

INFORMATIONAL NOTICE MISCELLANEOUS TAX 2015-01

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EDUCATION TAX CREDITS

Act 194 of 2014, effective October 31, 2014, amended Article XVII-F of the Tax Reform Code (Educational Improvement Tax Credit now called "Education Tax Credits") to expand the definitions of "business firm" and "pass-through entity," include malt beverage tax as an applicable tax and allow for use of the credits on joint personal income tax returns.

Section I. How was the definition of "business firm" expanded?

"Business firm" was expanded to include an entity subject to malt beverage tax and a special purpose pass-through entity ("Special Purpose Entity"). A Special Purpose Entity is a pass-through entity, the purpose of which is the making of contributions and whose shareholders, partners or members are composed of owners or employees of other business firms.

Section II. How is a Special Purpose Entity formed?

A Special Purpose Entity may be composed of shareholders, partners or members, or employees, of one or more other business firms.

Only individuals who are shareholders, partners or members, or employees of other business firms may be shareholders, partners or members of a Special Purpose Entity.

Shareholders or partners or members of a business firm can form several different Special Purpose Entities with different ownership percentages.

The definition of business firm does not include sole proprietorships or entities not subject to tax. As such, the owners or employees of sole proprietorships or entities not subject to tax cannot form a Special Purpose Entity.

A Special Purpose Entity can have employees and engage independent contractors.

A Special Purpose Entity must provide evidence of its formation in the same detail as any other business firm, such as the name of the entity, whether formed or authorized to do business in Pennsylvania, and the type of business. For a Special Purpose Entity, the type of business is a "special purpose entity."

Section III. How was the definition of a "pass-through entity" expanded?

A pass-through entity now includes a pass-through entity that owns an interest in another pass-through entity.

Prior to Act 194 of 2014, a pass-through entity could distribute tax credits to its shareholders, partners or members. Now Educational Improvement Tax Credits and Opportunity Scholarship Tax Credits ("Education Tax Credits") can be distributed through multiple tiers of pass-through entities.

However, the credits cannot be passed-through once they are passed to an entity that is not a pass-through entity, or to an individual.

How and when an election to pass-through a credit is made was not expanded. To make an irrevocable election to pass-through credits to partners, members or shareholders, a business should complete form REV-1123 CT, available at www.revenue.pa.gov. A separate election must be completed for each year the credit is awarded and not used in whole or in part.

Section IV. Does the expanded definition of a "pass-through entity" include a trust?

For Education Tax Credits a "pass-through entity" is defined as a partnership as defined in section 301(n.0), a single-member limited liability company treated as a disregarded entity for federal income tax purposes, or a Pennsylvania S corporation as defined in section 301(n.1). The term now also includes a pass-through entity that owns an interest in a pass-through entity.

Under Section 301(n.0) of the Tax Reform Code, the term "partnership" means a domestic or foreign general partnership, joint venture, limited partnership, limited liability company, business trust or other unincorporated entity that for Federal income tax purposes is classified as a partnership.

Therefore, a business trust can be a pass-through entity.

However, a personal or family trust is distinct from a business trust in that it is not a flow-through entity. Moreover, a personal or family trust is not an "other incorporated entity that for Federal income tax purposes is classified as a partnership." Accordingly, a personal or family trust cannot be considered a "pass-through entity that owns an interest in a pass-through entity."

Section V. Can the Educational Improvement or Opportunity Scholarship Tax Credits be used as estimated payments for personal income tax purposes?

No. Although the credits cannot be used as, or in place of, estimated tax payments, the projected amount of credit should be used to determine the total amount or adjusted total amount of estimated tax payments required to be made for a taxpayer.

Ordinarily, the estimated tax payment calculation for a tax year involves the approximation of the income and total tax liability for a tax year. The calculation then applies a projection of the withholding and all tax credits, including the Education Tax Credits to the tax liability.

If the total tax liability less withholding and credits results in an amount that is greater than \$246, estimated tax payments are due. Typically four equal installment payments are made.

The award of an Education Tax Credit may prompt the adjustment of total amount of estimated tax payments required. The total amount of estimated payments less the installment payments made during the tax year prior to the award of the tax credit equals the amount of the remaining estimated tax payments required to be made. This amount should then be divided by the number of remaining installment periods for the tax year.

EXAMPLE: Joe Taxpayer estimates his total income for the next tax year to be \$500,000.00 and his tax liability using a tax rate of 3.07% to be \$15,350.00. Joe Taxpayer expects his withholding for the next tax year to be \$10,000.00 and he does not expect to have any type of tax credit to be awarded for the next tax year. Therefore, Joe Taxpayer projects that he will need to make estimated payments totaling \$5,350.00 or \$1,337.50 for each installment period.

During the tax year, Joe Taxpayer applies for and receives an Education Tax Credit in the amount of \$1,500.00. He receives this credit after making two estimated payments. Joe Taxpayer's adjusted amount of total estimated tax payments for the tax year (assuming no changes to the total income and tax rate) is \$3,850.00 (15,350.00-10,000.00-1,500.00) and the remaining total estimated tax payment that need to be made equals \$1,175 (3,850.00-2,675.00). Joe Taxpayer's remaining installment payments can be reduced to \$587.50 each (1,175.00÷2).

If Joe Taxpayer had made three estimated payments when he was notified of the Education Tax Credit award, no additional estimated tax payments would be required. If notice of the award was prior to the second estimated payment, the three remaining estimated payments would need to be \$837.50.

Section VI. Can the Educational Improvement or Opportunity Scholarship Tax Credits be used as estimated payments for corporate tax purposes?

Yes. For taxpayers who are required to make quarterly estimated payments, the credits may be used to satisfy a quarterly liability. The approval date of the credit is preserved on the taxpayer's account and if the credit is sold, the original approval date is preserved on the taxpayer's account as well.

For more information and to apply for an Educational Improvement Tax Credit, visit the Department of Community and Economic Development's website at <u>www.newpa.com</u>, or call the DCED Customer Service Center at 1-800-379-7448.

Tax questions may be directed to the Department of Revenue at 717-772-3896.