

PUBLIC COMMENTS AND RESPONSES

110CSR21G

INCOME TAX PAID AT THE ENTITY LEVEL BY ELECTING PASS-THROUGH ENTITIES

Regarding the proposed legislative rule designated as 110 C.S.R. 21G, the State Tax Department received comments from: K. Scott Phillips, CPA, Director at Gray Griffith & Mays (“Phillips”); William Goettel, CPA, President and CEO of First Exchange Bank (“First Exchange Bank”); David R. Pollitt, President and CEO of Rowland Land Company, LLC (“Rowland Land”); Timothy Aiken, President/CEO of Union Bank, Inc. (“Union Bank”); Wallace Suttle, Chief Financial Officer of Suttle and Stalnaker, PLLC (“Suttle”); and Gunner Huggins CPA of Elliott Davis LLC CPAs (“Elliott Davis”); as well as a joint submission from Robert G. Tweel of the law firm Jackson Kelly PLLC; Judy Proctor, CPA, CGMA, Chief Executive Officer of the West Virginia Society of CPAs; and Steven S. Robey, CPA, Chairman of the Tax Committee of the West Virginia Chamber of Commerce (“Joint Submission”).

Comments are summarized with the Tax Department’s responses below:

Joint Submission

The Joint Submission’s comments are grouped according to sections. The first grouping concerns section 110-21G-2 (Definitions) and section 110-21G-6 (Pass-Through Entity Qualification to Make the Election).

Comment 1:

Section 110-21G-2 contains the definitions used throughout the Rules. Section 110-21 G-6 details the requirements for an entity to make the election to be taxed at the entity level.

As currently drafted, Section 6.2.1. denies effective application of the Statute to partners of lower tier partnerships. Section 6.2.1. states that, "If an upper tier pass-through entity owns another lower tier pass-through entity, the lower-tier pass-through entity may not make the election to be taxed as an electing PTE under W. Va. Code §11-21-3a. An upper tier pass-through entity may make the election for itself if the upper tier pass-through entity is otherwise eligible under the statute to make the election." If enacted as proposed, this section does not allow owners of lower tier pass-through entities that are not themselves pass-through entities to take advantage of the PTE tax election, which runs contrary to the purpose and benefit of the Statute. If a lower-tier passthrough has owners that are not corporations or pass-through entities (i.e., individuals), they should be afforded the benefit as provided by the Statute. The Statute does prohibit disregarded entities from making the PTE election, but lower-tier partnerships are not disregarded entities under federal tax law. We propose that Section 6.2.1. should read as follows: "If an upper tier passthrough entity owns another lower tier pass-through entity *and the lower-tier pass-through entity has only owners that are all eligible to make the pass-through entity election*, then the lower-tier pass-through entity may not make the election to be taxed as an electing PTE under W. Va. Code §11-21-3a. An upper

tier pass-through entity may make the election for itself if the upper tier passthrough entity is otherwise eligible under the statute to make the election." (Emphasis added).

To ensure conformity of the definitions section with the change detailed above for Section 6.2.1., we propose revisions to the definition of "Tiered partnership" in Section 2.2.8. This definition should specify that a tiered partnership, "means any partnership or other pass-through entity that has one or more *owners that are eligible electing pass-through entities* ~~tiered partners~~." (Emphasis added).

Section 6.2.2. disallows a corporate partner from taking the tax credit for any income tax paid on its behalf. As drafted, this section could be confusing with its current use of "corporate." In order to clarify that a partner taxable as a C corporation cannot take the tax credit, we propose that Section 6.2.2. be revised as follows, "If an upper tier pass-through entity has a *partner taxable as a C corporation* ~~as a partner~~, the corporate partner will not be able to take a tax credit for any income tax paid on its behalf by the partnership as W. Va. Code 11-24-1, et seq., does not provide for any such tax credit or adjustment." (Emphasis added).

Response: The proposed rule has been changed to delete references to tiers, so that tiered partnerships are allowed to elect taxation at the entity level.

Comment 2: The second grouping concerns section 110-21G-4 (Owner's Reconciliation Tax Credit for Tax Paid at the Entity Level) and section 110-21G-7 (Taxable Income).

This section provides rules and computation information for calculating taxable income for purposes of the election and credit.

Currently, Section 4.3., Section 7.2., and Section 7.2.4. address the calculation of tax for resident owners and the PTE. More specifically, they address how the owner may claim the credit for taxes paid to other states on the same income of the PTE owner. For West Virginia resident owners of the PTE, we would recommend that the credit for any taxes paid to other states by either the PTE or on behalf of the PTE owner by the PTE either through required withholding, a composite return, or through a PTE tax of another state be permitted as a credit on the WV PTE return. Because both the reconciliation credit and the credit for taxes paid to other states are nonrefundable, not permitting this credit on the PTE return will likely result in a non-refundable credit to the PTE owner who is a West Virginia resident. Additionally, because the PTE income of a West Virginia resident is included in both the PTE return and the individual PTE owner's return, the state of West Virginia is protected against an inappropriately claimed credit at the PTE level because the individual will still need to appropriately track and claim the credit for taxes paid to another state.

The following example demonstrates the concern.

Assume AB partnership is an eligible PTE with 2 equal individual owners. One is a West Virginia resident, and the other is a Pennsylvania resident (which does not currently have a PTE tax option). Assume further that 50% of the adjusted gross income of the partnership is allocated to West

Virginia and 50% to Pennsylvania. Finally, assume a tax rate of 6.5% for both PA and WV. If the AB has federal adjusted gross income of \$1,000,000, the following summarizes the results under prior law and current law.

Under prior law, AB would have filed a composite return in both WV and PA. In WV, it would have paid \$16,250 on behalf of the PA resident's WV sourced income of \$250,000 (\$1,000,000 multiplied by 50% source multiplied by 50% ownership of PA resident). AB would also file a PA composite return and would have paid \$16,250 on behalf of the WV resident partner. Accordingly, WV would have collected \$32,500, and PA would have collected \$32,500 in tax.

Under the proposed regulations, the result would change in one specific way. When AB elects to file a PTE return in West Virginia, it will still pay \$16,250 on behalf of the PA partner's WV sourced income, but it will now pay \$32,500 on behalf of the WV resident partner (i.e., 6.5% of his entire AB partner income of \$500,000). When the WV partner files his West Virginia return, he will still report the \$500,000 income, he will receive a reconciliation credit of \$32,500 and a credit for taxes paid to PA with the PA composite return of \$16,250. However, his WV tax liability will only be \$32,500, and he will have \$48,750 in non-refundable credits (\$32,500 reconciliation and \$16,250 for taxes paid to PA). The WV resident will have a resulting \$16,250 nonrefundable credit that he would be able to carry-forward for five years, but basically will be building an expiring non-refundable credit. Note, in this example, West Virginia will have collected \$48,750 in tax collections for this specific year (with \$16,250 credit carry forward offsetting in future years).

If AB were permitted to credit the composite return withholding against its PTE tax liability, then the WV resident would have no carry-forward credit, and the state would have the same tax collections as under prior law.

It is important to note that because the income from AB is included on both the PTE return and the individual's return, it is highly unlikely that West Virginia will not collect the appropriate amount of tax. For example, if the PTE grossly underpaid on the WV resident (say half of what was due with the credit or \$8,125), on his individual return, because all \$500,000 of income is included, the WV resident will still owe \$8,125 on his individual return. Accordingly, West Virginia will be made whole because the individual must still include all income on his or her return and will not have the credits necessary to offset the tax liability.

We would recommend that the language of the statute permits the state the ability to credit against the PTE tax liability taxes paid to other states by either the PTE or on behalf of the PTE owner by the PTE either through required withholding, a composite return, or through a PTE tax of another state. W.Va. Code 11-21-20(a) ("6 ... The owner of a pass-through entity shall also be considered liable for and to have paid state income taxes to another state paid by the pass-through entity on behalf of an owner through withholding, a composite return, or otherwise. If an owner receives a refund or credit for overpayment of all or part of a pass-through entity tax imposed by another state, the amount paid by the owner shall be reduced by the refund or credit.") Because this credit flows to the owner, the state should permit the PTE to take the credit against WV resident's allocable income.

For these reasons, we would recommend the changes to the following sections (emphasis added):

"4.3. Resident owners' tax credit for tax paid to another state Subject to the requirements and limitations of W. Va. Code 11-21-20, individual resident owners of the electing PTE may claim a credit for income taxes paid by the electing PTE to other states for the same taxable year under laws substantially similar to the West Virginia pass-through entity income tax, or directly paid by a West Virginia resident pass-through entity owner, on pass through income taxed by another state, that is also subject to West Virginia personal income tax, which would be taxed by both the other state and the State of West Virginia but for the W. Va. Code §11-21-20 tax credit. *Any such credit may also be included as a credit against the PTE tax liability as determined by such individual resident owner 's includable income in any PTE tax liability pursuant to Section 7.2.1 to the extent paid on behalf of such owner through non-resident withholding, a composite return, or a similar PTE tax in such other state.*" (Emphasis added).

"7.2.4. West Virginia residents are taxable on all of their pass-through entity income regardless of the pass-through entity's allocation and apportionment. However, subject to the requirements and limitations of W. Va. Code §11-21-20, owners of the electing PTE may claim a credit for income taxes paid to another state. *Any such credit may also be used as a credit against the PTE's tax liability as determined by such individual resident owner's includable income in any PTE tax liability pursuant to Section 7.2.1 to the extent paid on behalf of such owner through nonresident withholding, a composite return, or a similar PTE in such other state.*" (Emphasis added).

Response: The proposed rule has been changed to accept the recommendations in the comment.

Comment 3: The third grouping concerns only section 110-21G-4 (Owner's Reconciliation Tax Credit for Tax Paid at the Entity Level).

This section details an owner's reconciliation credit for taxes paid at the entity level. Currently, Section 4.1.2. states that, "A trust (other than a trust that is disregarded for income tax purposes) that is an owner of an electing Subchapter S corporation may claim the reconciliation tax credit that it receives on its fiduciary income tax return, but it is not permitted to distribute any portion of the reconciliation tax credit to its beneficiaries." We propose that this section should be revised to address specifically qualified Subchapter S trusts ("QSSTs"), electing small business trusts ("ESBTs"), and grantor trusts as owners of Subchapter S corporations. Additionally, the parameters for claiming and distributing the credit should be clarified for each type of trust.

An ESBT does not need to distribute any portion of the reconciliation tax to its beneficiaries since the income does not have to be distributed currently and because the trust is the permitted owner of the Subchapter S corporation shares; however, grantor trusts and QSSTs should have the ability to distribute the reconciliation tax credit to their beneficiaries. With both grantor trusts and QSSTs, the income flows through to the beneficiary of the trust and such beneficiary must pay tax on the entirety of the trust's share of the Subchapter S corporation's income. While the appropriate treatment is likely that the deemed owners of the QSST or grantor trust for federal income tax report the income and reconciliation credit, some trusts do report on a return. Accordingly, we

believe the regulations need to be clear that the deemed owner for federal income tax may avail itself as a direct owner entitled to the reconciliation credit.

Response: The proposed rule has been changed to accept the recommendations in the comment.

Comment 4: Section 4.2. states that, "The reconciliation tax credit for tax paid by the electing PTE may only be claimed in the taxable year *in which* the tax was timely paid by the electing PTE." (Emphasis added). We understand that this language mirrors the advice put forth in IRS Notice 2020-75; however, for state tax purposes we believe the language should be "*for* which the tax was timely paid..." (Emphasis added). Accordingly, the full provision would read as follows: "The reconciliation tax credit for tax paid by the electing PTE may only be claimed in the taxable year *for which* the tax was timely paid by the electing PTE." (Emphasis added).

Response: The proposed rule has been changed.

Comment 5: The fourth grouping concerns section 110-21G-2 (Definitions) and section 110-21G-3 (Introduction).

This section introduces the nonrefundable income tax credit for authorized owners of an electing PTE for income tax paid by the electing PTE. Currently, this section reads that "W. Va. Code §11-21-3a authorizes a *qualifying* pass-through entity to make the annual election." (Emphasis added). We propose that the language is revised to state that "W. Va. Code §11-21-3a authorizes an *electing* pass-through. . . ." (Emphasis added). The Statute does not contemplate any type of "qualified" or "qualifying" pass-through entity and does not define or specify what a "qualifying PTE" may be. In order to remain consistent with the language of the Statute and avoid any confusion, we believe this change is necessary and proper.

To ensure conformity of the definitions section with the change detailed above for Section 3, we propose revisions to the definition of "Reconciliation tax credit" in Section 2.2.6. This definition should specify that, "'Reconciliation tax credit' means a credit that owners of an electing pass-through entity may take against their West Virginia personal income tax liability for income taxes paid by the ~~qualified~~ electing pass-through entity." (Emphasis added).

Response: The proposed rule has been changed to delete the word "qualified" from subdivision 2.2.6 and the word "qualifying" from section 3.

Phillips

Comment 1: 2.2.4 and 2.2.5) Do "partners" include non equity partners who only receive a guaranteed payment from the pass-through entity?

Response: The proposed rule does not distinguish between equity partners and non-equity partners. Unless a “non-equity partner” does not hold an interest directly or indirectly in the PTE, they are included in the definition of “partner.”

Comment 2: 4.2) What is the definition of “timely paid”?

Response: Subsection 4.2 of the current rule states: “4.2. Timing -- The reconciliation tax credit for tax paid by the electing PTE may only be claimed in the taxable year in which the tax was timely paid by the electing PTE. If the reconciliation tax credit exceeds the owner’s tax liability for the taxable year, the excess credit may be carried forward by the owner for not more than five consecutive tax years.” In this context, “timely paid” means the time set by W. Va. Code §11-21-52 for paying the tax due under article 21. Timely payment of estimated tax is addressed in section 10 of the rule.

Comment 3: 5.5) What constitutes “consent”? Must ALL partners agree to the election? Can one partner of a 100 partner entity keep it from being able to make the election?

Response: As noted in section 5.5 of the proposed rule, “[e]ach electing PTE may decide how to obtain consent from its owners.” Essentially, the rules of the entity itself will determine what constitutes “consent.”

Comment 4: 7.2.1) Does “all items of income, gain, loss and deduction” include separately stated deduction items such as pension contribution and health insurance? If these are NOT included then the partner may have too much tax paid in on their behalf with no way of getting the overpayment back. We recommend that these deduction items be included in the net income and tax calculations.

Response: Whether a deduction such as for pension contributions or health insurance is included in “all items of income, gain, loss and deduction” depends on whether the deduction flows through and is included in the income of the resident owner, as stated in the proposed rule.

Comment 5: 9.3) What if an entity pays part of the tax before 3/15 and part after 3/15? Can the credit only be taken on the amount paid by 3/15? We would recommend that the credit be allowed on the total amount of payments and that the entity be penalized for any late payment.

Response: The proposed rule has been changed to eliminate the timely payment requirement from tax credit claims.

Comment 6: 9.4) What circumstances would cause an entities [sic] election to be revoked due to paying less than 100% of liability by 3/15? We would recommend interest and penalties at the entity level and NO revocation.

Response: Revocation of the election is discretionary to the Tax Commissioner. It is an extraordinary action and should not be viewed as the default.

Comment 7: 10.3) Are the estimated tax payment rules mirror to that of individuals in that the annualization method can be used as well as the 100% of prior year liability rule?

Response: Yes.

First Exchange Bank

The comments by First Exchange Bank were self-described as “observations.”

Comment 1: We have several out of state shareholders who may be penalized if they cannot receive a refund of overpaid taxes on their behalf.

Response: The agency takes no action based upon this comment.

Comment 2: I am assuming 7.3.5 of the public comment document would include an ESOP/KSOP plan.

Response: This provision specifically provides for exclusion of those items of gain that would not be a part of federal adjusted gross income and thereby not subject to tax under W. Va. Code §11-21-1 et seq.

Rowland Land

Comment 1: "Section 5.5 Each electing PTE may decide how to obtain consent from its owners. The election is binding on all the owners."

Could we please get clarification of whether all owners must consent to the election? We have over 130 Members, many of whom hold small minority interest, pay little WV income tax, and will not benefit from the legislation since they can no longer claim a refund from WV for the difference between taxes paid on their behalf and actual tax due. As such, it will be impossible to receive consent from all Members. This provision penalizes the Members that pay the significant portion of income taxes to WV. We recommend a Company be able to make the PTE election based on a simple majority vote of outstanding units/shares.

Response: As noted in section 5.5 of the proposed rule, “[e]ach electing PTE may decide how to obtain consent from its owners.” Essentially, the rules of the entity itself will determine what constitutes “consent.”

Comment 2: We request individual Members be allowed to opt out of the PTE election. Our 130+ Members reside in over 20 different states as well as internationally. We are pleased to see that the WV guidance allows WV residents to claim a credit for income taxes paid by an electing PTE to other states (section 4.3); however, not all states permit taking that credit if the tax is paid at the entity level. Therefore, if the Company makes the PTE election and Members are not permitted to opt out, some may actually be double taxed on the income in WV and in their home state. This would significantly penalize residents of those states and may prevent other Members from benefiting from the PTE election, thus again eliminating the individuals the legislation is designed to benefit from participation.

Response: An election at the PTE level necessarily applies to all members of the PTE. There is no option for individual members to choose a treatment different than the PTE election. The Tax Commissioner declines to make the suggested change.

Comment 3: "Section 6.2.1 If an upper tier pass-through entity owns another lower tier pass-through entity, the lower-tier pass-through entity may not make the election to be taxes as an electing PTE under W. Va. Code 11-21-3a."

We request upper-tier pass-through entity Members be excluded from the PTE election via an opt-out or exclusion process. Per this section, if even one Member is also a pass-through entity (upper-tier) the Company (lower-tier) is prevented from making the PTE election, even if the upper-tier entity's ownership is very small. This results in one very minority interest owner unintentionally penalizing the majority for whom the legislation is designed to help. We respectfully request Members be allowed to opt out and upper-tier Members be excluded from participation. In Arizona, for example, an upper-tier entity cannot participate in the PTE election of a lower-tier entity, but it does not exclude the lower-tier entity from making the PTE election. In this case, the upper-tier entity makes its own PTE election as well, which resolves the issue. Alternatively, the regulations could allow a lower-tier entity to make the PTE election so long as any upper-tier entity ownership is immaterial to the total ownership.

Response: The proposed rule has been changed to delete references to tiers.

Comment 4: In the Notice of Public Comment, it was summarized that the economic impact of the rule is expected to be revenue neutral. We agree with that assessment as it relates to shareholders/members/partners who are WV residents. However, we feel the State may in effect receive increased income from non-resident shareholders/members/partners, as is the case with our company where 96% of our members are non-residents. Currently, we prepare and submit Non-resident Withholding at the maximum tax rate for all non-resident Members. Each of them can, and many do, file a WV return in order to claim a refund for the difference between the amount paid on their behalf and their actual tax liability. Considering any PTE tax paid on their behalf would result in a non-refundable credit, WV would receive that difference by default since we are required to pay taxes at the maximum rate while no one owes the maximum due to the tiered tax

rates and other factors. The vast majority of the WV income tax on our \$50 million income in 2022, substantially all from WV sources and taxable in WV, would be retained by the State rather than being refunded to our out-of-state Members.

Response: Pass-through entities are not required to be taxed at the entity level; the statute and rule merely provide for the option to make such an election. Circumstances may exist where a pass-through entity may consider forgoing the election to be the better choice for its members.

Comment 5: We are highly in favor of the PTE tax legislation and hope we are able to participate, but under the currently drafted regulations, we will be unable to participate due to minority owner pass-through entity (tiered) Members and Members in home states where a credit for income taxes paid to WV at the entity level are not permitted. The ability to opt-out and exclude tiered Members will afford us the opportunity to participate in this advantageous legislation. There are other states, such as California and Arizona, that allow individual Members to opt out of a Company's PTE election. We would appreciate your consideration of these points as we feel they will benefit WV resident taxpayers and increase income to the State via the non-refundable nature of the tax credits for non-residents.

Response: The proposed rule accurately reflects the provisions of W. Va. Code §11-21-3a, which does not allow for any member of a pass-through entity to opt out of an election made by the pass-through entity.

Union Bank

Comment 1: Nonrefundable Tax Credit for Owners with 5 yr carryforward limit: This would be punitive for nonresident owners who have no other WV taxable income. They would not ever be able to claim the credit.

Response: The rule accurately reflects the provisions of W. Va. Code §11-21-3a(q).

Comment 2: Trusts (section 4.1.2): This does not specifically address ESOP trusts as owners, which are very unique trusts created for very specific purpose. An ESOP trust does not file a tax return, and does not have tax liability as an entity. Tax liability only arises when the individual participants in the ESOP take taxable withdrawals from the plan upon their retirement, etc.. The proportionate amount of the of the Entity Level tax attributable to the ESOP as an owner, should be paid into the ESOP trust, for the eventual tax liability of its individual participants, as they withdraw funds from the ESOP.

Response: The proposed rule has been changed to clarify this.

Suttle

Comment: Good morning, after reading the Amendment to the existing WV Code 11-21-3a(p), I have one item that seems to be a misinterpretation of the law that was passed by the legislature and it is also not fair to all WV taxpayers.

The issue revolves around Section 110-21G-6.2.1 as it relates to tiered partnerships. It is my understanding that the law was enacted to assist pass-through business owners in West Virginia in skirting the \$10,000 cap on Schedule A deductions for state and local income taxes. However, Section 110-21G-6.2.1 is contrary to the legislature's intent to assist WV taxpayers. Please see an example of my reasoning below:

WV Partnership with the following ownership:

75% owned by an individual that operates the day-to-day business

25% owned by an S-Corporation that participates in management and funding of the partnership

Based on the proposed language in Section 110-21G-6.2.1, this partnership could not elect to pay the pass-through entity tax because of tiered ownership. Thus, the individual 75% owner who gets the majority of the taxable income will NOT get the Federal tax benefit of a state tax deduction at the partnership level.

However, the S-Corporation that owns the other 25% will be allowed to make the election on their tax return and its shareholders WILL get the Federal benefit of a state tax deduction at the S-Corporation level.

Tax Ramifications (assuming both owners are in the 35% Federal bracket): 75% Individual will pay an additional \$17,063 in Federal taxes simply because the other partner is a tiered partner!

This is not the intent of the law and is contrary to a strict reading of SB 151.

As a tax preparer, I ask that you reconsider this portion of the code and allow the passthrough to pay the tax for all individuals or trusts in the pass-through, but exclude the owners that are a tiered owner.

Thus, in my example, the WV Partnership could elect and pay the tax on the individual 75% owner, but not on the 25% S-Corporation owner. However, the 25% S-Corporation owner would still be allowed to elect and pay the tax on its return for qualifying shareholders (individuals and trusts). This would then make the tax deduction available to ALL individual taxpayers, as the legislature intended.

Response: The rule has been changed to allow tiered partnerships to qualify for the election.