

State Tax Observations

New Jersey Pass-Through Business Alternative Income Tax Act

By Steven J. Eller, CPA, JD, Partner

As a way to circumvent the \$10,000 state and local tax deduction cap, New Jersey Governor Phil Murphy signed the Pass-Through Business Alternative Income Tax Act (“Act”) on January 13, 2020. Effective for tax years beginning on or after January 1, 2020, the law provides that pass-through entities (i.e., partnerships, LLCs and S-Corporations) that have at least more than one owner (including single-member LLC’s that check the box and make an S-election) may elect to pay income tax at the entity level rather than at the partner, member, shareholder (“Member”) level.

Election

To have this election apply, all Members have to consent or it can be made by someone such as an officer, manager or member who is authorized under the governing organizational document. The election is annual and must be made on or before the due date of the entity’s return (without extensions) on forms yet to be published. While it cannot be made retroactively, it can be revoked if the revocation is filed before the original due date of the entity’s return.

Tax Rates

The four brackets range from 5.675% on distributive proceeds less than \$250,000 to 10.9% on distributive proceeds exceeding \$5,000,000.

Distributive proceeds are defined as the sum of “net income, interest, dividends, royalties, rents, guaranteed payments and gains of a pass-through entity derived from or connected with sources within the State ...”.

Payments

Payment of the tax is due on or before the 15th day of the third month following the close of the entity’s tax year for federal tax purposes. Estimated tax payments must also be made on or before the 15th day of the fourth month, sixth month and ninth month and the 15th day of the first month succeeding the close of the tax year.

Credits

While deductible for federal tax purposes at the entity level, each Member will then receive a tax credit equal to its proportionate share of the tax. If the credit exceeds the tax, the excess will be considered an overpayment which can be refunded.

For trusts and estates, the credit may be allocated to beneficiaries or be used against its own tax liability. For corporate members, the credit will be allowed against both the corporate business tax and the surtax but cannot reduce the total tax below the statutory minimum. If there is an excess credit, it can be carried over for up to 20 years.

The law also provides New Jersey residents a credit for a pass-through entity tax imposed by another state such as Connecticut.

Combined Reporting

In keeping with the new combined reporting rules, this Act also provides that a pass-through that elects to pay this tax shall be included in a combined group and file a combined return unless:

1. All of the members of the pass-through entity are taxpayers subject to the New Jersey Gross Income Tax and
2. No business entity taxed as a corporation under the Corporation Business Tax Act has a direct, indirect, beneficial or constructive ownership or control of the pass-through entity.

Questions

While this law seems to achieve its purpose, it also leaves several questions unanswered.

First, there is no clarity as to its effect on nonresident owners. For example, under Connecticut's law which was signed in May 2018, nonresident individuals of an entity are generally not required to file a Connecticut personal income tax return for tax years in which the pass-through is their only source of Connecticut income and the pass-through has paid the entity tax, with certain exceptions including when the individual's nonresident tax credit is insufficient to fully satisfy the Connecticut personal income tax liability. Under this law, it appears that the Member is still required to file a tax return.

Another question is how tiered business entities will be treated?

Lastly, and perhaps most importantly, is how will the Internal Revenue Service treat this. For example, will it treat this tax like tax withholding thereby negating its intended purpose?

Contact Us

As noted, there are questions remaining to be resolved with the New Jersey pass-through legislation so it is important you keep up-to-date. In the interim, for more information on any taxing level, please contact your PKF O'Connor Davies tax team or:

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