the Mississippi Department of Revenue (DOR). This election is binding for that taxable year and all taxable years thereafter unless the electing PTE revokes the election by submitting Form 84-381 to the DOR by the due date of the applicable tax return, or by the date the tax return is filed, whichever is later. Furthermore, the election must be approved in accordance with the entity's governing documents or a majority vote of the owners.

How does it work?

The electing PTE will pay state income tax estimates throughout the year and, subsequently, each owner, member, partner, or shareholder (owner) of the PTE will receive a credit against the taxes imposed in an amount equal to his or her pro rata share of tax paid by the electing PTE for that year. Additionally, they will receive a deduction in taxable income at the federal level for the related taxes paid by the entity. The PTE will then provide a K1 to the owning member(s) to include on their tax return reflecting the income and expense deductions.

If an owner's share of the tax paid by the PTE exceeds the owner's personal tax liability for the year, the overpayment may be refunded or credited to the subsequent year.

If an electing PTE has an annual income tax liability over \$200, the PTE will have to pay quarterly tax estimates. Estimates are due on the fifteenth day of the fourth month, sixth month, ninth month and twelfth month of the income year just like corporate state tax estimates. *(More on this later)*



HOW THIS WORKS CAN BE BEST ILLUSTRATED BY THIS EXAMPLE:

John and David own a cash basis LLC 50/50 that operates exclusively in the state of Mississippi. John and David elected PTE status for their LLC in January 2023 for the 2023 tax year. The LLC has \$6,000,000 in total taxable income for the 2023 year (\$3,000,000 of taxable income to each owner).



Due to the LLC being an electing PTE, it paid all four \$75,000 ($\$6,000,000 \times 5\% \times .25$) quarterly state income tax estimates in 2023. The \$300,000 (\$150,000 each) in state income tax credits flow through to John and David's individual 2023 state income tax returns.

The PTE would receive a deduction for the \$300,000 for the taxes paid during 2023, lowering the PTE's federal taxable income to \$5,700,000 (\$2,850,000 each to John and David). If we assume that both John and David are taxed at the highest federal tax rates of 37% and each already has \$10,000 of other state and local taxes on their returns, the total tax savings should be \$111,000, or \$55,500 each ($\$300,000 \times 37\% \times .5$).

If John and David **decided not to elect PTE status for their LLC in 2023, they would each be only able to deduct up to \$10,000** in State and Local Income taxes paid in the tax year, which taxed at the highest federal tax level would only result in \$3,700 in tax savings each.

2023 QUARTERLY STATE INCOME TAX ESTIMATES	\$300,000 ($\$6,000,000 \times 5\%$)
STATE INCOME TAX LIABILITY	\$300,000 ($\$150,000$ each)
LLC DEDUCTIONS	\$300,000 (applied against the \$6,000,000 of taxable income)
FEDERAL TAXABLE INCOME	\$5,700,000 ($\$2,850,000$ each)
HIGHEST FEDERAL TAX RATES	37%
TOTAL TAX SAVINGS	\$111,000 \$55,500 each



What else can I do?

Purchasing **Mississippi Historical Tax Credits (MS HTC)**, or other state tax credits, is another way to further reduce state income tax liability. MS HTC's offset your state income tax liability and are usually purchased for 85 to 90 cents on the dollar. If MS HTC's are purchased through the electing PTE, they can be applied against the PTE's tax liability. However, if the PTE is a cash basis taxpayer, the MS HTC's taxes are deemed to be paid when the tax return is filed, or the due date of the return, whichever occurs first. This usually will delay the deduction until the following year, unless previous year MS HTC's are purchased in the current tax year.

MS HTC's become extremely valuable if a PTE did not elect to be an electing PTE during 2023, so estimated tax payments have not been made. It subsequently decides that it wants to be an electing PTE for 2023. When it files its 2023 return it will be required to pay the tax on its state taxable income, plus it will be charged with estimated tax payment penalties. However, if the PTE finds and acquires 2023 MS HTCs, even in 2024, the PTE will receive the discounts on the credits and the credits will eliminate the estimated tax payment penalties.

We will provide another example here that has the exact same assumptions as the earlier example. The only difference is John and David's LLC has also purchased 2022 MS HTC in 2023 at 90 cents on the dollar for a total price of \$270,000. This allows for a total state income tax credit of \$300,000 for the 2022 tax year. Not only is there state income tax savings generated by the credits of \$30,000 (\$15,000 each), the LLC would also get to deduct a net amount of \$270,000 in federal tax deductions in 2023 (\$300,000 in gross deductions less \$30,000 in short term capital gain generated from the MS HTCs), which would reduce the LLC's taxable income to \$5,775,000 (\$2,887,500 each).

So, John and David will each have federal tax savings of \$49,950 ($\$270,000 \times .5 \times 37\%$) in addition to \$15,000 in state income tax savings totaling \$64,950! Should you not have a pass through entity to purchase credits or otherwise pay MS tax liability, it might be possible with proper and thoughtful planning to create a pass through entity for your income to flow through and use this entity to fund your state tax liability.

MS HTC IN 2023 90 CENTS/\$	\$270,000 (\$135,000 each)
STATE INCOME TAX CREDITS	\$300,000 (\$150,000 each)
STATE INCOME TAX SAVINGS	\$30,000 (\$15,000 each)
NET LLC FEDERAL TAX DEDUCTIONS	\$270,000
LLC TAXABLE INCOME	\$5,775,000 (\$2,887,500 each)
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FEDERAL TAX SAVINGS	\$99,900 (\$49,950 each) (\$270,000 x .5 x .37%)
TOTAL TAX SAVINGS	\$129,900 \$64,950 each



What if I do not live in Mississippi, but have businesses that operates in the state?

If you are not a Mississippi (MS) resident, but own interests in a business that conducts business in MS and is subject to MS taxation, it is possible to benefit from these new laws. However, there is the potential that the business may already be electing composite tax treatment and this could interfere with the electing PTE statutes. Please consult your tax advisor if this pertains to you.

Summary

In summary, the new bills put into law allow for certain pass-through entities to pay state income tax liabilities that the owners would otherwise have to pay directly through the entity. This allows the pass-through entity to deduct state income taxes against income for federal income tax purposes, leading to federal tax savings for owners. There are additional regulations that will provide additional clarity and guidance surrounding this new legislation, and as that information comes available, we will provide further updates. Additionally, incorporating Mississippi tax credits into planning could also lead to even more savings for the taxpayer!

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