Study on the
Adoption of a Pass-Through Entity Income Tax

Report Prepared for the

Joint Standing Committee on Taxation

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Department of Administrative and Financial Services

Maine Revenue Services

Office of Tax Policy

Executive Summary

Pursuant to R. 2023, c. 170, “Resolve, to Require the Office of Tax Policy to Study the Adoption of a Pass-through Entity Income Tax,” the Office of Tax Policy at Maine Revenue Services examined and evaluated the State’s current system of taxation of business income, focusing on the current system of taxing pass-through business income at the partner or shareholder level, the federal limitation on the federal income tax deduction for state and local taxes, and the possible adoption of a pass-through entity income tax to work around the limitation.

In 2017, federal legislation known as the Tax Cuts and Jobs Act placed a limit of $10,000 on the federal income tax deduction allowed for state and local taxes (“SALT”) by individuals on their federal income tax returns for tax years 2018 through 2025. This limitation was part of a larger tax cut package that reduced taxes on individuals and on their pass-through income through, among other things, enacting the qualified business income deduction, tax rate reductions, an increase to the standard deduction, and an increase in the alternative minimum tax exemption amount. By design, the SALT limitation reduced the overall TCJA revenue cost by lessening the extent of the potential tax cut received by taxpayers paying higher state and local taxes.

In response, 36 states developed pass-through entity taxes to shift the SALT deduction for taxes on business income from the individual, where it was limited, to the pass-through entity generating the income, thereby working around the federal limitation.

While effective for some, these workarounds provide relief from the federal limitation to a narrow subset of taxpayers. First, they only cover those with business income generated by means of pass-through entities and thus do not help taxpayers with other sources of income who pay state and local taxes, for example wage or investment income earners or sole proprietors. And second, the relief is focused on a narrow range of high-income tax earners.

The pass-through entity taxes and offsetting credits created by state workarounds to the federal SALT deduction limitation are structurally complex and raise legal, compliance, and administrative issues, primarily because they are a major departure from the federal tax treatment of pass-through entities and present revenue forecasting and budgeting challenges. The administrative complexity can be addressed, in part, through careful crafting of the pass-through entity tax provisions and through additional funding, but it is fundamentally a question of resource prioritization. Allocating the bureau resources necessary to implement such a workaround is possible but it would come at a significant *opportunity cost*. Bureau resources would need to be redirected from other priorities, including providing taxpayer service and guidance for existing income tax law, enforcing existing law, and implementing new programs.

Whether the SALT deduction limitation will be allowed to expire at the end of 2025 as scheduled is an open question. Possibilities under serious discussion include an expiration of the limitation, an extension or making the limitation permanent, an increase of the allowable deduction amount, and a disallowance of state workarounds, or a combination of two or more of these. In short, the future workings of the SALT deduction are highly uncertain.[1]

The Report recommends waiting until after the uncertain future of the SALT deduction limitation is resolved at the federal level – a timeline that could be as short as a few months or reasonably stretch into 2026 – before enacting any State response to the federal limitation. If, instead, the Legislature enacts legislation prior to federal action, the Report strongly recommends delaying the effect of the Legislation until tax years beginning on or after January 1st, 2026. Such an approach would provide time for a smooth implementation of the workaround and allow an opportunity for the Legislature to react to expected changes at the federal level. In addition, this Report recommends that the Maine Legislature only consider enacting a pass-through entity tax if it addresses a long-term issue facing the State due to the complexity of the federal SALT deduction limitation and the pass-through entity taxes and offsetting credits created by the states to work around the limitation, their narrow application to a small subset of taxpayers, and the shifting federal landscape on which they are based.

[1] *See* Steve Wamhoff, *Different Approaches to the Trump Tax Law's Cap on Deductions for State and Local Taxes (SALT)* (January 17, 2025), https://itep.org/different-approaches-to-trump-tax-law-salt-cap/; William McBride, Erica York, Garrett Watson, *Questions About Tax Cuts, Tariffs, and Reconciliation After the Election* (November 13, 2024), https://taxfoundation.org/blog/trump-tax-cuts-tariffs-reconciliation/; Paul Jones, Future Uncertain for SALT Cap Workarounds as Congress Debates Extension (December 31, 2024), 2024 TNTS 249-5, https://www.taxnotes.com/tax-notes-today-state/alternative-minimum-tax/future-uncertain-salt-cap-workarounds-congress-debates-extension/2024/12/31/7ph06?highlight=2024-36804; John W. Simpson, Charles E. Hutchison, *What We Know (and Don't) About Big Federal Tax Changes in 2025*, 186 Tax Notes Federal 703 (Jan. 27, 2025).

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Introduction

"Resolve, to Require the Office of Tax Policy to Study the Adoption of a Pass-through Entity Income Tax" ("the Resolve"), R. 2023, c. 170 directs the Department of Administrative and Financial Services, Bureau of Revenue Services, Office of Tax Policy ("the Office") to examine and evaluate the State's current system of taxation of business income, including the current system of taxing pass-through business income at the partner or shareholder level, and the possible adoption of a pass-through entity income tax to tax such pass-through income, including the possibility of moving the taxation of that income, or some portion of it, from the partner or shareholder level to the business entity that generated the income.

The Resolve requires the study to examine the impact of the adoption of a pass-through entity income tax on a mandatory and an elective basis, on a permanent and time-limited basis and on a retroactive basis. The Resolve also requires the Office to consider the impact of the federal state and local tax deduction limitation on individual taxpayers in the State, and the manner and fiscal impact of how a pass-through entity income tax has been enacted and implemented in other states to, in part, address the state and local tax deduction limitation.

The Resolve authorizes the Office to consult with national income tax experts as appropriate.

At the conclusion of the study, the Resolve requires the Office to submit a report to the joint standing committee of the Legislature having jurisdiction over taxation matters no later than January 15, 2025, that includes its findings and recommendations, including suggested legislation. The joint standing committee may submit legislation related to the report to the 132nd Legislature in 2025.

Background

At the outset, it is helpful to understand the general framework of individual and pass-through entity taxation in the United States and the state income taxes that are linked to the federal income tax through a process called Internal Revenue Code ("IRC" or "Code") conformity. Maine's conformity to federal income tax law provides numerous advantages to the State and taxpayers.[2]

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[2] "When states link to the federal code, it benefits both their residents and their government's tax administrators. Using federal rules and definitions simplifies state returns for taxpayers, who only need one set of documents and calculations for both their federal and state returns. Different states using the same federal laws also helps residents who earn income in multiple states. On the administrative side, states that use the federal code can rely on the IRS, Treasury Department, and federal courts for regulation, guidance, liability determinations, and compliance." Richard Auxier and Frank Sammartino, *The Tax Debate Moves to*

Business income is taxed on a net income basis, that is gross income or revenue minus business expense deductions related to the generation of that income. These deductions include ordinary and necessary business expenses like employee compensation, maintenance of machinery and equipment, depreciation, advertising, and taxes.

Unlike corporations taxed under Subchapter C of the Code ("C Corporations") which pay tax on their net income directly, pass-through entities ("PTEs") are a type of business entity that pass through their net income to their owners. Common PTE types include partnerships and limited liability companies ("LLCs") treated as partnerships, and corporations taxed under Subchapter S of the Code ("S Corporations"). These owners, which, depending on the entity type may be called partners, members, or shareholders, include their share of the pass-through entity's net income on their individual tax return and pay tax on that income, combined with the individual's income from other sources. Sole proprietors also pay tax on their business income on their individual tax return; however, they are not treated as a partnership for federal income tax purposes.

Unlike C Corporations, pass-throughs and sole proprietors who can deduct business expenses, individuals generally pay tax on their adjusted gross income with more limited deductions available. Most individuals use the standard deduction that allows them to reduce their income by a fixed amount specified in law. However, individuals may choose to itemize their deductions and calculate an amount specific to their circumstances.

Central to this study is the deduction for state and local taxes (the "SALT deduction").[3] The SALT deduction allows individuals to deduct certain taxes they paid to state and local governments. These include state income taxes or sales taxes and local property taxes; for individuals who have business income, such as sole proprietors and pass-through entity owners, federal tax law allows unlimited deductions for business-related property taxes and sales taxes. The personal deductions, including the SALT deduction for income tax paid by the individual on their pass-through income, are available to individuals who

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the States: The Tax Cuts and Jobs Act Creates Many Questions for States that Link to Federal Income Tax Rules.
"[Conforming to the IRC] allows state administrators and taxpayers alike to rely on federal statutes, rulings, and interpretations, which are generally more detailed and extensive than what any individual state could produce. It provides consistency of definitions for those filing in multiple states and reduces duplication of effort in filing federal and state taxes. It permits substantial reliance on federal audits and enforcement, along with federal taxpayer data. It helps to curtail tax arbitrage and reduce double taxation. For the filer, it can make things easier by allowing the filer to copy lines directly from their federal tax forms. In the words of one scholar, federal conformity represents a case of 'delegating up,' allowing states to conserve legislative, administrative, and judicial resources while reducing taxpayer compliance burdens." Jared Walczak, *Toward a State of Conformity: State Tax Codes a Year After Federal Tax Reform* (Jan. 2019), available at https://files.taxfoundation.org/20190201130844/Toward-a-State-of-Conformity-State-Tax-Codes-a-Year-After-Federal-Tax-Reform-FF-631.pdf. *See also* DELEGATING UP: STATE CONFORMITY WITH THE FEDERAL TAX BASE, 62 Duke L.J. 1267.

[3] Internal Revenue Code ("the Code" or "IRC") § 164.

choose to itemize their deductions on their federal tax return (rather than take the standard deduction).

In 2017, federal legislation known as the Tax Cuts and Jobs Act ("TCJA") placed a limit of $10,000 on SALT personal deductions taken by individuals on their federal income tax return for tax years beginning after December 31, 2017, and before January 1, 2026 (the "SALT deduction limitation").[4,5] This limitation was part of a larger tax cut package that reduced taxes on individuals and on pass-through income through, among other things, enacting the qualified business income deduction[6], tax rate reductions, an increase to the standard deduction, and an increase in the AMT exemption amount.[7]

In what would become an important distinction, the SALT deduction limitation was drafted such that it only applies to individuals, including those who pay SALT taxes related to income from businesses undertaken by sole proprietorships and pass-through entities. In response, state and local lawmakers proposed tax credit systems to work around the limitation, with Connecticut as the first state to enact a viable workaround in their pass-through entity tax ("PTE tax") in 2018.[8] Rapid adoption of PTE taxes by state lawmakers led the "Parity for Main Street Employers" group to propose model legislation,[9] which has been adopted by states to varying degrees. These PTE taxes work, at a high level, by moving the state income tax payment on a passthrough's business income from the owner, where it is bound by the SALT deduction limitation, to the PTE where the limitation does not apply. However, because sole proprietors do not use a separate PTE, these workarounds are not

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[4] IRC § 164(b)(6).

[5] While the TCJA imposed a new limitation on the SALT deduction, it removed one existing limitation and greatly reduced another. Under pre-TCJA law, itemized deductions, including the SALT deduction, was phased out at higher income limits (the "PEASE limitation"). In addition, the SALT deduction is not allowed under the individual alternative minimum tax ("AMT"). The TCJA temporarily repealed the PEASE limitation and increased the income thresholds at which the AMT applies.

[6] The qualified business income deduction allows certain pass-through entity owners to deduct 20% of their qualified pass-through entity income subject to limitations.

[7] See *The Effect of The TCJA Individual Income Tax Provisions Across Income Groups and Across the States*, Tax Policy Center (2018) available at https://taxpolicycenter.org/publications/effect-tcja-individual-income-tax-provisions-across-income-groups-and-across-states.

[8] Other early adopters included Louisiana, Maryland, New Jersey, Oklahoma, Wisconsin, and Rhode Island. With the temporary exception of Connecticut, whose PTE tax was originally mandatory, all of these PTE taxes are elective. Additionally, Louisiana allows a PTE to elect to be treated as a C Corporation for the purpose of state taxation only.

A few jurisdictions, including New York, attempted to allow taxpayers to donate to state charity funds to receive a major portion of their donation back as a tax credit but these types of credit schemes were ultimately unsuccessful when the IRS released final regulations disallowing the benefit of that approach in 2019. Treas. Reg. § 1.170A-1(h)(3).

[9] Main Street Employers, *Model Statutory Language for Pass Through Entity Tax*, 2018. Note that, while many states have considered and adopted the Model Legislation to varying degrees, no state has fully adopted it as a PTE tax.

effective for business conducted by sole proprietors, and we are unaware of any state initiative that provides comparable relief to these taxpayers.

Following a period of legal uncertainty on the viability of these PTE taxes, in 2020 the Internal Revenue Service ("IRS") formally expressed its intent to propose regulations to clarify that SALT taxes imposed on and paid by a partnership or an S Corporation are allowed as a deduction by the PTE in computing its taxable income.[10] The Notice clarified that the entity level deduction did not need to be taken into account separately and is not limited by the SALT deduction limitation regardless of whether the PTE tax is elective or mandatory, and that the forthcoming regulations would retroactively apply to existing PTE taxes.[11] These regulations have not yet been promulgated.

Currently, and despite a lack of additional IRS guidance or regulations addressing the matter, 36 states have enacted PTE tax legislation, including 7 states that enacted workarounds in 2023 – the last year in which states have enacted such taxes.[12] The mechanics of these PTE taxes vary significantly between states and are explained in the following section.

Mechanics

PTEs generate income that flows through to the owners of the entity, resulting in potential tax liability in any state where an owner resides or where the entity derived that income. When the owner pays the state tax liability, they may claim the federal SALT deduction for the amount paid; however, due to the SALT deduction limitation, individual[13] owners who itemized their deductions may only claim a federal deduction for up to $10,000 of the state taxes paid.[14]

Example 1: No PTE tax. Partner is a resident of State and a 50% partner in Partnership. Partnership has $1 million in income, of which half flows to Partner. State has no PTE tax. Partner pays State tax at a rate of 7.15% and federal tax at a rate of 29.6%.

- Partnership income: $1,000,000
- Partnership PTE tax: $0.

[10] Notice 20-75, IR-2020-252.
[11] *Id*; Although some critics may persuasively articulate the substance-over-form argument for disallowing a deduction for elective PTE taxes, the IRS has yet to issue proposed regulations or any further guidance on the matter. The long-term absence of any follow-up guidance, the explicit intent to recognize PTE taxes as entity-level taxes not subject to the SALT deduction limitation, and the rapidly approaching expiration of the limitation at the end of 2025, all support the conclusion that the IRS is unlikely to change its stated position in the near future. For more information, see Jackel, SALT Workaround Notice Works Politically but Not Legally, Taxnotes, Nov. 16, 2020; *see also* Hamilton, Danger Ahead? IRS Greenlights Passthrough Workaround to SALT Cap, Taxnotes, Nov. 16, 2020.
[12] https://us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/56175896-pte-map.pdf.
[13] That is, an individual as opposed to a legal entity.
[14] The examples below assume any standard or itemized deduction is fully utilized offsetting other income.

- Partnership income after deduction for PTE tax: $1,000,000
- Partnership income allocated to Partner: $500,000.
- Partner's State income: $500,000.[15]
- Partner's State tax: $35,750.
- Partner's State PTE credit: $0.
- Partner's federal income: $500,000.[16]
- Partner's federal tax: $148,000.
- Partners total tax is $183,750.

To work around the SALT deduction limitation, a PTE begins by paying a PTE tax that is generally levied as a percentage of the PTE's income attributable to the taxing state. Next, that entity may claim a federal deduction for paying the tax (which is not limited to $10,000) against its non-separately stated taxable income. The entity then calculates the distributive share of income for each owner based on its income as reduced by the deduction for the paid PTE tax. Finally, the individual pays income tax on their distributive share of the PTE income. As a result, the owners receive the benefit of a deduction for paid state taxes – applied at the PTE level, through the reduction in their distributive share of income, without the application of the $10,000 limitation or a reduction in the $10,000 limitation available for other state taxes the owner may pay.

To complete the workaround, the owner must receive state tax relief for the payment of the initial entity-level tax in the form of a credit, deduction, or income exclusion. Many states offer a credit for all or nearly all of that owner's share of the PTE tax paid. Upon receiving state tax relief, the owner generally receives the benefit on their individual tax return for the taxes paid by the PTE yet retains the initial federal tax benefit of reduced pass-through income.

Example 2: PTE tax with 100% credit. Partner is a resident of State and a 50% partner in Partnership. Partnership has $1 million in taxable income, of which half flows to Partner. State applies a PTE tax at a rate of 7.15% and allows Partners a 100% credit for the tax paid by the PTE.

- Partnership income: $1,000,000.
- Partnership PTE tax: $71,500.
- Partnership income after deduction for PTE tax: $928,500.
- Partnership income allocated to Partner: $464,250.

[15] In this example, State does not allow a SALT deduction for state income taxes paid by either Partner or Partnership.
[16] Partner receives a federal SALT deduction for State taxes paid but has already received the entire $10,000 deduction based on other State taxes (e.g., property tax) and so receives no additional deduction for the taxes paid by Partner on this pass-through income.

- Partner's State income: $500,000.[17]
- Partner's State tax: $35,750
- Partner's State PTE credit: $35,750.
- Partner's federal income: $464,250.[18]
- Partner's federal tax: $137,418.
- Partners total tax[19] is $173,168, resulting in federal tax savings of $10,582.

Some states offer tax relief for most, but not all, of the owner's portion of the PTE tax paid. While the difference may be small for individual owners, in the aggregate, states can use and adjust the credit rate to raise revenue.

Example 3: PTE tax with 90% credit. Same as above, except State only allows a credit for 90% of the taxes paid by the PTE.

- Partner's State PTE credit: $32,175.
- Partners total tax[20] is $176,743, resulting in federal tax savings of $10,582 and a State tax increase of $3,575.

The SALT deduction limitation workaround fails when an owner is a resident of a different state from where the PTE pays the tax and the owner's resident state does not afford a credit, deduction, or exemption for the tax paid by the PTE. Unless the reduction in flow-through income outweighs the expense of paying the PTE tax, the owner realizes no benefit from the PTE electing into the PTE tax, or even a loss, if not allowed a credit or other tax relief. Such is the case for Maine resident owners of PTEs that pay PTE tax in other states.[21]

In general, state variance in PTE taxes has led to effective, yet incongruent, results for taxpayers. Specifically, states vary on the treatment of entity and taxpayer eligibility, owner consent, tax base and rates, net operating losses, election mechanics, owner credits or deductions, tiered partnerships, credit for taxes paid to other jurisdictions, estimated tax payments, and withholding or composite returns.

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[17] In this example, State does not allow a SALT deduction for state incomes taxes paid by either Partner or Partnership.
[18] Partner receives a federal SALT deduction for State taxes paid but has already received the entire $10,000 deduction based on other State taxes (e.g., property tax) and so receives no additional deduction for the taxes paid by Partner on this pass-through income. Partner has received the benefit of the deduction taken by Partnership.
[19] Including tax paid by Partnership and allocated to Partner.
[20] Including tax paid by Partnership and allocated to Partner.
[21] See "Maine credit for taxes paid to another jurisdiction" below.

Findings and Recommendations

Characteristics of Existing Pass-Through Entity Taxes

A complex issue with numerous important legislative decision points

Since the enactment of the TCJA SALT deduction limitation, 36 states have enacted PTE taxes. These states have made different decisions when implementing these taxes and the IRS has released limited guidance on the impact of those decisions. This has led to a host of questions and issues among states, and tax advisors and taxpayers. It has also left states contemplating a PTE tax without a widely adopted model to follow.

There are a number of complex issues with important decision points worthy of legislative consideration, applicable tax years, entity and taxpayer eligibility, owner consent, tax computation, tax rates, net operating losses, election mechanics, owner credits or deductions, treatment of tiered partnerships, credit for taxes paid to other jurisdictions, and estimated tax payments, withholding or composite returns.[22] Appendix D of this Report sets out the recommended design criteria to be considered by the Legislature in working through these important legislative decision points in an orderly fashion if the Legislature moves forward in considering a PTE tax this Session.

Election requirements

Currently, all PTE taxes enacted by other states in response to the SALT deduction limitation are elective.[23] An elective tax provides pass-through entities and their owners the greatest flexibility in utilizing the tax to minimize their federal tax liability while allowing them to opt out of the PTE tax when doing so is advantageous to their owners. A mandatory PTE tax, on the other hand, is a step in the direction of completely taxing pass-through income at the entity level instead of the owner level. In addition, a mandatory tax would ensure that all PTEs are taxed under the same rules. **This Report recommends elective participation in any PTE tax.**

States generally require a PTE to make an annual election on their entity's income tax information return or on a separate form. However, the election details vary among states in several important regards, including whether, or to what extent, owner consent is required; which types of PTEs may make the election; which types of owners the election may apply; and, how and when the election may be made or changed.

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[22] *See* AICPA, *Summary Information on States' Elective Pass-Through Entity (PTE) Tax and Links to Tax Authorities' Information and Guidance* (July 30, 2024), https://us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/56175896-links-to-pass-through-entity-pte-taxes-states-legislation.pdf?vngagetrans=kiZXWgj6TCnWZekpS4U.

[23] Connecticut, the first state to enact a PTE tax, originally enacted a mandatory PTE tax but it has since been amended to allow an election.

For example, in California, the election must be made on a timely filed return, owners must individually opt in, publicly traded partnerships and entities in a combined reporting group may not elect the PTE tax, and, while all owner types are allowed, only the income attributable to individuals, trusts and estates is included in the computation of tax.[24] Contrastingly, in New York the election must be made by March 15th of the tax year and PTEs may elect to pay the PTE tax with nearly all classes of owners, but only the income attributable to individual partners is included in the computation of the tax.[25]

In light of the overall complexity of PTE taxes, this Report stresses simplicity as a guiding principle when it can be achieved while still meeting the overall goal of a SALT cap workaround. **As such, this Report recommends that any election be made by the PTE, apply to all eligible owners, and be binding on those owners.**

Tax rate and tax base

Tax rate and tax base also vary by state, with some states like California, Connecticut, Massachusetts, and Rhode Island adopting a flat tax rate, and others like New York adopting a progressive rate based on PTE income.[26] Wisconsin applies its corporate income tax rates.[27] Massachusetts clarifies that their flat tax rate applies to "qualified income taxable in Massachusetts," which is defined as "the income of an eligible pass-through entity ... allocable to a qualified member and included in the qualified member's Massachusetts taxable income..."[28] New York, on the other hand, outlines the specific calculation of the tax base in their legislation.[29]

Commonly, the tax base includes all income passed through to resident owners and state-sourced income passed through to nonresident owners. However, states vary on which classes of owners (e.g., individual, corporate, nonprofit, trust, passthrough, etc.) should be included in the calculation with some going so far as to allow each owner the option to elect into the tax.[30]

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[24] Ca. Rev. & Tax. Code § 17052.10 et seq.
[25] N.Y. Art. 24-A § 860(h).
[26] See Ca. Rev. & Tax. Code § 17052.10 et seq.; Conn. Gen. Stat. § 12-699 et seq.; Mass. Gen. Laws ch. 63D, §§ 1 to 7.; R.I. Gen Laws 44-11-2.3(e).; N.Y. Art. 24-A § 860(h).
[27] Wis. Stat. § 71.21.
[28] Mass. Gen. Laws ch. 63D, §§ 1 to 7.
[29] New York's PTE tax defines and uses "pass-through entity taxable income" as a tax base. Additionally, New York actually calculates PTE taxable income differently between S corporations and partnerships: https://www.tax.ny.gov/e-services/ptet/calculations.htm. The New York State Bar Association recommended this in their report to the Dept. of Rev. regarding PTE tax legislation: https://nysba.org/app/uploads/2021/01/Report-1446.pdf.
[30] *Summary Information on States' Elective Pass-Through Entity (PTE) Tax and Links to Tax Authorities' Information and Guidance*, AICPA (July 30, 2024) available at https://us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/56175896-links-to-pass-through-entity-pte-taxes-states-legislation.pdf.

States generally use the income reported by the PTE on its state information return as the starting point in calculating the tax base – however, Maine lacks such a return which would complicate the rollout of a PTE tax in the State. The approach taken in Appendix D, Pass-Through Entity Income Tax: Legislation Design Criteria, seeks to minimize this complication by modifying the existing composite return and related programming. An alternative approach requiring administratively creating a new tax type would cause significant additional challenges and costs. **This Report recommends applying a single tax rate on the aggregate amount of the eligible owners' federal distributive income.**

State tax credits or deduction for PTE taxes paid

The majority of states offer tax credits to resident owners of a PTE that paid a PTE tax. However, a few states allow outright income exclusion or deduction of the related PTE income as opposed to a credit.[31] Additionally, PTE tax legislation varies as to how credits, deductions, or other forms of tax relief apply to state residents who are owners of an out-of-state PTE paying a PTE tax in that other state. Many states take the approach of affording a credit for PTE taxes paid to other states that are "substantially similar" to their own PTE tax.[32] To alleviate ambiguity, the New York Department of Taxation and Finance published a list of state taxes that qualify as "substantially similar."[33] The model legislation also suggests the usage of the "substantially similar" verbiage.[34]

Under current law Maine does not allow resident owners a credit for taxes paid to other jurisdictions by the PTE, significantly reducing the utility of other state PTE taxes for Maine resident owners of PTEs electing into those out-of-state PTE taxes, see the discussion below "Maine credit for taxes paid to another jurisdiction" and associated recommendation.

Permanent or time-limited basis

The SALT deduction limitation and increased standard deduction are statutorily set to expire at the end of 2025 after which the impact of PTE taxes designed to work around the limitation become much more limited. These workarounds will serve some purpose with respect to the federal PEASE limitations and the federal AMT.[35] However, the number of

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[31] Ala. Code § 40-[section forthcoming], enacted as Ala. Act 2021-1.; Ga. Code Ann. sections 48-7- 21; Rule 560-7-4.01.; S.C. Code Ann. section 12-6-545 et seq; Wis. Stat. § 71.21. It is worth noting that Wisconsin tax administrators have spoken highly of this approach.

[32] For example, New York affords its residents a credit for PTE taxes paid to other states that are "substantially similar" to the New York PTE tax. Similar language is found in New Jersey's PTE tax legislation (N.J.S.A. 54A:12-1 et seq.) and Arizona (Ariz. Rev. Stat. Ann. § 43-1014.).

[33] See N.Y. Dept. of Rev. Guidance, "States with a tax substantially similar to PTET." See also Ill. Dept. of Rev. Pub. 129, "Pass-Through Entity Information." Note that these lists aren't exactly similar, and some ambiguity still exists as to what exactly a "substantially similar" tax is, and the determination may be subjective based on the enacting state's PTE tax.

[34] Main Street Employers, "Model Statutory Language for Pass Through Entity Tax," 2018.

[35] See footnote 5 above. Maine does not have an individual AMT.

affected taxpayers and the amount of income in question, and the potential revenue impact on the State will all be significantly reduced.

Whether the SALT deduction limitation will be allowed to expire is an open question. Possibilities under serious discussion include an expiration of the limitation, an extension or making the limitation permanent, an increase of the allowable deduction amount, and a disallowance of state workarounds, or a combination of two or more of these. In short, the future workings of the SALT deduction are highly uncertain.

The three New England states that have enacted pass-through entity taxes in response to the SALT limitation have not included a sunset, or end date, to their taxes.[36] Thus, they will statutorily continue regardless of what happens at the federal level.

However, due to the uncertainty in the federal landscape and the short timeframe remaining before changes are required at the federal level, Maine is not in a good position to make long-term tax policy decisions concerning the taxation of pass-through income. **As such, if the Legislature chooses to enact a Maine PTE tax, this report recommends against enacting a temporary or permanent PTE tax while the future of the SALT tax deduction limitation remains uncertain.**

Retroactive basis

Of the 36 states that enacted pass-through entity taxes in response to the SALT deduction limitation, two have created taxes retroactive to 2018, the beginning of the limitation. Tax professionals have questioned whether the IRS will respect these retroactive taxes and allow a deduction – to date, there has not been an authoritative answer to this question.[37,38]

In 2023, the last year in which PTE taxes have been enacted, 4 states enacted PTE taxes retroactive to tax year 2022. While the exact timing varies among states, in each of these cases the legislatures considered bills affecting the ongoing 2022 tax filing season. It is

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[36] With limited exceptions, this has been the general approach taken across the country.

[37] Notice 2020-75 specifically contemplates tax years as far back as 2018, but only when the payments are made before November 9, 2020 and pursuant to laws enacted prior to November 9, 2020. Notice 2020-75 Applicability Date reads:

> The proposed regulations described in this notice will apply to Specified Income Tax Payments made on or after November 9, 2020. The proposed regulations will also permit taxpayers described in section 3.02 of this notice to apply the rules described in this notice to Specified Income Tax Payments made in a taxable year of the partnership or S corporation ending after December 31, 2017, and made before November 9, 2020, provided that the Specified Income Tax Payment is made to satisfy the liability for income tax imposed on the partnership or S corporation pursuant to a law enacted prior to November 9, 2020. Prior to the issuance of the proposed regulations, taxpayers may rely on the provisions of this notice with respect to Specified Income Tax Payments as described in this section 4.

[38] Ron Cook, Jeanette Tolar, *Colorado pass-through entity tax updates: What you need to know* (December 21, 2022), https://www.plantemoran.com/explore-our-thinking/insight/2022/12/colorado-pass-through-entity-tax-updates.

uncertain whether, or to what extent, the shorter nature of the retroactive period, and in some sense concurrent timing with the filing season, puts the legal basis for these taxes on a better footing than those with longer retroactive periods. However, the administrative complexity of changing the filing season mid-stream and the necessary amended returns is worth serious consideration.[39]

A retroactive application of the PTET (e.g., to tax year 2024) would create high administrative costs and necessitate problematic systems modifications. This is due to the complexity and cost to alter tax systems, forms, instructions, guidance, etc. that have already been placed into service and are being used and relied upon by taxpayers, administrators, tax professionals, and software companies. It is expected that many affected returns will have already been filed and processed under current statute before a new law could be enacted, and administrative and computer processes designed, tested, and implemented. Affected taxpayers (entities and owners) would be required to file amended returns based on new law, procedures, and systems, causing significant confusion and adding administrative complexity.

For example, retroactive application to 2024 would require an update to 2024 forms, causing two different sets to be in public circulation, one of which would be outdated. Corresponding scanning technology would need to be updated for any paper copies submitted. The STARS database would need to be updated with recoding taking place for the 2024 tax year. This creates subtle differences between the old and updated 2024 year coded in the STARS system and would increase processing errors, especially for taxpayers who had already filed a return before the updated coding takes place (*i.e.*, during the regular 2024 tax year filing season). These errors would need to be manually resolved by staff, which would be time intensive and costly. In addition, it is likely that retroactive implementation would take place sometime in mid-to late-Summer to early Fall. This time is generally utilized for other critical staff functions in the income tax unit, importantly including preparation for the next filing season. Finally, software vendors would have to update forms to conform to their own functions, to which they have no obligation to implement. This process would effectively create a second filing season during the Summer and Fall of 2025 for all PTE tax filers.

Weighing the complexity of complying with and administering a retroactive PTE tax and the uncertainty in federal treatment, this Report strongly recommends against retroactive application of any PTE tax enacted by the State.

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[39] In addition, the timing of the federal deduction and the coordination with state credits or deductions is an area of inconsistency and uncertainty that is exacerbated when a state allows retroactive application of their PTE tax.

Other important factors

In addition to the items discussed above, there is considerable variation among the states in the treatment of net operating losses, refundability or carryforward of state credits, tiered partnerships, estimated tax payments, withholding, and composite returns. These details, while technical, have important implications on the ease of compliance and administration, and the effectiveness of the tax in assisting taxpayers in minimizing their federal tax burden.

The variation also causes additional compliance costs on taxpayers that operate in multiple jurisdictions and may lower the value of these PTE taxes for multistate PTEs and their owners.

Maine credit for taxes paid to another jurisdiction

In Maine, "a resident *individual* is allowed a credit against the tax otherwise due … for the amount of income tax imposed on that *individual* for the taxable year by another state of the United States…"[40] Such relief for taxes paid to other jurisdictions is commonly found in state tax codes and has Constitutional implications.[41] The application of such relief with respect to out-of-state PTE taxes imposed on and paid by PTEs owned by Maine residents was addressed in a 2018 Maine Law Court decision and a 2020 decision of the Maine Board of Tax Appeals ("BTA").

In 2018, the Maine Supreme Judicial Court (sitting as the Law Court) interpreted section 5217-A as unavailable to Maine-resident taxpayers who sought a credit on their Maine individual income tax returns for business taxes paid to the State of New Hampshire by an LLC of which one of the taxpayers was a member.[42] See *Goggin v. State Tax Assessor* (*Goggin*), one of the Goggins was a member of a New Hampshire LLC that paid business taxes to New Hampshire.[43] Interpreting section 5217-A by its plain meaning, the Law Court affirmed MRS's denial of the member-taxpayers' claim to credits on their Maine individual income tax returns because the New Hampshire taxes were imposed on and paid by the entity, not by the individuals themselves.[44]

In March of 2021, the BTA considered the applicability of section 5217-A to a Maine resident individual who was a member of a Connecticut S Corporation subject to Connecticut's mandatory PTE tax.[45] In that case, as published in publicly available redacted form, the BTA affirmed MRS's denial of the credit claimed on the Maine resident

[40] 36 M.R.S. § 5217-A (emphasis added).
[41] *See Comptroller of the Treasury of Md. v. Wynne*, 575 U.S. 542 (2015).
[42] *Goggin v. State Tax Assessor*, 2018 ME 111, 191 A.3d 341.
[43] *Id*.
[44] *Id*.
[45] Taxpayer v. MRS, Dkt. No. BTA-2020-1 (Maine Bd. Of Tax App. Mar. 20, 2021) available in redacted form pursuant to 36 M.R.S. § 191(2)(YY) at https://digitalmaine.com/tax_appeals_decisions/.

taxpayer's individual income tax return for the PTE tax paid by his Connecticut S Corporation based on the Law Court's interpretation of section 5217-A in *Goggin* and the plain language of the statute.[46] The taxpayer attempted to distinguish his case from *Goggin* by arguing that he had a direct personal income tax liability because Connecticut initially imposed on him an individual income tax on his share of the income derived in the state from the S Corporation.[47] Citing *Goggin*, the BTA affirmed MRS's determination that section 5217-A is applied after the application of all credits.[48] Accordingly, because the credit that the taxpayer received on his Connecticut individual income tax return for the PTE tax paid to Connecticut by the PTE eliminated the taxpayer's Connecticut individual income tax liability, the BTA held that section 5217-A did not provide him with a credit on his Maine individual income tax return. The taxpayers did not appeal that decision to Superior Court.

Therefore, absent statutory change, under the Law Court's decision in *Goggin* section 5217-A does not allow Maine residents who are members of PTEs to claim a credit on their Maine individual income tax returns for income taxes that are imposed on the PTEs and paid to other jurisdictions by those PTEs

When pass-through entities elect into PTE taxes in non-Maine states, the lack of a Maine credit for the taxes paid by the PTE reduces, and in many cases eliminates or even reverses, the benefits of the out-of-state SALT deduction limitation workarounds for Maine resident owners of those pass-through entities. While the denial of these credits is required by Maine tax law, taxpayers have raised equity and policy concerns with that result while states and taxpayers alike wait for Congress to act on the expiring SALT deduction limitation.[49]

Analysis of Potential Beneficiaries and State Revenue Impact

The distribution of pass-through entity income

Pass-through entity income is skewed toward high-income taxpayers. On 2021 federal income tax returns with a Maine address, 70% of taxpayers with Federal AGI above $1 million and 52% of taxpayers with Federal AGI between $500,000 and $1 million report S

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[46] *Id*.
[47] *Id*.
[48] "Additionally, as used in section 5217-A, the "[i]ncome taxes imposed by another jurisdiction means the tax after credits (except withholding and estimated tax payments)." See M.R.S., Income/Estate Tax Division, Credit for Taxes Paid to Another Jurisdiction, Guidance Document, page 3, (December 2019): "After application of all available credits—including the credit for the Company's Connecticut business profits tax—the Taxpayer had no Connecticut individual income tax liability. Consequently, the Taxpayer has not shown that he is entitled to any Maine credit under section 5217-A for individual income taxes imposed upon him by Connecticut. No adjustment to the assessment on this basis is warranted." *Taxpayer v. MRS,* BTA-2020-1 (Mar. 20, 2021) (publicly redacted decision, see n.45 above).
[49] As discussed above, Maine tax law has a long history of not allowing an individual tax credit for taxes paid by a PTE. Reversing this treatment would have implications beyond the federal SALT deduction limitations and PTE taxes designed to avoid the limitation.

Corporation or partnership income; the share of returns is below 7% for all income categories below $100,000 (Table 1). Taxpayers with Federal AGI above $500,000 account for 1% of federal tax returns, 18.1% of federal total income, and 69% of S Corporation and partnership net income. The distribution of the federal tax benefits of a PTE tax, which reduces taxable S Corporation and partnership income, will largely track the distribution of PTE income.

Table 1: S- Corporation and Partnership Income by Federal AGI Group, 2021[50]

Federal AGI	# Tax Returns, All	Share with S-Corp and Partnership Income or Loss	Average Nonzero S-Corp and Partnership Income	S-Corp and Partnership Income Share of Total Income, All Returns	Share of Total S-Corp and Partnership Income
<=$0	19,190	6.8%	-$84,718		-3.3%
$1 < $10,000	78,960	1.1%	-$6,316	-1.4%	-0.2%
$10,000 < $25,000	114,550	1.7%	-$1,932	-0.2%	-0.1%
$25,000 < $50,000	183,040	2.2%	$3,841	0.2%	0.4%
$50,000 < $75,000	110,960	3.9%	$9,021	0.6%	1.1%
$75,000 < $100,000	69,360	6.1%	$13,597	0.9%	1.7%
$100,000 < $200,000	103,500	10.6%	$27,452	2.1%	8.9%
$200,000 < $500,000	30,600	27.4%	$92,174	8.6%	22.8%
$500,000 < $1m	4,980	51.8%	$240,895	18.3%	18.3%
>$1m	2,160	69.9%	$1,129,972	26.1%	50.3%
All Returns	717,300	5.6%	$84,663	6.2%	

Source: Internal Revenue Service, SOI Historic Table 2 (Federal individual income returns filed using a Maine address)

Limitation on deduction of state and local tax and federal tax benefits of a Maine PTE Tax

The $10,000 limitation on state and local tax itemized deductions increases federal taxable income and consequently the federal tax liability of taxpayers who pay more than $10,000 in state and local taxes and who would itemize deductions in the absence of the SALT deduction limitation.[51] In estimating the impact of the federal state and local tax deduction

[50] S- Corporation and partnership income excludes portfolio income passed through to the individual taxpayer.

[51] The total federal tax liability of a taxpayer who has itemized deductions and has federal AMT liability under current law may not be affected by the SALT cap depending on their income and long-term capital gains and qualified dividends even when state and local taxes exceed $10,000.

limitation on individual taxpayers, we can look to the effect of repealing the limitation. High-income taxpayers would disproportionately benefit from SALT limitation repeal due to their disproportionate share of taxable income and the graduated individual income tax brackets.

A challenge with estimating the federal tax impact of the SALT deduction limitation is that we do not observe itemized deductions for taxpayers who claim the standard deduction due to the limit on the deductibility of state and local taxes in tax years 2018 and later. Therefore, our estimates are based on the population of 2017 tax returns aged to 2019.[52,53]

We estimate that the SALT deduction limitation increased federal tax liability by $187 million for Maine residents in 2019 (Table 2), with about 53% of the increase from taxpayers with Federal AGI above $500,000 and 87% with Federal AGI above $200,000.[54] The average tax impact increases with income and is over $50,000 for taxpayers with more than a $1 million Federal AGI.

Table 2: Benefit of SALT Deduction Limit Repeal for Maine Full-Year Resident Returns, 2019

Federal AGI	Returns impacted by SALT cap	Share of Returns	Total Tax Impact ($mil)	Average Tax Benefit of Repeal
<= $100,000	5,770	1.0%	$3.56	$617
$100,000 < $125,000	4,406	11.1%	$3.40	$771
$125,000 < $150,000	4,772	20.8%	$4.72	$989
$150,000 < $200,000	9,025	42.1%	$12.47	$1,381
$200,000 < $300,000	10,202	74.9%	$26.86	$2,633
$300,000 < $500,000	6,299	92.5%	$37.65	$5,977
$500,000 < $1,00,000	2,861	96.8%	$44.56	$15,574
>$1,000,000	1,043	93.9%	$53.85	$51,609
Total	44,379	6.6%	$187.07	$4,215

[52] Another challenge is modeling the federal AMT with incomplete tax data. Interactions with the federal AMT reduce, and in some cases eliminate, the benefit of SALT cap repeal for some taxpayers.
[53] Aging tax returns from a base tax year to a future tax year means growing income amounts and reweighting returns to match certain features of the future tax year.
[54] A recent analysis by the Tax Policy Center estimated that 67.5% of the federal tax benefit of repealing the limit on state and local tax deduction accrues to tax units with expanded cash income exceeding $500,000 and 93.7% to tax units with expanded cash income $200,000 in 2025. See Tax Policy Center, T24-0070 — Repeal $10,000 Limit on Deductible State and Local Taxes, by ECI Level, 2025, available https://www.taxpolicycenter.org/model-estimates/repeal-limit-deductible-state-and-local-taxes-salt-september-2024/t24-0070-repeal .

Restricting to taxpayers who report S Corporation or partnership income (Table 3) focuses on the subpopulation who may benefit from a state PTE tax; the estimates are very similar for this subpopulation and the full population of taxpayers.

Table 3: Benefit of SALT Deduction Limit Repeal for Maine Full-Year Resident Returns with Pass-Through Entity Income or Loss, 2019

Federal AGI	Returns with tax cut	Share of Returns with Tax Cut	Total Tax Cut ($mil)	Average Tax Cut
<= $100,000	976	5.1%	$0.81	$833
$100,000 < $125,000	737	19.4%	$0.82	$1,105
$125,000 < $150,000	869	29.7%	$1.21	$1,389
$150,000 < $200,000	1,797	47.8%	$3.36	$1,872
$200,000 < $300,000	2,866	74.9%	$9.02	$3,147
$300,000 < $500,000	2,635	92.0%	$16.20	$6,149
$500,000 < $1,00,000	1,740	97.6%	$28.06	$16,125
>$1,000,000	816	94.9%	$44.30	$54,305
Total	12,436	31.9%	$103.78	$8,345

The context of the pre-TCJA law and all TCJA changes should be considered when evaluating the distribution of the federal tax impact of the limitation on the state and local tax deduction. First, the limitation was imposed as part of a package of tax changes in the TCJA, many of which benefited high-income taxpayers and owners of pass-through entities in particular. These changes include the qualified business income deduction, tax rate reductions, a significant increase to the standard deduction, and an increase in the AMT exemption amount. Second, limitations on state and local income tax deduction implicitly existed prior to the TCJA through the phase out of itemized deductions and the Alternative Minimum Tax.

Net state and federal revenue implications of a PTE tax

The amount raised by a Maine PTE tax depends on the amount of PTE income, the tax take-up rate[55], and other policy choices. A 7.15% PTE tax could raise between $260 and $350 million (gross)under the current $10,000 SALT deduction limitation; this amount would be largely offset by the individual income tax credit. This range assumes the Maine PTE tax immediately reaches its long run potential; if factors such as uncertainty about future

[55] For instance, if the tax is elective, what percentage of eligible PTEs elect to utilize the new PTE tax.

federal policy or transition issues limit take-up, then the early Maine PTE tax revenue may be below this range. The change in State net revenues due to a PTE tax can be broken down into three factors: 1) The individual income tax credit rate; 2) The increase in the tax credit for income tax paid to other jurisdictions; and 3) incomplete individual income tax credit take-up.

1. *Increase in state revenue if the tax credit for the PTE tax is less than 100%*

   An individual income tax credit rate of less than 100% of the taxpayer's PTE tax share increases net State revenues, all else equal. The amount raised by an incomplete credit equals (1 – credit rate)*gross PTE tax revenue. For example, a PTE tax that raised $300 million and a 90% credit would directly increase net State revenue by $30 million. Offering a partial tax credit could reduce the PTE tax take-up rate.

2. *Decrease in state revenue from the expansion of the tax credit for income tax paid to other jurisdictions ("TPOJ credit")*

Offsetting any direct revenue gains from a partial PTE tax credit is the increase in the TPOJ credit when the State begins allowing TPOJ credits for other state PTE taxes.[56]

The revenue loss from the TPOJ credit is uncertain because MRS does not have tax data to directly measure Maine resident shares of other state PTE taxes. However, tax data can inform speculation about the magnitude of the likely impact. Non-Maine PTE taxes reduce the non-Maine state income tax liability of Maine residents (TPOJ credit eligible) while shifting their non-Maine tax burden to the entity level (not TPOJ credit eligible). Therefore, we may expect the Maine TPOJ credit to decline as other states implement PTE taxes. However, the Maine TPOJ credit is at or above its historic share of resident tax liability in 2021 and 2022. This result could indicate that the other state PTE taxes have not had a material impact on the Maine TPOJ credit; alternatively, record breaking 2021 capital gains and other factors may have increased the Maine TPOJ credit, and the credit would have been even higher if PTE taxes had not been implemented in other states. The 2023 tax data, which should be considered preliminary at this point in time, indicates a lower than normal (3% of tax liability) TPOJ credit despite normal growth rates in business income and capital gains. The influence of other state PTEs on the TPOJ credit may now be apparent. If the 2023 credit equaled the 2014-2018 average share of tax liability (3.5%), then it would be $10.8 million higher.

[56] See "Maine credit for taxes paid to another jurisdiction" above.

Table 4: Tax Credit for Income Tax Paid to Other Jurisdictions (OJ), Maine Full-Year Resident Returns

					OJ Credit, Share of:	
Tax Year	OJ Credit, $mil	# OJ Credit	Share of Returns with OJ Credit		Income Tax Before Credits	Federal AGI
2002	$24.1	11,558	2.0%		2.4%	0.1%
2003	$27.2	11,806	2.0%		2.6%	0.1%
2004	$30.4	11,792	2.0%		2.6%	0.1%
2005	$38.0	12,380	2.1%		3.1%	0.1%
2006	$44.2	12,975	2.2%		3.3%	0.2%
2007	$56.9	13,790	2.2%		4.0%	0.2%
2008	$40.3	13,627	2.2%		3.1%	0.1%
2009	$34.5	13,476	2.3%		2.8%	0.1%
2010	$42.7	13,726	2.3%		3.2%	0.1%
2011	$44.7	13,805	2.3%		3.3%	0.2%
2012	$49.8	14,314	2.4%		3.4%	0.2%
2013	$45.3	13,612	2.2%		3.4%	0.1%
2014	$46.2	14,376	2.3%		3.3%	0.1%
2015	$50.1	14,751	2.4%		3.4%	0.1%
2016	$50.0	15,004	2.3%		3.5%	0.1%
2017	$54.9	15,534	2.4%		3.6%	0.1%
2018	$58.1	16,296	2.5%		3.5%	0.1%
2019	$61.1	16,247	2.4%		3.5%	0.1%
2020	$66.9	15,811	2.3%		3.5%	0.2%
2021	$98.8	18,106	2.4%		4.1%	0.2%
2022	$85.2	17,632	2.5%		3.7%	0.2%
2023	$72.2	17,131	2.5%		3.0%	0.1%

The 2023 credit will increase over time. The 2022 credit increased by $2.5 million between early January 2024 and early January 2025.

If Maine were to enact some form of PTE tax similar to those reviewed in this Report, allowing the Maine TPOJ Credit for the New Hampshire Business Profits Tax, enacted in 1970, likely would have the largest Maine revenue consequences of all state PTE taxes. Data from K-1s (Form 1065 and Form 1120S) by payer state show large differences between TPOJ credits claimed by Maine residents with a K-1 only from New Hampshire addresses compared to Maine residents who only have a K-1 from a state other than New Hampshire or Maine.[57] Residents with a New Hampshire K-1 are about half as likely to claim an TPOJ

[57] The main analysis is restricted to taxpayers with a K-1 with positive non-portfolio income from a single state in 2021 and 2022.

credit and the TPOJ credit as a share of positive non-portfolio K-1 income is about 5 percentage points[58] less for the residents with a New Hampshire K-1. The revenue loss from allowing the TPOJ credit for the New Hampshire Business Profits Tax could be in the $3 - $6 million range.

3. *Increase in State revenue attributable to imperfect tax credit take-up*

Unclaimed credits for PTE tax paid may increase State revenues. Unclaimed credits may be a nontrivial share of total credits; for example, Rhode Island, which has a 100% credit rate, reports unclaimed credits equal to 7.5% – 14% of net PTE collections per tax year.[59] However, the state revenue implications of unclaimed credits are unclear.

The circumstances involved with unclaimed credits determines their state revenue impact. Consider a nonresident owner of a PTE that pays a Maine PTE tax and who fails to file a Maine individual income tax return. If the nonresident's only Maine-sourced income is from the PTE, then the failure to file and claim the PTE tax credit does not increase state revenue. Other situations, such as a taxpayer who files an income tax return but is not aware of their PTE tax credit eligibility or who does not have sufficient tax liability to fully utilize a nonrefundable PTE tax credit, could increase state revenues. The short run may have lower credit take-up compared to the long run as policy awareness increases and credit carryforwards are claimed. Tax policy analysts in California assume 98% credit usage in the long run.[60]

4. *Summary of State revenue implications*[61]
    - Gross PTE tax revenue may be in the $260 - $350 million range under the current $10,000 SALT deduction limitation and will depend on the take-up rate of the elective PTE tax. If the PTE tax starts slowly, this range could overstate PTE tax revenues.
    - Net State revenues will increase by (100% - PTE tax credit rate)*gross PTE tax revenue. Thus, a credit rate of 100% would offset all of the gross PTE tax revenue.
    - The State will also raise revenue from unclaimed tax credits, perhaps on the order of 1-2% of PTE tax revenue in the long run.

[58] 5 percentage points is the average of the 2021 and 2022 difference.
[59] See question 22 in the additional information provided by the Rhode Island Division of Taxation for the Revenue Estimating Conference, May 6, 2024, available at: https://www.rilegislature.gov/Special/rcc/REC202405/Division%20of%20Taxation%20May%202024%20REC%205.6.24.pdf
[60] Colby White and Allen Prohofsky, Presentation on the Pass-Through Entity Elective Tax in California, 2023 FTA Revenue Estimating Conference, available at: https://taxadmin.org/wp-content/uploads/resources/23rev_est/white.pdf
[61] We estimate that the federal tax benefit will be about 30.5% of gross PTE tax revenues and that most of the benefit will go to taxpayers with Federal AGI exceeding $500,000.

- The State will lose revenue from the expansion of the credit for income tax paid to other jurisdictions. Due to data limitations, there is significant uncertainty over the amount of this revenue loss, but $6 - $12 million may be a reasonable range.

State revenue timing

The analysis in the preceding section described the potential revenue impact of a Maine PTE tax by *tax year*. However, state budgeting occurs on a fiscal year basis, fiscal year revenues include payments and refunds from multiple tax years, and a long period of time may pass for revenues from a tax year to align with tax liability for the tax year. If individual income tax estimated payments do not quickly adjust for the availability the PTE tax credit, then high collections in the first fiscal year or two could be followed by excess refunds that negatively impact revenues. Even a PTE tax designed to be revenue neutral by tax year could have large but offsetting revenue impacts by fiscal year.

The introduction of a PTE tax would create additional uncertainty about the State revenue performance. Distinguishing between forecast errors involving when revenue is received versus how much total revenue will be received would not be possible in the short run. A consistent theme of the Office of Tax Policy's conversations with other states is confusion with interpreting the revenue data in the initial period, at least two fiscal years, after the introduction of a PTE tax.

Conclusion

The Report recommends waiting until after the uncertain future of the SALT deduction limitation is resolved at the federal level – a timeline that could be as short as a few months or reasonably stretch into 2026 – before enacting any State response to the federal limitation. If, instead, the Legislature enacts legislation prior to federal action, the Report strongly recommends delaying the effect of the Legislation until tax years beginning on or after January 1st, 2026. Such an approach would provide time for a smooth implementation of the workaround and allow an opportunity for the Legislature to react to expected changes at the federal level. In addition, this Report recommends that the Maine Legislature only consider enacting a pass-through entity tax if it addresses a long-term issue facing the State due to the complexity of the federal SALT deduction limitation and the pass-through entity taxes and offsetting credits created by the states to work around the limitation, their narrow application to a small subset of taxpayers, and the shifting federal landscape on which they are based.

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APPROVED | CHAPTER
APRIL 16, 2024 | 170
BY GOVERNOR | RESOLVES

STATE OF MAINE

IN THE YEAR OF OUR LORD

TWO THOUSAND TWENTY-FOUR

H.P. 1212 - L.D. 1891

Resolve, to Require the Office of Tax Policy to Study the Adoption of a Pass-through Entity Income Tax

Sec. 1. Department of Administrative and Financial Services, Bureau of Revenue Services, Office of Tax Policy to examine and evaluate system of taxation of business income and possible adoption of pass-through entity income tax. Resolved: That the Department of Administrative and Financial Services, Bureau of Revenue Services, Office of Tax Policy shall examine and evaluate the State's current system of taxation of business income, including the current system of taxing pass-through business income at the partner or shareholder level, and the possible adoption of a pass-through entity income tax to tax such pass-through income, including the possibility of moving the taxation of that income, or some portion of that income, from the partner or shareholder level to the business entity that generated the income. The study must include examination of the impact of the adoption of a pass-through entity income tax on a mandatory and an elective basis, on a permanent and time-limited basis and on a retroactive basis. The Office of Tax Policy shall also include in the study consideration of the impact of the federal state and local tax deduction limitation on individual taxpayers in the State, and the manner and fiscal impact of how a pass-through entity income tax has been enacted and implemented in other states to, in part, address the state and local tax deduction. The Office of Tax Policy may consult with national income tax experts as appropriate. No later than January 15, 2025, the Office of Tax Policy shall submit a report based on the study to the joint standing committee of the Legislature having jurisdiction over taxation matters that includes its findings and recommendations, including suggested legislation. The joint standing committee may submit legislation related to the report to the 132nd Legislature in 2025.

Part III – Administrative, Procedural, and Miscellaneous

Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes

Notice 2020-75

SECTION 1. PURPOSE

This notice announces that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to issue proposed regulations to clarify that State and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment.

SECTION 2. BACKGROUND

.01 Computing taxable income or loss

(1) Section 164(a) of the Internal Revenue Code (Code) generally allows a deduction for certain taxes for the taxable year within which paid or accrued, including: (i) State and local, and foreign, real property taxes; (ii) State and local personal property taxes; and (iii) State and local, and foreign, income, war profits, and excess profits taxes. In addition, section 164 allows a deduction for State and local, and foreign, taxes

not described in the preceding sentence that are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 of the Code. Section 164(b)(2) provides that, for purposes of section 164, a “State or local tax” includes only a tax imposed by a State, a possession of the United States, (U.S. territory), or a political subdivision of any of the foregoing, or by the District of Columbia.

(2) Section 703(a) of the Code generally provides that the taxable income of a partnership is computed in the same manner as in the case of an individual except that the items described in section 702(a) of the Code must be separately stated and certain enumerated deductions are not allowed to the partnership. For example, section 703(a)(2)(B) disallows the deduction for taxes provided in section 164(a) with respect to taxes described in section 901 of the Code, which include not only taxes paid or accrued to foreign countries but also taxes paid or accrued to U.S. territories (which are treated as State and local taxes under section 164(b)(2)). Section 1363(b)(1) and (2) of the Code generally provides the same with respect to an S corporation.

(3) Section 702(a) provides that a partner, in determining the partner’s income tax, is required to take into account separately the partner’s distributive share of certain partnership items of income, gain, loss, deduction, or credit (tax items) that are set forth in that section, as well as the non-separately computed income and loss. For example, section 702(a)(6) requires that a partner take into account separately the partner’s distributive share of taxes, described in section 901, paid or accrued to foreign countries and to U.S. territories.

(4) Section 1366(a)(1) of the Code provides that, in determining the tax of a shareholder of an S corporation, the shareholder is required to take into account

separately the shareholder's pro rata share of the S corporation's tax items, the separate treatment of which could affect the liability for tax of any shareholder of the S corporation, as well as the non-separately computed income and loss. For this purpose, section 1366(a)(1) requires, in part, that a shareholder take into account separately the shareholder's pro rata share of the S corporation's taxes, described in section 901, paid or accrued to foreign countries and to U.S. territories.

(5) Revenue Ruling 58-25, 1958-1 C.B. 95, holds that a Cincinnati, Ohio tax imposed upon and paid by a partnership on the net profits of the partnership's business conducted in Cincinnati was deductible in computing the taxable income or loss of the partnership. The ruling holds that "any tax imposed upon and paid by a partnership on the net profits of its business conducted in Cincinnati is deductible in computing the taxable income of the partnership and the partners are not precluded from claiming the standard deduction." Thus, the partners' distributive shares of the net profits tax were not separately stated and the partners' distributive shares of the partnership's non-separately stated income or loss, which reflects a deduction for the tax paid by the partnership, could be taken into account by the partners in computing adjusted gross income under section 62 of the Code, not as itemized deductions.

.02 <u>State and local tax (SALT) deduction limitation</u>

(1) Section 164(b)(6), as added by section 11042(a) of Public Law 115-97, 131 Stat. 2054 (December 22, 2017), commonly referred to as the Tax Cuts and Jobs Act, limits an individual's deduction under section 164(a) (SALT deduction limitation) to $10,000 ($5,000 in the case of a married individual filing a separate return) for the aggregate amount of the following State and local taxes paid during the calendar year:

(i) real property taxes; (ii) personal property taxes; (iii) income, war profits, and excess profits taxes; and (iv) general sales taxes. This SALT deduction limitation applies to taxable years beginning after December 31, 2017, and before January 1, 2026, and does not apply to taxes described in section 164(a)(3) that are imposed by a foreign country or to any taxes described in section 164(a)(1) and (2) that are paid and incurred in carrying on a trade or business or an activity described in section 212.

(2) In enacting section 164(b)(6), Congress provided that "taxes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner's or S corporation shareholder's distributive or pro-rata share of income or loss on a Schedule K-1 (or similar form), will continue to reduce such partner's or shareholder's distributive or pro-rata share of income as under present law." H.R. Rep. No. 115-466, at 260 n. 172 (2017).

(3) Certain jurisdictions described in section 164(b)(2) have enacted, or are contemplating the enactment of, tax laws that impose either a mandatory or elective entity-level income tax on partnerships and S corporations that do business in the jurisdiction or have income derived from or connected with sources within the jurisdiction. In certain instances, the jurisdiction's tax law provides a corresponding or offsetting, owner-level tax benefit, such as a full or partial credit, deduction, or exclusion. The Treasury Department and the IRS are aware that there is uncertainty as to whether entity-level payments made under these laws to jurisdictions described in section 164(b)(2) other than U.S. territories must be taken into account in applying the SALT deduction limitation at the owner level.

SECTION 3. FORTHCOMING PROPOSED REGULATIONS

.01 Purpose and scope. The Treasury Department and the IRS intend to issue proposed regulations to provide certainty to individual owners of partnerships and S corporations in calculating their SALT deduction limitations. Based on the statutory and administrative authorities described in section 2 of this notice, the forthcoming proposed regulations will clarify that Specified Income Tax Payments (as defined in section 3.02(1) of this notice) are deductible by partnerships and S corporations in computing their non-separately stated income or loss.

.02 Forthcoming regulations. To achieve the purpose described in section 3.01 of this notice, the Treasury Department and the IRS expect to propose regulations consistent with the provisions set forth in this section 3.02.

(1) Definition of Specified Income Tax Payment. For purposes of section 3.02 of this notice, the term "Specified Income Tax Payment" means any amount paid by a partnership or an S corporation to a State, a political subdivision of a State, or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or the S corporation. This definition does not include income taxes imposed by U.S. territories or their political subdivisions. Thus, this definition solely includes income taxes described in section 164(b)(2) for which a deduction by a partnership is not disallowed under section 703(a)(2)(B), and such income taxes for which a deduction by an S corporation is not disallowed under section 1363(b)(2). For this purpose, a Specified Income Tax Payment includes any amount paid by a partnership or an S corporation to a Domestic Jurisdiction pursuant to a direct imposition of income tax by the Domestic Jurisdiction on the partnership or S corporation, without regard to whether the imposition of and liability

for the income tax is the result of an election by the entity or whether the partners or shareholders receive a partial or full deduction, exclusion, credit, or other tax benefit that is based on their share of the amount paid by the partnership or S corporation to satisfy its income tax liability under the Domestic Jurisdiction's tax law and which reduces the partners' or shareholders' own individual income tax liabilities under the Domestic Jurisdiction's tax law.

(2) Deductibility of Specified Income Tax Payments. If a partnership or an S corporation makes a Specified Income Tax Payment during a taxable year, the partnership or S corporation is allowed a deduction for the Specified Income Tax Payment in computing its taxable income for the taxable year in which the payment is made.

(3) Specified Income Tax Payments not separately taken into account. Any Specified Income Tax Payment made by a partnership or an S corporation during a taxable year does not constitute an item of deduction that a partner or an S corporation shareholder takes into account separately under section 702 or section 1366 in determining the partner's or S corporation shareholder's own Federal income tax liability for the taxable year. Instead, Specified Income Tax Payments will be reflected in a partner's or an S corporation shareholder's distributive or pro-rata share of non-separately stated income or loss reported on a Schedule K-1 (or similar form).

(4) Specified Income Tax Payments not taken into account for SALT deduction limitation. Any Specified Income Tax Payment made by a partnership or an S corporation is not taken into account in applying the SALT deduction limitation to any individual who is a partner in the partnership or a shareholder of the S corporation.

SECTION 4. APPLICABILITY DATE

The proposed regulations described in this notice will apply to Specified Income Tax Payments made on or after **November 9, 2020**. The proposed regulations will also permit taxpayers described in section 3.02 of this notice to apply the rules described in this notice to Specified Income Tax Payments made in a taxable year of the partnership or S corporation ending after December 31, 2017, and made before **November 9, 2020**, provided that the Specified Income Tax Payment is made to satisfy the liability for income tax imposed on the partnership or S corporation pursuant to a law enacted prior to **November 9, 2020**. Prior to the issuance of the proposed regulations, taxpayers may rely on the provisions of this notice with respect to Specified Income Tax Payments as described in this section 4.

SECTION 5. DRAFTING INFORMATION

The principal author of this notice is the Office of Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, contact Kevin I. Babitz or Robert D. Alinsky at (202) 317-5279 (not a toll-free number).

Design: For tax years beginning on or after January 1, 2026, using the Form 1040C-ME (Composite Income Tax Return) as modified to impose an elective Maine pass-through entity (PTE) tax on partnerships, LLCs treated as partnerships, and S corporations. Pass-through entities subject to franchise tax or insurance premiums tax will be excluded.

Entities electing to file under the PTE tax must do so on behalf of *all* eligible owners.

Calculation of tax:

- Maine resident individuals, trusts and estates: 7.15% of the total distributive share of PTE income; and
- Maine nonresident individuals, trusts and estates: 7.15% of the Maine-source distributive share of PTE income.[1]

PTE tax credit: Provide a refundable credit to PTE owners (i.e., individuals, trusts, and estates) whose distributive income is used to calculate the PTE tax. The credit is equal to 100% of the owner's distributive share of the PTE tax paid, except that the credit for a nonresident owner is equal to the PTE tax on the distributive share of income sourced to Maine. No credit will be allowed unless the PTE pays the computed PTE tax and provides sufficient information to identify the owner entitled to the credit and the amount of credit.

Exclusions from the tax: The distributive share of income of owners that are not subject to income tax under 36 M.R.S., Part 8 as individuals, trusts, or estates (e.g., corporate, nonprofit, PTE owners and owners subject to the franchise or insurance premiums tax).

Election of PTE: The PTE elects on its annual PTE tax return to be subject to the tax. The election would have to be made on the return filed by the original or extended due date. The election of the PTE is binding on the owners.

Nonresident Owner Filing Obligation: A nonresident owner individual, trust, or estate included in a PTE tax or composite return would have no other obligation to file a Maine income tax return, but only if they had no other Maine-source income except for income from other PTEs for which the PTE has filed either a Composite Return or a PTE return, and the amount of tax paid by the PTE(s) meets the qualified members Maine tax obligation related to that income. In such cases, a separate individual or fiduciary return would not be necessary.

[1] Note, for purposes for the PTET, except as provided by the exclusions below, direct owners include members whose ownership in a PTE is held through a disregarded entity. No income modifications would apply in calculating distributive share of income and no income tax credits would be allowed in calculating the PTET. Existing estimated tax law would apply, and the PTE would pay the estimated tax.

Effect on PTE income, gains, loss, deductions, etc.: The proposed PTE tax would have **no** effect on the pass-through income, gain, loss, deductions, Maine income modifications, business credits, etc. flowing through from the PTE (whether partnership or S corporation) to the owners. The proposal merely adds a PTE tax on the aggregate amount of the eligible owners' federal distributive income. In addition, this design includes a related state refundable credit and addition modification for the owners affected by the PTE tax.

Credit for taxes paid to another jurisdiction: The credit for taxes paid to another jurisdiction under the individual income law would be amended to allow Maine residents to claim credit for their share of PTE tax imposed by another state if the state's PTE tax is substantially similar to the proposed Maine PTE tax with potentially other limiting criteria. The PTE tax must be imposed on an entity that is treated as a partnership or S corporation for federal and Maine income tax purposes.

Addition modification for state and local taxes deducted by the PTE: Generally, Maine does not allow a deduction for state and local income taxes. Thus, an addition modification under the individual income law must be enacted to recapture an owner's distributive share of any federal deduction claimed by the PTE for state and local income taxes paid (i.e. the owner's share of the deduction as reflected in the owner's distributive share of entity income). This modification is also necessary due to PTE taxes paid by PTEs to other states.

Forms/system changes: This proposed implementation method envisions modifications to the Composite income tax return that could allow taxpayers the option to elect to file as a PTE and pay the associated PTE tax. Currently, this return is primarily aimed at PTEs with nonresident owners that have Maine-source income from the entity. By adapting the return to include information on both in-state and out-of-state members and to report both the distributed and undistributed portion of PTE income, MRS could extend its functionality to cover the needs of a PTE tax. In the STARS framework, a single return could effectively provide information and facilitate the distribution of funds.

To successfully implement this option, it would be necessary to define, design, and create new fields and schedules for submission on paper, via Modernized Electronic Filing (MeF), and through the Maine Tax Portal (MTP). Additionally, modifications to existing forms will be essential to accommodate this tax type, which will require comprehensive configuration and testing across all methods of submission through the document scanning system (TRIPS) and the MTP, with rules established for each specific type.

In addition, the income tax forms for individuals, trusts and estates will have to be modified to accommodate the tax credits and income addition modifications described above.

This approach could potentially minimize confusion for taxpayers who choose to file PTE taxes. Furthermore, it stands out as one of the more straightforward options to configure and test, as it would not necessitate regression testing of Corporate Income Tax (CIT) or Individual Income Tax (IIT) returns, nor would it impact the configuration of those returns during annual updates. Changes related to PTE forms during annual revisions would be contained, affecting only the PTE account type.

Administrative costs: To be determined based on final legislation.