PTET in Private Equity Accounting Deals in 2025 and Beyond?

Accounting firm deals often involve complex tax issues, and it is important to understand their implications. If you have any questions on this article, please do not hesitate to reach out to Matthew Hinderman or Russell Shapiro, who leads LP's Accounting Firm Practice. As part of our ongoing series on tax issues for accounting firm transactions, this article discusses the tax complications of PTET in accounting deals.

What is PTET?

In connection with the first Trump administration's tax bill known as the Tax Cuts and Jobs Act ("Jobs Act"), a cap on state and local tax deductions was instituted at $10,000 ("SALT Cap") for tax years 2018 through 2025. The SALT Cap was applicable at the individual level and was not applicable to entities.

As a workaround for the SALT Cap, most states (and one locality) that have state or local income taxes enacted so-called passthrough entity taxes ("PTET"). A PTET is a state or locality's elective entity-level income tax on partnerships or S corporations ("Passthrough Entity"). The Passthrough Entity pays the income tax at the Passthrough Entity level and the individual owner of the Passthrough Entity is given a credit for this tax on their individual state tax return.

In Notice 2020-75, issued shortly after the 2020 election, the IRS concluded that PTET payments to a state or local jurisdiction were deductible when computing the Passthrough Entity's non-seperately-stated income or loss. The effect of this was to allow unlimited state and local deductions at the Passthrough Entity level, thereby reducing the amount of income that the individual owner of the Passthrough Entity was required to pick up on their K-1 and effectively giving the owner an unlimited deduction for state and local income taxes for income from the Passthrough Entity without being subject to the SALT Cap.

Notably, this workaround is generally only applicable to state and local income taxes and does not provide relief for other state and local taxes and does not provide relief for state and local income taxes with respect to income that is not earned through a Passthrough Entity. Therefore, even if an owner of a Passthrough Entity receives relief from the SALT Cap for the PTET amount paid, the owner would still be subject to a $10,000 SALT Cap on their other taxes, like property taxes or income taxes from sales of individuals stock, etc.

The Uncertain Future of the SALT Cap

The SALT Cap is currently set to expire at the end of 2025. Many of the various state PTET laws will either expire at the end of 2025 or expire when the SALT Cap has expired. Certain states' PTET will continue, and determinations would need to be made at such time if subject to tax in those states whether it would still be advantageous to use the PTET depending on any other limitations applied on itemized deductions.

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In the current Trump administration, many expect legislators to propose a tax bill in 2025 before the expiration of the SALT Cap. It is unknown at this time whether the SALT Cap would be allowed to lapse, whether it would be removed or altered, or whether any contrary guidance to Notice 2020-75 could be issued. Based on published reports, President Trump is apparently in favor of eliminating the SALT Cap, but given that the budget reconciliation process will likely be needed to pass a tax bill, the SALT Cap might be needed to produce tax increases to offset other tax decreases.

Therefore, at this time, the SALT Cap and PTET is in flux, as the SALT Cap could be extended as part of a tax package, left to expire, or perhaps modified in some way. Potential modifications could be increasing the amount of the SALT Cap deduction from $10,000 to a higher amount to account for inflation since it was instituted or allowing more deductions for individuals that are not able to avail themselves of the PTET benefits because they are not business owners of Passthrough Entities.

PTET in Private Equity Accounting Deals

Though it is possible that the PTET may only be around for 2025, it could be relevant for years to come and needs to be contemplated as part of any accounting deal that occurs while it is still relevant.

From a big picture standpoint, there are two types of accounting deals involving private equity: (i) a new platform deal where a private equity buyer ("PE Buyer") buys part of an initial accounting firm to be used for future add-on acquisitions and (ii) an add-on to an existing platform. PTET is relevant and needs to be considered in both types of deals and can arise in different ways in each type of deal when the accounting firm target ("Target") being acquired is a Passthrough Entity.[1]

Platform Deals.

In a platform deal, generally a PE Buyer is investing in or buying an existing Target. There are many structures that a PE Buyer might use depending on their structure and preferences. Assuming that the Target has both an attest and non-attest business, any structure requires creating an alternative practice structure ("APS") to separate the attest business which generally can't be owned by non-CPAs (i.e., can't be owned by the PE Buyer directly) and the non-attest business which can be owned directly by the PE Buyer.

The formation of the APS in a platform accounting deal is generally accomplished by the current accounting firm forming a new limited liability company subsidiary ("Non-Attest

[1] Although the PTET applies to both tax partnerships and S corporations, this article will focus on Targets that are tax partnerships. Many of the same issues discussed in this article can apply to a Target that is an S corporation, but given that an S corporation can complicate the rollover in a transaction and potentially require the use of personal goodwill, which is beyond the scope of this article, we will focus on Targets that are tax partnerships. If you have an S corporation, PTET should also be analyzed as there are solutions to ensure that PTET applies in S corporations while solving for rollover issues, such as personal goodwill or owning the rollover equity through the S corporation.

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Sub") and contributing all non-attest assets to the Non-Attest Sub. The Non-Attest Sub will generally be treated as a disregarded entity at this time, unless there is a need for the Non-Attest Sub to be a tax partnership for anti-churning[2] purposes under Section 197(f) of the Internal Revenue Code of 1986, as amended (the "Code").

In a common structure, the PE Buyer will then buy a portion of the Non-Attest Sub with the Target retaining the remaining interests in the Non-Attest Sub for the rollover component of the consideration, with the Non-Attest Sub becoming a tax partnership.[3] The Target in this structure would be selling the interests of the Non-Attest Sub, and assuming that the accounting firm is a Passthrough Entity that qualifies for PTET, should be able to qualify for the benefits of PTET. The Target would then distribute out the remaining membership interests in Non-Attest Sub to its owners.

Under the APS, the attest business must remain owned by CPAs.[4] Therefore, under this structure for a new platform, the Target would generally stay around as the attest business going forward. This is helpful for the application of the PTET to these types of transactions, as generally the Target has already filed the applicable PTET elections required during the year so that the gain from the sale of the Non-Attest Sub can qualify for PTET.[5]

However, difficulties can arise in a new platform deal if the current Target has already structured itself as an APS or the Target does not have an attest business that will continue to be operated under the old Target.

Challenges can arise from another change in the Jobs Act that eliminated the technical termination rules under Code Section 708(b)(1)(B). Previously when a transfer of more than 50% of a tax partnership occurred within a 12-month period, the tax partnership

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[2] The anti-churning aspects of these types of transactions are beyond the scope of this article, but will be discussed in a future article, along with potential tax benefits associated with debt distributions in the formation of a new accounting platform. For purposes of this article, we will assume that Non-Attest Sub will be a disregarded entity and there are no anti-churning issues that would require it to be a tax partnership prior to the purchase by the PE Buyer.

[3] Alternatively, the PE Buyer could form a new buying tax partnership that operates as the holding company for the structure going forward, which would buy the interests in Non-Attest Sub and the Target would contribute the remaining interests in the Non-Attest Sub, creating a tax partnership and tax-deferred rollover under Code Section 721 for the rollover component of the transaction. This structure would also result in the Target selling interests and being eligible in the same manner as the main structure discussed in the article. For purposes of simplicity, the article will focus on the structure where the PE Buyer buys directly interests in the Non-Attest Sub. However, the application of the rules discussed herein, should equally apply to the alternate where PE Buyer forms a new holding tax partnership.

[4] Although beyond the scope of this article, generally the Non-Attest Sub would enter into a management services agreement with the remaining attest entity pursuant to which much of the value would be allocated to the Non-Attest Sub and away from the attest entity.

[5] For certain states, such as New York, the election must be filed by March 15 of the year in which the sale occurs in order to apply for PTET for the year. If a new tax partnership were required to be formed due to a different structure being utilized, and such tax partnership was formed after such election period has lapsed, it could be more difficult to qualify for PTET on the sale.

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would be treated as terminated and a new tax partnership would arise. Now, without this technical termination rule, tax practitioners have expressed concerns regarding tax partnership continuations.

One potential area gray area regarding tax partnership continuation can arise in a scenario where the APS has been set up before the PE Buyer's acquisition or when there is no attest business to remain in the Target post-closing. Going back to our platform structure discussed above, this would result in the Target forming and selling part of the Non-Attest Sub to the PE Buyer and retaining the interests in Non-Attest Sub and distributing those interests to the Target's owners and the Target deemed to have liquidated for tax purposes as it no longer contained any assets. In this instance, practitioners could be concerned that the Internal Revenue Service ("IRS") could apply continuation rules to say that the Non-Attest Sub is a continuation of the Target and that essentially the Target's owners of sold some of their interests in the Target directly to the PE Buyer.

The IRS could potentially make this argument because before the transaction there was one tax partnership owned by the owners and after the transaction there was one tax partnership owned by the initial owners and the PE Buyer so that it should be viewed as a continuation of the initial tax partnership and a sale of partnership interests by the initial owners. What is also important in the IRS's argument is that the new tax partnership is not an existing entity and does not have any other assets other than what was under the Target. Under this recast, since the initial owners would be treated as their selling partnership interests directly, there would be no Passthrough Entity that could be viewed as selling the interests and allowing the PTET to apply to such sale.

In this structure, one potential solution to minimize the possibility of a recast as a continuation of the tax partnership would be for the initial owners to hold their interests in the Non-Attest Sub indirectly through the Target as opposed to distributing them from the Target to the individual owners. Although this can create potential complications with maintaining a holding entity structure for the initial owners to hold their rollover interests, it would provide a solid argument that the continuation rules do not apply because the Target isn't treated as dissolved for tax purposes when the Non-Attest Sub interests were distributed out but instead remains and is still a tax partnership. Accordingly, there would be two tax partnerships in the structure – the initial accounting firm and the new Non-Attest Sub. This should provide a stronger argument that the sale of the Non-Attest Sub interests was in fact sold by a Passthrough Entity – the Target – as it continues to be a tax partnership after the transaction.

If the PTET is still applicable, and this situation arises in a state that has significant state income taxes, the benefit of PTET would likely far outweigh the potential complications going forward of the initial owners holding their rollover interests through the Target, a holding entity.

<u>Add-On Transactions</u>

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Although there are many new accounting platforms formed, acquisitions by an existing accounting platform are far more common. Under these transactions, PTET is also very important and generally should be able to be structured for even in instances where the Target has already set up an APS structure or does not have an attest business.

The more common situation will be when the Target has both an attest and non-attest business and has not set up the APS structure. In this scenario, as with platform deals, the Target will generally form a Non-Attest Sub and transfer the non-attest assets to that entity. The buying accounting firm ("Buyer") will generally buy a portion of the Non-Attest Sub from the Target and have the Target contribute the remainder of the Non-Attest Sub to the parent ("Parent") in the Buyer structure in what is generally intended to be a tax deferred transaction under Code Section 721. The Buyer will generally create a separate entity to purchase the attest business from the Target. The Target[6] will then distribute the interests in the Parent to the individual owners of the Target.

If the Target has already set up an APS or does not have an attest business, the transaction's structure would be very similar to the above transaction. If an APS structure was already set up in the Target, then the Buyer's attest business would buy the attest business from the Target's separate APS entity. If the Target does not have an attest business, there would be no final step regarding the attest business. In both scenarios, the Target would distribute the Parent interests to its owners.

Therefore, in each of the above scenarios, the final aspect of the transaction would result in the Target distributing out the Parent interests to the individual owners. If there are no other assets in the Target, it is possible the IRS could treat the Target as liquidated for tax purposes, like in the platform discussion above.

However, in the add-on acquisition, the Parent and Buyer are existing entities that have other assets in them and are not just owning the assets of the Target. Therefore, the Parent and/or Buyer should not be viewed by the IRS as a continuation of the Target; it should be treated as selling the interests of Non-Attest Sub and eligible for PTET.

In conclusion, for private equity-based accounting deals in 2025, PTET needs to be carefully considered and planned for as it can provide a very beneficial tax benefit to the individual owners of Target.

The corporate and tax attorneys at Levenfeld Pearlstein have vast experience advising professional service firms on exit strategies, including transactions that involve PTET. For more information, please contact Matthew Hinderman at mhinderman@lplegal.com or Russell Shapiro at rshapiro@lplegal.com.

[6] As discussed above, this article is focusing on Targets that are taxed as tax partnerships, and the discussion on Add-On Transactions also will just be discussing Targets that are taxed as tax partnerships.

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