

COMMITTEE ON LEGISLATIVE RESEARCH
OVERSIGHT DIVISION

FISCAL NOTE

L.R. No.: 5494S.03I
 Bill No.: SB 1154
 Subject: Taxation and Revenue - Income
 Type: Original
 Date: March 23, 2022

Bill Summary: This proposal establishes the SALT Parity Act.

FISCAL SUMMARY

ESTIMATED NET EFFECT ON GENERAL REVENUE FUND			
FUND AFFECTED	FY 2023	FY 2024	FY 2025
General Revenue*	Minimum Unknown to Minimum (Unknown)	Minimum Unknown to Minimum (Unknown)	Minimum Unknown to Minimum (Unknown)
Total Estimated Net Effect on General Revenue	Minimum Unknown to Minimum (Unknown)	Minimum Unknown to Minimum (Unknown)	Minimum Unknown to Minimum (Unknown)

*Oversight notes due to the personal income consideration of each member within the Partnerships, LLC's, or Corp-S companies the overall change in collected tax would not be expected to surpass the \$250,000 threshold.

ESTIMATED NET EFFECT ON OTHER STATE FUNDS			
FUND AFFECTED	FY 2023	FY 2024	FY 2025
Total Estimated Net Effect on <u>Other</u> State Funds	\$0	\$0	\$0

Numbers within parentheses: () indicate costs or losses.

ESTIMATED NET EFFECT ON FEDERAL FUNDS			
FUND AFFECTED	FY 2023	FY 2024	FY 2025
Total Estimated Net Effect on <u>All</u> Federal Funds	\$0	\$0	\$0

ESTIMATED NET EFFECT ON FULL TIME EQUIVALENT (FTE)			
FUND AFFECTED	FY 2023	FY 2024	FY 2025
Total Estimated Net Effect on FTE	0	0	0

- Estimated Net Effect (expenditures or reduced revenues) expected to exceed \$250,000 in any of the three fiscal years after implementation of the act or at full implementation of the act.
- Estimated Net Effect (savings or increased revenues) expected to exceed \$250,000 in any of the three fiscal years after implementation of the act or at full implementation of the act.

ESTIMATED NET EFFECT ON LOCAL FUNDS			
FUND AFFECTED	FY 2023	FY 2024	FY 2025
Local Government	\$0	\$0	\$0

FISCAL ANALYSIS

ASSUMPTION

Officials from the **Department of Revenue (DOR)** assume the Parity Act under the Tax Cut and Jobs Act (2017) the federal government limited the amount of state and local taxes (SALT) an individual could deduct for federal income tax purposes to no more than \$10,000 (\$5,000 for those married filed separately) annually. However, there were no changes to the limitations on the amount of a deduction connected with a business entity directly.

Capping the amount of the SALT deduction at the federal level resulted in fewer taxpayers being able to reduce their federal tax liability.

Under current law a pass-through entity's (S Corporations or Partnership) shareholders pay income tax on the shareholder's pro rata share of the entity's income attributable to Missouri. They file their share on their individual income tax return rather than the business entity filing a corporate income tax return. Therefore, each member reports their proportion of the entity's whole income. Therefore, each of the individual members is subject to the \$10,000 SALT limit on their return.

This proposal creates the SALT Parity Act. The purpose of the act is to help companies increase the amount of itemized deductions they can claim at the federal level by finding a work-around of the \$10,000 SALT deduction. Increasing their itemized amount would result in a savings to taxpayers, as their federal tax liability would decrease.

A business entity is not bound by the \$10,000 limit. So a plan was created in several states and appears to be allowed by the federal government that would allow the business entity to report the group's income and pay the taxes of the group as a whole. The business entity then receives the greater itemized deduction on their federal return and lowers their overall tax liability. This results in a savings to the business entities.

This proposal is setting up this work around at the state level for Missouri businesses. This proposal in Section 143.436.3 & 143.436.4 would allow partnerships and S Corporations to pay as a whole. The partnership or S Corp would report income for the whole business and file a return on behalf of the entire group. For tax years beginning on or after January 1, 2023, this act would allow the pass-through business entity to elect to pay a company tax. The tax is to equal the sum of each member's income and loss items, as described in federal law, reduced by a deduction allowed for qualified business income, as described in federal law, and modified by current provisions of state law relating to the taxation of pass-through entities, with such sum multiplied by the highest rate of tax in effect for the state personal income tax rate.

Per this proposal they would be required to use the highest individual income tax rate for the tax rate. That rate is currently 5.3% for TY 2022. Currently, if members of the business entity pay taxes, the amount paid depends on their income and which tax bracket they are assessed at. Having these business entities pay the state the highest individual income tax rate could potentially result in an increase in revenue to the state as opposed to each member filing separately.

Upon filing the business entity tax return, the business entity notifies the Department of its election to file as a group and provides a report to the Department of the proportional share of income earned and tax paid of each member. The individual members of the business entity are then required to file an individual income tax return. They must report the amount of the pro rata share that was paid by the business entity. They are then allowed a credit against the tax already paid by the business entity.

The credit is equal to 95% of their pro rata share of the tax paid. This proposal states these credits are not refundable but can be carried over until fully taken. The lack of refundability of the credits could result in some members not being able to use their credits. If credits are never redeemed this results in revenue to the state.

This proposal is Section 143.436.11 requires these business entities to annually elect whether or not to participate in this business entity tax program. This program is strictly voluntary. Due to the voluntary nature of this program, the Department is not able to determine how many potential S Corps or partnerships would chose to participate each year.

The Department assumes that business entities would chose to participate based on what is best for the majority of its members. While a business entity may choose what is best for the majority of its members, some members may not see a benefit under this program. Individual income tax returns are specific to each taxpayer's life situation. Two people with the same job and same income may have very different life situations that can impact the amount of tax liability they will have. One may be married with kids while the other may be single with no kids but an illness that requires extensive medical payments. Their final tax liability may be different.

Is it possible that due to an individual's life situation they end up owing less in taxes to the State than they otherwise would have if their business reported under current law? It is possible. It is also possible they could owe more. Depending on which happened, additional or less revenue to the state is possible.

The Department notes it is unable to estimate the actual fiscal impact of this proposal. The Department cannot predict the number of business entities that would chose to participate in this voluntary program. Nor is it able to predict how many of the individual taxpaying business entity members would benefit or be hurt by this proposal. The Department notes that business entity members would benefit from the increased federal deduction and receive a savings on their federal return. However, based on the taxes paid by the business entity as a whole and the

credits provided the members this proposal would not result in more than a minimal impact to the state.

The Department notes this proposal would ease an administrative burden on the Department. Under current law, in order to audit the Department spends a lot of time trying to identify all the members of a business entity to ensure all the tax is paid. With the business entities filing the taxes and reporting the number of partners and pro rata share of the income, this would allow the Department to more easily audit these businesses, saving time and resources. This proposal with the previous partnership audit reporting laws that passed in 2020 will ease some of the time consuming tracking of these business entities. The amount of the impact can't be determined due to the voluntary nature of the program.

The Department notes this will require making changes to existing tax reporting forms and potentially the creation of a new form for identifying the business entity members and their pro rata share. These changes are estimated to cost \$5,000. Additional programming and other website updates would result in \$3,596 in costs.

Officials from the **Office of Administration – Budget & Planning (B&P)** assume this proposal would allow pass-through businesses (LLCs, partnerships, sole proprietorships, and S-corporations) to file their Missouri income tax at the entity level, rather than the individual level starting with tax year 2023. B&P notes that the election to complete an entity level tax return shall be made on a voluntary year-by-year basis.

B&P notes that the purpose of this bill is to allow businesses to fully deduct their state and local taxes (SALT) at the federal level, while minimizing the impact to states that pass this or similar language. Under the Tax Cut and Jobs Act (TCJA, 2017) individuals cannot claim a SALT deduction greater than \$10,000, while businesses can claim their full SALT expenses. This has created a significant federal tax increase for pass-through businesses whose SALT deduction is greater than the \$10,000 cap x the number of pass-through members. For example:

- Business A consists of 4 members and has a total SALT liability of \$20,000
 - Business A would not be impacted by the individual SALT limitation as the combined SALT limit for the 4 members would be \$40,000 (4 members x \$10,000 per member cap).
 - Business A would likely not choose to file taxes at the entity level under this proposal.

- Business B consists of 4 members and has a total SALT liability of \$80,000
 - Business B would be impacted by the individual SALT limitations as the combined SALT limit of \$40,000 (4 members x \$10,000 per member cap) is less than the \$80,000 entity SALT liability.
 - Business B would likely chose to file taxes at the entity level under this proposal.

B&P further notes that as of the creation of this fiscal note, the IRS is allowing this particular SALT cap work around. If the IRS disallows this work around, B&P assumes that entities would no longer choose to file a Missouri return at the entity level.

Currently each member of a pass-through business must file their own Missouri income tax return showing their portion of business income and deductions. The individual is then responsible for their portion of the Missouri income tax. Individuals are also granted a tax credit for taxes paid in other states, for businesses that operate in multiple states.

Under this proposal, the entity itself could elect to file a Missouri income tax return. The business is to include the same income, deductions, and credits granted at the federal level. If the calculations result in a net loss, the loss is not refundable, but the business may carry the loss forward until fully used. B&P notes that individuals are not granted a similar net operating loss credit. Therefore, this provision may have an unknown impact on TSR and GR.

B&P notes that businesses would be required to use the corporate income allocation method, as opposed to the current individual allocation method, when determining the amount of income to allocate to Missouri and other states. Therefore, this provision may have an unknown positive or negative impact to TSR and GR depending on the composition of a business's income.

In exchange for filing at the entity level, the entity must calculate their tax due using the highest individual income tax under Section 143.011 in a given tax year. Currently individuals calculate their tax due using the graduated brackets and rates under Section 143.011. This may have minimal impact to TSR and GR.

This proposal would allow non-Missouri residents, with no other Missouri source income other than the income now reflected at the entity level, to not file a Missouri income tax return.

This proposal would further grant Missouri residents, and non-residents with other Missouri source income, a 95% tax credit for their pro-rata share of the taxes paid to other states at the entity level. This credit would only be granted for the taxes paid at the entity level to other states. This may have an unknown impact to TSR and GR. B&P notes that the impact would depend on the impacts created by changing how business income is allocated between states. The credit is non-refundable, but may be carried forward until fully used.

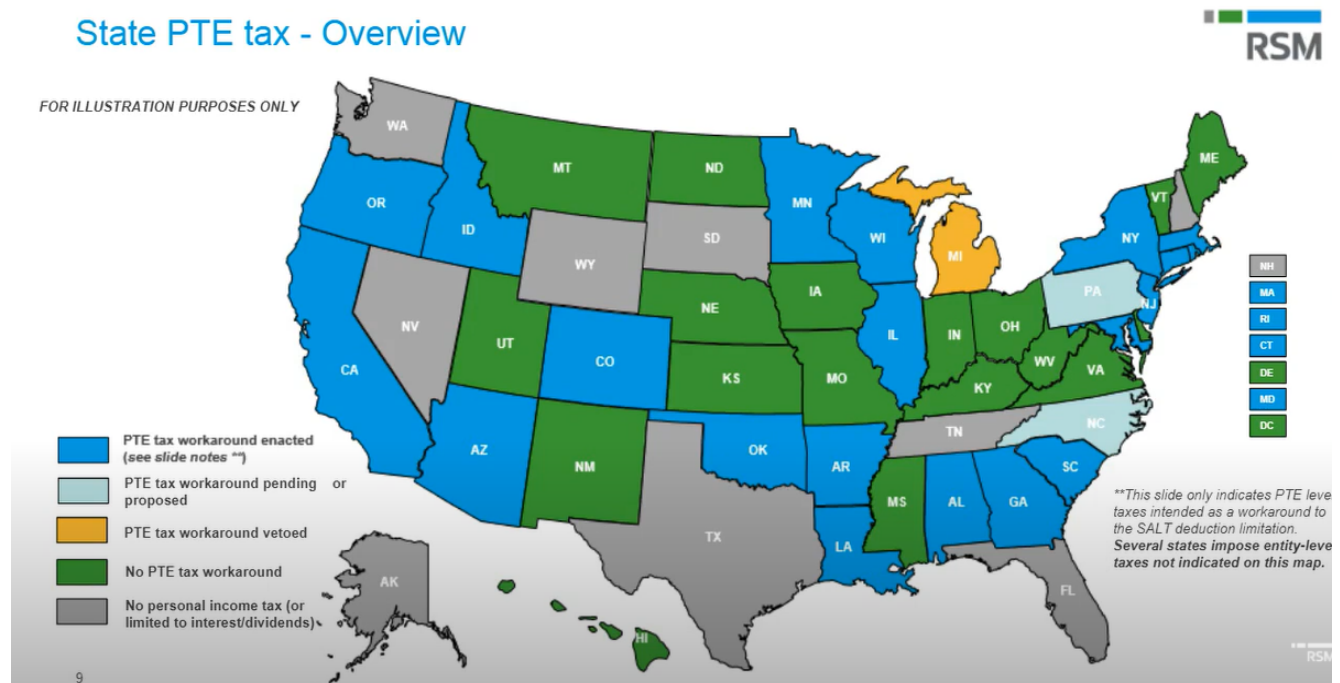
B&P does not know how many businesses would elect to pay Missouri taxes at the entity level. Further, B&P does not know the income composition of such businesses or the current tax liability of members and thus cannot estimate how this proposal may impact their Missouri tax liability. Therefore, B&P estimates that this provision may have an unknown positive or negative impact on TSR and GR beginning with FY24.

Oversight notes that **DOR** and **B&P** both note the deductions for purpose of the state and local taxes (SALT) paid by pass-through business owners are currently capped at \$10,000. Conversely, C corporations are allowed to fully deduct these same expenses. In states that tax

pass-through firms at the owner level, the disparate treatment puts their firms at a significant disadvantage compared to C corporations. As such, restoring the federal SALT deduction in its entirety for pass-through entities has been a key priority for S-CORP and the Main Street Employers coalition ever since the cap was implemented back in 2017.

Oversight notes, that according to the taxpolicycenter.org, a joint project from the Urban Institute and the Brookings Institution, in 2017, 16 percent of tax filers with income between \$20,000 and \$50,000, 76 percent of tax filers with income between \$100,000 and \$200,000, and over 90 percent of tax filers with income above \$200,000 claimed SALT.

Oversight notes since 2018, the Main Street Employers coalition has led advocacy efforts to restore the State and Local Tax (SALT) deduction for pass-through businesses. More than a half dozen states have enacted various version of such a legislation to date and, following the 2020 Treasury Department announcement, IRS Notice 2020-75 (11/2020), validating this legislative approach, SALT Parity measures are being actively considered in more than a dozen states this year.



<https://news.bloombergtax.com/tax-insights-and-commentary/salt-cap-workaround-pass-through-entity-tax-update-part-ii>

Oversight notes that under this proposal, a small business may elect to pay tax at the entity level, and a corresponding credit is allowed at the partner, member, or shareholder level. There are four main categories of businesses, which would qualify for such a deduction as shown below:

a) General Partnerships

- b) Limited Partnerships
- c) Limited Liability Companies
- d) Sub-Chapter S Corporations

Additionally, there are no restrictions as to Multi-tier Partnerships or Trust that are entity partner members.

Oversight notes that officials from the DOR and SOS added, via additional e-mails, that there are currently at least 81,000 S-Corporations in Missouri. Missouri DOR is not able to discern how many partnerships are currently in Missouri. Officials from the SOS note that a partnership can exist and function as a business without any kind of document setting out the rights or responsibilities of the partners. These partnerships function similarly to a sole proprietorship, but have two or more owners (partners). The only partnerships which have to register with the SOS are those which intend to limit the liability of the individual partners or the partner company, and in this regard, function similarly to a corporation. Therefore, DOR or SOS cannot begin to guess or estimate the collective number of partnerships which operate in Missouri at any given time as they're not all required to register.

Oversight notes that by paying tax at the entity level, members of the PTE are deducting expenses and taxes incurred by the trade or business (i.e., an above-the-line deduction) versus a conventional below-the-line deduction at an individual level that would be subject to the SALT limitation of \$10,000. Moreover, according to estimates from the U.S. Congress' Joint Committee on Taxation less than 15% of taxpayers currently qualify to itemize their deductible amounts while filing taxes with average AGI of \$60,981 and an average SALT amount of \$9,958.

As provided in the proposal, companies file their income tax at the individual level while using the 95% credit for filing at the entity level as a deduction. For purpose of this proposal, **Oversight** will assume that the company election process will happen throughout FY 2023 due to the various companies filing tax schedules. (i.e. some filing monthly, quarterly, annually, etc.)

For information purpose, **Oversight** will show the various impact of the proposal below:

Table 1

Proposed - *assuming \$200,000 deductible without SALT cap		
Entity Level	ABC LLP - 2 Members 50/50 Partners	
Net Income	800,000	
Tax liability paid	32,000	
Member level	A - 50%	B-50%
Net Income	\$ 400,000.00	\$ 400,000.00
Tax	\$ 21,200.00	\$ 21,200.00
Tax Credit at 95%	(\$32,000/2)*.95	(\$32,000/2)*.95
Tax credit amount awarded	\$ 15,200.00	\$ 15,200.00
Tax liability amount at members level	\$ 6,000.00	\$ 6,000.00
Total tax paid	\$ 22,000.00	\$ 22,000.00
		\$ 44,000.00

Oversight use the example in the Table 1 to show how the 95% tax credits would work against the personal income taxes at the individual member level from the current law.

Table 2

Current Law		
Entity Level	ABC LLP - 2 Members 50/50 Partners	
Net Income	1,000,000	
Tax liability paid	0	
Member level	A - 50%	B-50%
Net Income (entity + other income)	\$ 600,000.00	\$ 600,000.00
Tax	\$ 31,800.00	\$ 31,800.00
Tax Credit at 95%		
Tax credit amount awarded		
Tax liability amount at members level		
Total tax paid to the State	\$ 31,800.00	\$ 31,800.00
		\$ 63,600.00

Oversight notes in the table 2 example how the current law provides lesser tax deductions beyond SALT allowable deductions. However, Table 3 also shows that due to the personal income consideration of each member within the Partnerships, LLC's, or Corp-S companies the overall change in collected tax would not be expected to surpass the \$250,000 threshold.

Table 3.

Entity Level	ABC LLP - 2 Members 50/50 Partners		
Net Income		800,000	
Tax liability paid		32,000	
Member level		A - 50%	B-50%
Net Income (entity + other income)	\$	600,000.00	\$ 600,000.00
Tax	\$	31,800.00	\$ 31,800.00
Tax Credit at 95%		$(\$32,000/2) \cdot .95$	$(\$32,000/2) \cdot .95$
Tax credit amount awarded	\$	15,200.00	\$ 15,200.00
Tax liability amount at members level	\$	16,600.00	\$ 16,600.00
		$(31,800-15,200)$	
Total tax paid	\$	32,600.00	\$ 32,600.00
		partner 1+ partner 2 tax totals	\$ 65,200.00

Oversight is not able to discern the level of gain or loss to general revenue in any given year because there are no data currently showing the amount of individual income levels or tax rate for each affected company specified within the proposal. (i.e. LLP, LP, S-Corp. etc.)

Oversight note the proposal shall be effective January 1, 2023. The taxpayers will not be filing their 2023 income taxes until January 1, 2024 (FY 2024) Therefore, Oversight will note minimum Unknown positive to Unknown negative impact beginning FY 2024 in the fiscal note.

Oversight notes that while the Tax Cuts and Jobs Act placed a \$10,000 cap on the SALT deduction, it's only temporary. The cap applies to taxable years 2018 through 2025. After tax year 2025, the cap will end, and taxpayers will once again be able to deduct 100 percent of their eligible state and local taxes, unless other tax code changes are passed before then.

Rule Promulgation

Officials from the **Joint Committee on Administrative Rules** assume this proposal is not anticipated to cause a fiscal impact beyond its current appropriation.

Officials from the **Office of the Secretary of State (SOS)** note many bills considered by the General Assembly include provisions allowing or requiring agencies to submit rules and regulations to implement the act. The SOS is provided with core funding to handle a certain amount of normal activity resulting from each year's legislative session. The fiscal impact for this fiscal note to the SOS for Administrative Rules is less than \$5,000. The SOS recognizes that this is a small amount and does not expect that additional funding would be required to meet these costs. However, the SOS also recognizes that many such bills may be passed by the General Assembly in a given year and that collectively the costs may be in excess of what the office can sustain with its core budget. Therefore, the SOS reserves the right to request funding

for the cost of supporting administrative rules requirements should the need arise based on a review of the finally approved bills signed by the governor.

Oversight assumes SOS is provided with core funding to handle a certain amount of activity each year. Oversight assumes SOS could absorb the costs related to this proposal. If multiple bills pass which require additional staffing and duties at substantial costs, SOS could request funding through the appropriation process.

Officials from the **City of O’Fallon** and **City of Springfield** both assume the proposal would not have a direct fiscal impact on their respective organizations. **Oversight** does not have any information to the contrary. Therefore, Oversight will reflect a zero impact in the fiscal note.

<u>FISCAL IMPACT – State Government</u>	FY 2023 (10 Mo.)	FY 2024	FY 2025
GENERAL REVENUE FUND			
<u>Cost or Gain – DOR - Section 143.436 entity and individual tax liability paid</u>	Minimum Unknown to Minimum (Unknown)	Minimum Unknown to Minimum (Unknown)	Minimum Unknown to Minimum (Unknown)
ESTIMATED NET EFFECT ON THE GENERAL REVENUE	<u>Minimum Unknown to Minimum (Unknown)</u>	<u>Minimum Unknown to Minimum (Unknown)</u>	<u>Minimum Unknown to Minimum (Unknown)</u>

<u>FISCAL IMPACT – Local Government</u>	FY 2023 (10 Mo.)	FY 2024	FY 2025
	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>

FISCAL IMPACT – Small Business

Certain small businesses would be able to realize greater deductible amounts for purpose of the taxation thus enjoy expected amount of earnings as a result of this proposal.

FISCAL DESCRIPTION

Current law provides that, in lieu of a corporate income tax on a pass-through entity, shareholders of such pass-through entity shall pay income tax on the shareholder's pro rata share of the entity's income attributable to Missouri. For tax years beginning on or after January 1,

2023, this act allows the pass-through entity to elect to pay the tax, as described in the act. The tax shall be equal to the sum of each member's income and loss items, as described in federal law, reduced by a deduction allowed for qualified business income, as described in federal law, and modified by current provisions of state law relating to the taxation of pass-through entities, with such sum multiplied by the highest rate of tax in effect for the state personal income tax.

A nonresident who is a member, as defined in the act, shall not be required to file a tax return for a tax year if, for such tax year, the only income derived from this state for such member is from one or more affected business entities, as defined in the act, that has elected to pay the tax imposed under this act.

Each partnership and S Corporation shall report to each of its members, for each tax year, the member's pro rata share of the tax imposed by this act.

Each taxpayer, including part-year residents, that is subject to the state personal income tax shall be allowed a tax credit if such taxpayer is a member of an affected business entity that elects to pay the tax imposed by this act. The tax credit shall be equal to 95% of the taxpayer's pro rata share of the tax paid under this act. Such tax credit shall be nonrefundable, but may be carried forward to subsequent tax years, except that a tax credit authorized for taxes paid to other states shall not be carried forward.

Each corporation that is subject to the state corporate income tax shall be allowed a tax credit if such corporation is a member of an affected business entity that elects to pay the tax imposed by this act. The tax credit shall be equal to the corporation's pro rata share of the tax paid under this act. Such tax credit shall be nonrefundable, but may be carried forward to subsequent tax years.

An affected business entity shall designate an affected business entity representative for the tax year to act on behalf of the affected business entity in any action required or permitted to be taken by an affected business entity pursuant to this act, a proceeding to protest taxes, an appeal to the Administrative Hearing Commission, or review by the judiciary with respect to such action, and the affected business entity's members shall be bound by those actions.

This legislation is not federally mandated, would not duplicate any other program and would not require additional capital improvements or rental space.

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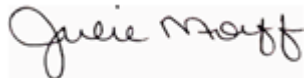
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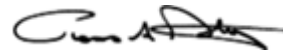
March 23, 2022

SOURCES OF INFORMATION

Department of Revenue
Office of Administration – Budget & Planning
Joint Committee on Administrative Rules
Office of the Secretary of State
City of O’Fallon
City of Springfield



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March 23, 2022



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March 23, 2022