Pass-Through Entity-Level Tax: Frequently Asked Questions

1. **What is the purpose of the Pass-Through Entity Tax?**

   Act 362 of 2021 created a voluntary tax that pass-through entities can pay if owners of more than 50% of the voting rights of a pass-through entity elect to do so. Income of a member that is subject to the pass-through entity tax would be excluded from Arkansas income tax. While this may increase the Arkansas income tax liability of a taxpayer it will also decrease the amount of taxes considered in computing the SALT deduction available for federal income tax purposes and thus reduce the members federal tax liability.

2. **What is an affected business entity?**

   A general partnership, limited partnership, limited liability company with one or more members, or for federal income tax purposes, a Subchapter S corporation in which members that hold more than fifty percent (50%) of the voting rights in the business entity elect on an annual basis before the due date or extended due date of the business entity's income tax return to be taxed under the Elective Pass-Through Entity Act Ark. Code Ann. § 26-65-101 et seq.

3. **How does an affected business entity make the election?**

   The affected business entity will need to complete and file Form AR362 or file a PET tax return on Form AR1100PET before the return due date as extended.

4. **When must the election be made?**

   The election must be made annually on or before the due date or extended due date of the business entity's income tax return to be taxed under 26-65-101 et seq.

5. **How does an affected business entity receive an extension of time for filing form AR1100PET if the affected business entity is not requesting a federal extension?**

   Arkansas allows two different types of extensions: Arkansas-only extensions and federal extensions.

   Arkansas-only extensions

   Arkansas law provides for an extension of up to six months. To claim this extension, file form AR1155-PET

   Federal extensions

   Any extension allowed by the Internal Revenue Service (IRS) automatically extends the Arkansas due date to an additional month beyond the corresponding federal extended due date. To claim a federal extension, check the Extension Filed box on the AR1100PET form.

6. **Can the election be revoked?**

   Yes, the election may be revoked by filing an amended AR362 Form on or before the extended due date. Members who hold an aggregate of more than 50 percent of the voting rights in the business entity must consent to the revocation. If there are credits or estimated payments made prior to revocation, there are options to have those credits/payments refunded or carry-forward to the next tax year; transferred to an income tax composite or pass-through withholding account.

7. **How does the affected business entity notify the members that the election has been made?**

   Once the entity has made the election by filing form AR362, the entity must provide each member with a copy of the election.

8. **How does the affected business entity notify its members their share of income/tax?**

   The pro-rata interest of each member of a pass-through entity shall be reported to each member on forms prescribed and furnished by the DFA. AR1100PET, Page 2, provides a breakdown of each member's share of income. In addition, each member must be provided Schedule ARK-1 that shows their portion of items of income/loss, deduction, credit, etc. to the entity.

9. **When making the election, will there be any signatures required to show consent of the members?**

   Yes, a responsible party is required to sign form AR362 indicating members holding more than fifty percent of the voting rights have given approval.

10. **Can an affected business entity with a short tax year make the election?**

    Yes, an affected business entity may make the election for taxable years beginning on or after January 1, 2022. However, the election must be made before the extended due date of the affected business entity's short period.

11. **What is the entity-level tax rate?**

    The net taxable income of the affected business entity is taxed at the top marginal income-tax rate under § 26-51-201(a)(2). For tax years beginning on or after January 1st, 2023 the top marginal income tax rate is 4.7%.

12. **Are capital gains taxed at a different rate?**

    Yes, the rate of tax on capital gains shall be fifty percent (50%) of the top marginal income-tax rate under § 26-51-201(a)(2). For tax years beginning on or after January 1st, 2023 the capital gains tax rate is 2.35%.

13. **When is the due date for the pass-through entity level tax?**

The pass-through entity tax is due before the 15th day of the fourth month after the end of the taxable year. It must be paid in quarterly installments to avoid underpayment penalties if the pass-through entity tax was elected in the previous year. The pass-through entity tax would be subject to all interest and penalty provisions of the Arkansas Tax Procedure Act (ATPA).

14. **Is an electing partnership required to make quarterly estimated tax payments?**

Yes, estimated payments are required and can be submitted using form AR1100ESPET. An affected business entity that is required to pay tax shall make a required annual payment each taxable year in four (4) estimated installments on the fifteenth day of the:

(A) Fourth month of the taxable year;
(B) Sixth month of the taxable year;
(C) Ninth month of the taxable year; and
(D) First month of the next succeeding taxable year.

15. **Can an affected business entity carry forward net operating losses?**

Yes, the affected business entity may carry forward the net operating loss in the same manner and for the same number of years as provided under § 26- 51-427. Net Operating losses that occur in 2022 and after may be carried forward up to 10 tax years.

16. **Can an affected business entity claim credits to offset taxable income at the entity level?**

Yes, an affected business entity that receives or earns a business incentive tax credit can claim the credit on form AR1100PET.

17. **Does an affected business entity need to report income from another affected business entity in which it is a member?**

No, an affected business entity that is a member of another affected business entity shall subtract its distributive share of the income or add its distributive share of the loss from the other affected business entity to the extent that the income or loss was derived from or connected with sources within Arkansas.

18. **Is a nonresident individual required to file an individual income tax return if they are a member of and affected business entity?**

A nonresident individual who is a member of an affected business entity is not required to file an individual income tax return if, for the taxable year, the only source of income derived from or connected with sources within Arkansas for the member or, if a joint income tax return is filed, the member and his or her spouse is from one or more affected business entities and each affected business entity files and pays the taxes at the entity level. With the exception of guaranteed payments, those must be reported on the individual return.

19. **What is the difference between a composite return and a pass-through entity tax return?**

    A composite return allows pass-through entities to file and pay the individual tax on behalf of nonresident members who elect to be included. If the pass- through entity tax is elected, all Arkansas income of the entity is subject to the PET tax and all owner members must participate.

20. **Can a nonprofit organization elect to file a pass-through entity tax return?**

    No, the affected business entity must be engaged in a business for profit.

21. **What if the affected business entity fails to pay the full amount of tax due?**

    The Department of Finance and Administration may assess the individual members of the affected business entity based on the member's pro rata share of the income as determined by the member's pro rata interest.

22. **Will estimated payments be required for 2023 pass-through entity tax?**

    The PET tax must be paid in quarterly installments if the tax exceeds $1,000 in order to avoid the penalty for underpayment of estimated taxes**. Estimated tax payments were not required in 2022 because the PET tax was a new tax.** Estimated/quarterly payments **will be required for 2023** filing period and forward as required by law.

23. **When must the PET tax be paid to avoid late payment of tax penalties and interest.**

    The PET tax must be paid by April 15, 2024 for calendar year 2023 returns or the 15th day of the fourth month following the end of the tax year for short periods or fiscal year filers. **Act 629 of 2021 states All tax payments are due on the original return due date and interest at 10% per annum and failure to pay penalties at 5% per month will be assessed on all taxes unpaid after the original due date which is April 15 for calendar year filers and the 15th day of the fourth month after the end of a tax year that does not end in December.**

24. **Must Form AR K-1 be completed for members if the PET tax is elected and if so what is to be included or excluded on an Arkansas income tax return?**

    Form AR K-1 must be filed for each owner-member of an entity electing to file a PET tax return on Form AR1100PET. The 2023 Arkansas Form AR K-1 includes a new check-box for Pass-through Entity Tax. If this box is checked and a PET tax return is filed, the Form AR K-1 should be completed just like it would for a partnership or Sub-S corporation. However, the items of income, deductions, etc., that normally would be included on the owner's Arkansas income tax return should be excluded **with the exception of** guaranteed payments to partners which are still taxable. For individuals, the items to be excluded will be shown on form AR-OI and capital gains or losses on Form AR1000D. For more details see the instructions for Forms AR1000F and AR1000NR. Corporations and other business entities will exclude all items of income or deduction from their Arkansas income tax return and multi-state businesses should exclude any items in the apportionment factors that come from an entity subject to the PET tax.

25. **Can a single member LLC make a PET tax election?**

Yes. Act 362 does not place any restrictions on Limited Liability Companies other than they must be a for profit business. **Sole proprietorships will not be allowed to elect the PET** tax as they are not mentioned in Act 362.

26. **Should a business that makes a PET tax election also file an Arkansas Sub-S or partnership return.**

No. If the business elects to file a PET tax return, it should not file an Arkansas Sub-S return or Arkansas partnership return.

27. **Must a taxpayer filing the Arkansas PET tax return include a copy of its federal return?**

Yes. Corporations must include a copy of Form 1120S, Partnerships must include a copy of Form 1065- and Single-member LLC's must include a copy of Form 1040 if owned by an individual and of the appropriate federal income tax return of a business entity that owns a single member LLC electing PET tax.

28. **Are partnerships allowed to deduct retirement plan contributions and self-employment health premiums for partnership members?**

Yes. Retirement plan contributions and self-employment health insurance premiums are deductible on the PET tax return as long as those contributions and premiums are not restricted by Cadillac plan restrictions.

29. **What are the state limitations for charitable contributions for PET tax purposes?**

The term affected business entity does not exist in Internal Revenue Code Section 170. Therefore, charitable contributions may offset up to 100% of taxable income for Arkansas PET tax purposes. Charitable contributions that exceed the taxable income will not be deductible but will be carried forward for up to 5 years to be deducted on future PET tax returns.

30. **How and where are short-term capital gains to be reported on the PET tax return?**

Act 362 does not specify how PET tax income and capital gains are to be calculated, but it does state that the Arkansas Income Tax Act is to be followed. A discussion of particular types of capital gains and losses are discussed in the next few questions.

31. **How is recapture of Section 179 depreciation reported for PET tax purposes?**

    Section 179 depreciation recapture is treated as ordinary income for all Arkansas income purposes.

32. **How are Section 1245 and Section 1250 gains and losses reported for PET tax purposes?**

    Arkansas has adopted IRC Section 1245 and 1250 for income tax purposes except for C corporations. Therefore, short-term capital gains and losses are treated as ordinary income subject to the 4.7% tax rate and long- term capital gains and losses are treated as capital gains or losses subject to the 2.35% tax rate. Section 1245 and 1250 depreciation recapture is treated as ordinary income.

33. **How are Section 1231 capital gains and losses treated for PET tax purposes?**

    Arkansas has adopted IRC Section 1231 for income tax purposes except for C corporations. Therefore, gains are treated as capital gains, but losses are treated as ordinary losses. There is no limit on Section 1231 losses and any excess may be carried forward as net operating loss to be used in future years.

34. **Why can't I make a payment for PET tax on ATAP?**

    Before payments for PET tax can be made through ATAP, a PET tax election must be filed.

35. **Can I file a PET tax return through ATAP?**
    Yes. That feature should be available now. Returns can also be filed by modernized efile or by paper returns.

36. **Can capital loss and net operating loss carryforwards be transferred to members during years when the PET tax election is not made or when the business permanently revokes it's PET tax election?**

    There is no provision in Act 362 that would allow tax attributes to carry forward to any other taxpayer. Therefore, capital loss and net operating loss carryforwards may only be carried forward to the PET tax entity that creates them. If the PET tax election is revoked, those attributes will be available if the entity elects PET tax in a future period as long as the carryforward period has not expired. Net operating losses created in 2021 or later carry forward for 10 years for Arkansas purposes.