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TAX AND WEALTH ADVISOR ALERT: TIME TO ACT ON ACT 368: WISCONSIN PASS-THROUGH ENTITY-LEVEL TAX ELECTION

In December of 2018, Wisconsin enacted tax legislation—Wisconsin Act 368—that specifically impacted LLCs, S-Corps, and partnerships ("pass-through entities"). The Act allows pass-through entities to make an annual election to be taxed at the entity-level, rather than at the individual level. This election may provide significant tax savings to Wisconsin businesses and their owners, but this election won't work for everyone. While the new Wisconsin law certainly brings some tax saving opportunities, there are election rules and potential issues that Wisconsin owners of pass-through entities must consider before deciding whether to make the election.

BACKGROUND

Historically, individuals were not limited in what they could deduct for state income and property taxes. However, starting in 2018, due to the Tax Cuts and Job Act, the deduction for state income and property taxes is now limited to $10,000. Wisconsin has attempted a creative approach with Act 368 to circumvent this limitation by allowing pass-through entities to be taxed at the entity-level. The idea is that the Tax Cuts and Job Act deduction cap applies to individuals and not businesses, so by allowing the pass-through entity to be taxed at the entity-level, the deduction is shifted from a capped deduction to an uncapped deduction.

TREATMENT

The new provision allows for pass-through entities to elect to be taxed at the entity-level which is a flat rate of 7.9% (the WI corporate income tax rate) rather than passing the income to shareholders to be taxed on their individual return (7.65% for individuals at the highest income tax rates). The entity-level tax would then be deductible by the pass-through on its Federal return resulting in a decrease of Federal income and corresponding Federal tax. Therefore, even though the entity-level rate is higher than the individual rate, this could still result in beneficial tax savings if pass-through owners were previously limited by the cap.

ELECTION

S-Corps can begin making the election beginning with the 2018 tax year, while partnerships and LLCs may make this election starting with the 2019 tax year. For S-corps, persons holding more than 50% of shares on the day of election must consent, while for partnerships, persons holding more than 50% of capital and profits interest on the day of election must consent. The advantageous feature about this election is that it is flexible, in that it can be made on an annual basis. Pass-through entities can opt in or out each year without limitation or penalty. Additionally, the election must be made on or before the due date or extended due date of the WI return.

POTENTIAL ISSUES

While this may sound like a straight forward decision to make the election for a Wisconsin owner of a pass-through entity, there are several potential issues to consider before making the election.

- *Tax Rate*: If taxpayers in pass-through entities are not subject to the top individual income tax rate of 7.65%, it is possible they may not receive enough of a benefit from the entity-level deduction to offset the cost of having to pay tax at a higher 7.9% rate.
- *Credits*: The only credit that pass-through entities may claim against the WI entity-level tax is the credit for income taxes paid to other states. The loss of the ability to claim manufacturing and agricultural credits in addition to research and development credits, for example, may outweigh the benefits of the election.
- *Loss Position:* The election would not be advisable for pass-through entities experiencing losses as there would be no deductible state taxes anyway and such losses would effectively be wasted.
- *Out -of-State Owners*: If the pass-through entities have a substantial number of out-of-state owners they may not benefit from the election if the owners are not allowed a corresponding exclusion or credit for the income tax being paid at entity-level in WI on their individual home state returns.
- *Lack of IRS Support*: There has been no guidance or reaction from the IRS yet, so there is a risk that future Federal laws or regulations could render this WI election ineffective. Other states have attempted workarounds and the IRS has made those ineffective by proposed regulations and notices. Although WI's workaround is a bit different than the state's that have tried, and there is support, there is still risk.
- *Legal Document Compliance*: The election may require amendments to the Wisconsin pass-through entities' operating agreement and formation documents. This should be discussed with legal counsel and the documents should be amended, if necessary, before the election is made.

Ultimately, pass-through entities in an income position that do not have any applicable WI credits or out-of-state owners have the best potential for tax savings. However, because the election does not have to be made until the extended due date, there is a real opportunity for Wisconsin owners of pass-through entities to analyze the above-mentioned issues with both tax advisors and legal counsel to determine whether the election is beneficial and/or worth the extra compliance costs before committing to the election.

If you are interested in learning more about Act 368 and WI's entity-level tax election or need assistance in tax and/or legal planning to take advantage of the election, please contact Attorney Britany E. Morrison at O'Neil Cannon to discuss how we are able to assist you in your needs.