

Reproduced with permission from Tax Management Memorandum, 62 TMM 3, 01/25/2021. Copyright © 2021 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

IRS Approves SALT Cap Workaround: A Helpful Option to Consider

By Philip Hirschfeld*
Cole Schotz PC,
New York, NY

Since adoption of the 2017 Tax Act's (TCJA)¹ \$10,000 limitation on the deductibility of state and local tax (SALT),² several states have been trying to adopt a legislative work-around to indirectly permit the SALT deduction. Early attempts by New York and a handful of states to allow an individual to make a charitable contribution to a state fund and then get a state income tax credit for the contribution was defeated by the IRS adopting regulations, which generally disallow a charitable deduction.³ On November 19, 2020, the IRS approved a more recent approach of several states to allow or require a partnership or S corporation to pay a pass-through entity state income tax, which entity level state tax is permitted as a deduction in computing the entity's taxable income that is allocated to its partners or S corporation shareholders without any limitation.⁴

The IRS's action offers a planning opportunity for pass-through entities in states adopting a pass-through

entity tax and a blueprint for other states to adopt similar legislation.⁵ Since this new state tax may result in possibly higher state taxes on out of state partners and shareholders who have to grapple with tax imposed by more than one state, a pass-through entity that has the choice to elect to pay this new tax should model its impact on the entity and *all* its owners before deciding to elect to pay it. This new pass-through entity tax, however, offers no assistance to wage earners, self-employed individuals, sole proprietorships, and businesses being conducted by a single member LLC that is treated as a disregarded entity. As a result, a legislative fix to eliminate the TCJA limitation on the SALT deduction may offer the best solution for all affected taxpayers. Governor Cuomo of New York recently introduced budget includes a proposal to adopt an optional New York pass through entity tax.⁶

IRS ANNOUNCEMENT

In Notice 2020-75, the Treasury and the IRS stated they plan to release proposed regulations that will allow a partnership or S corporation's "Specified Income Tax Payment" to be deductible as an ordinary and necessary business expense in determining the entity's non-separately stated taxable income or loss for the taxable year paid or accrued. A "Specified Income Tax Payment" under Notice 2020-75 is defined as "any amount paid by a partnership or an S corporation to a State, a political subdivision of a State, or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or the S corpo-

tax being imposed by a state adopting a pass-through entity tax (i.e., tax on the pass-through entity and tax on its members who are allocated a share of the entity's income), those states either exempt members of the pass-through entity from state tax imposed on their share of the entity's income *or* give those members a credit against their own state tax liability on such income equal to their share of the pass-through entity tax.

⁵ For example, on December 16, 2020, New York legislation was submitted to impose an unincorporated business tax on partnerships and limited liability companies that are treated as partnerships for federal tax purposes.

⁶ SD Borak, *Cuomo Targets SALT Cap Relief, Vacation Rentals in \$193 Billion Budget*, Daily Tax Rep. (Jan. 20, 2021).

* Philip Hirschfeld is a member of the Bloomberg Industry Group Pass-Through Entities Advisory Board and chair of the Taxation of Real Estate Committee of the ABA Section of Real Property, Trust and Estate Law.

¹ Pub. L. No. 115-97

² §164(b)(6) (\$10,000 limitation on annual deduction for individuals through 2026). All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

³ T.D. 9864, Contributions in Exchange for State or Local Tax Credits, 84 Fed. Reg. 27,513 (June 13, 2019) (adopting Reg. §1.170A-1(h)(3)). The regulation provides a de minimis exception where the SALT credit is less than 15% of the amount donated. In that circumstance, the full charitable donation will be allowed for federal tax purposes.

⁴ Notice 2020-75. To eliminate or minimize potential double

ration.” The deduction will be allowed whether the imposition of the income tax is mandatory or the result of an election by the entity.

Specified Income Tax Payments do not constitute an item of deduction that a partner or S corporation shareholder considers separately in applying the SALT deduction limitation as an individual. Thus, it cannot exist as a stand-alone item on the K-1 delivered to the partner. Instead, the partnership would include the deduction for a Specified Income Tax Payment in its computation of ordinary business income, net rental real estate income, or any other item of income specified on the K-1 to which the tax relates. Where the partnership lists more than one type of income on the K-1, the partnership will first need to allocate the Specified Income Tax Payment among all the reported classes of income shown on the K-1 and then, deduct the allocable portion to each appropriate income category.

The proposed regulations will apply to any Specified Income Tax Payments made on or after November 9, 2020, and taxpayers will also be allowed to apply the rules to such payments made in a tax year ending after December 31, 2017, and made before November 9, 2020.

STATES WHO HAVE ADOPTED A PASS-THROUGH ENTITY TAX

So far, seven states have adopted a pass-through entity tax. Connecticut imposed a mandatory income tax on pass-through entities for tax years starting on or after January 1, 2018.⁷ Six other states adopted elective versions of a pass-through entity tax:

1. **Louisiana:** Tax years beginning on or after January 1, 2019;⁸
2. **Maryland:** Effective July 1, 2020, for tax years beginning after December 31, 2019;⁹

⁷ Conn. Gen. Stat. §12-699(c); Connecticut Special Notice SN 2018(4) (June 6, 2018); Connecticut Office of the Commissioner Guidance OCG-7 (Aug. 21, 2018); Connecticut Office of the Commissioner Guidance OCG-6 (June 19, 2018).

⁸ La. Rev. Stat. Ann. §47:287.732.2(A)(1), as added by 2019 La. S.B. 223, effective retroactively for tax years beginning on or after January 1, 2019; Louisiana Revenue Information Bulletin 19-019 (Feb. 2, 2020). Applies to partnerships or S corporations and the partners or shareholders are then exempt from Louisiana tax on their income.

⁹ Md. Code Ann. Tax-Gen. §10-102.1(b)(2)(ii), as amended by 2020 Md. S.B. 523, effective for taxable years beginning after December 31, 2019; MD. Code Ann. Tax-Gen. §10-104(5); Maryland Administrative Release No. 6. Applies to partnerships or S corporations and the partners or shareholders get a credit for their share of the tax against their Maryland tax on the income.

3. **New Jersey:** Tax years beginning on or after January 1, 2020;¹⁰

4. **Oklahoma:** Tax years beginning on or after January 1, 2019;¹¹

5. **Rhode Island:** Tax years beginning on or after January 1, 2019;¹² and

6. **Wisconsin:** Tax years beginning on or after January 1, 2018.¹³

The pass-through entity tax is paid at the entity level on income earned by the pass-through entity. For federal income tax purposes, the pass-through entity then deducts its pass-through entity tax against its income, so the partners or S corporation shareholders only pay federal income tax on a net basis on the income reported to them on their Schedule K-1s.

A partner or S corporation shareholder is usually subject to tax by that same state on its share of the entity's income. As part of this new pass-through entity tax regime, some states allow each partner or S corporation shareholder a credit against its state tax liability for its share of the entity's tax¹⁴ while other states exempt those partners or shareholders from tax on their share of the income.¹⁵ Connecticut takes a hybrid approach. Its resident partners and shareholders get a credit against their state tax for their share of the pass-through tax while its nonresident partners are exempt from state tax on the income allocable to them from the pass-through entity.¹⁶

Elective treatment, as is available except in Connecticut, is beneficial since the pass-through entity tax may not work to the benefit of all partners. Without a pass-through entity tax, depending on income source

¹⁰ N.J. Rev. Stat. §54A:12-3(a), as added by 2018 N.J. S. 3246, effective for taxable years beginning on or after January 1, 2020; New Jersey Notice: Gross Income Tax/Corporation Business Tax Pass-Through Business Alternative Income Tax Act. Applies to partnerships or S corporations and the partners or shareholders get a credit for their share of the tax against their New Jersey tax on the income.

¹¹ Okla. Stat. Ann. tit. 68, §2355.1P-4(A), as added by 2019 Okla. H.B. 2665, effective for tax years beginning on or after January 1, 2019. Applies to partnerships or S corporations and the partners or shareholders are then exempt from Oklahoma tax on their income.

¹² R.I. Gen. Laws §44-11-2.3(b), as added by 2019 R.I. H. 5151 (effective July 1, 2019); Rhode Island Advisory 2019-13 (July 9, 2019). See also Rhode Island Publication 2019-04. Applies to partnerships or S corporations and the partners or shareholders get a credit for their share of the tax against their New Jersey tax on the income.

¹³ Wis. Stat. §71.21(6)(a); Wis. Pub. 102. Applies to partnerships or S corporations and the partners or shareholders are then exempt from Wisconsin tax on their income.

¹⁴ Maryland, New Jersey, and Rhode Island.

¹⁵ Louisiana, Oklahoma, and Wisconsin.

¹⁶ Connecticut Notice 2019(6) (Aug. 16, 2019).

ing and nexus of the entity, non-resident partners may be able to pay less state tax on the flow through income if they live in a low-or no-income tax jurisdiction. On the other hand, with the pass-through entity tax applying, non-resident partners have to grapple with potential double taxation by the state imposing the pass-through entity tax and their home state; as discussed below, the ability to claim a credit for the pass-through entity tax in their home state may not be permitted or is unclear. Those non-resident partners may be unwittingly subsidizing their resident partners personal state income tax. Each entity should model out the impact on all its partners to determine if it should elect to be subject to this new tax.

States adopting this approach may sometimes collect more in aggregate state taxes from the pass-through entity and its partners or shareholders than occurred if this new tax did not apply. For example, in Connecticut, individual and corporate owners of a pass-through entity were originally entitled to a credit against their Connecticut income tax equal to 93.01% of the owner's pro rata share of the entity tax paid by the pass-through entity, which eliminated their Connecticut tax liability. Connecticut then reduced the credit to 87.5% effective for tax years beginning on or after January 1, 2019.¹⁷ This reduction effectively increases the Connecticut income tax on Connecticut source income of the owners of pass-through entities by 0.385%. Any added state tax burden is usually far less than the savings in federal taxes achieved by allowing a full deduction for this new pass-through entity tax.

To illustrate the potential federal tax savings in one of the relevant states, New Jersey's pass-through entity tax, which is called the Business Alternative Income Tax or "BAIT," is imposed at graduated rates that range from 5.675% to 10.9%,¹⁸ which is slightly higher than the maximum individual income tax rate of 10.75%.¹⁹ Single member LLCs and sole proprietorships cannot, however, elect to pay the BAIT. Consider a New Jersey partnership that has five individual partners (each having a 20% interest) and \$5 million of NJ taxable income. Without this pass-through tax, each partner has \$1 million of taxable income and NJ tax paid by the partner is non-deductible due to the SALT limitation.

¹⁷ Conn. Gen. Stat. §12-699(g)(1)(A), §12-699(g)(2); Connecticut Special Notice SN 2019(12) (Mar. 4, 2020); Connecticut Special Notice SN 2019(6) (Aug. 16, 2019); Connecticut Special Notice SN 2019(5) (Aug. 21, 2019); Connecticut Special Notice SN 2018(4) (June 6, 2018).

¹⁸ N.J. Rev. Stat. §54A:12-3(a) (effective for taxable years beginning on or after January 1, 2020); New Jersey Notice: Gross Income Tax/Corporation Business Tax Pass-Through Business Alternative Income Tax Act.

¹⁹ N.J. Rev. Stat. §54A:2-1(a)(7).

If the partnership elects to pay the BAIT, the partnership pays \$427,887.50 of this new tax, which is deductible, so the partnership only reports \$4,572,112.50 of taxable income (\$5 million minus \$427,887.50). Each partner includes 20% of \$4,572,112.50 taxable income on its tax return, which is \$914,422.50, rather than \$1 million. Considering the maximum 37% federal individual tax rate, electing to pay the pass-through entity tax can reduce the individual's federal taxes by \$31,664. While each partner is subject to New Jersey tax on this income, New Jersey gives the partner a tax credit for 20% of the LLC's state tax payment of \$427,887.50 or \$85,577.50, which can eliminate or significantly reduce added New Jersey tax.

CREDIT FOR OUT-OF-STATE PARTNERS

The determination of whether the state of residence of a non-resident partner will allow for a credit against its own tax for that partner's share of the pass-through entity tax is determined by the law of that home state. The guidance in many of these states is limited because the pass-through entity tax program is new, and the IRS only recently issued guidance on its view of the program. Current guidance by the states is not consistent.

Some states allow a credit. California offers a credit known as the "other state tax credit" for net income taxes paid to another state.²⁰ California provides that a "member of a partnership is allowed to treat his, her, or its pro rata share of net income taxes paid to another state by the partnership as if those taxes had been paid directly by the partner."²¹ The Instructions to California Schedule S, which is used to claim the credit, also state a "partner is allowed a credit for the partner's share of net income taxes paid by the partnership to another state."²² As a result, a credit should be allowed by California for a pass-through entity tax.

Other states are receptive to allowing a credit, but further guidance is needed. Connecticut offers a credit for income taxes paid to another state.²³ While no statutory provision addresses the ability to claim a credit for a pass-through entity tax, the Instructions to Form CT-1040 (2019), Schedule 2, Credit for Income Taxes Paid to Qualifying Jurisdictions (p. 29) states that:

Qualifying income tax payments include direct and indirect pro rata share of taxes paid to a qualifying

²⁰ Cal. Rev. & Tax. Code §18001(a). *See also* Cal. Code Regs. tit. 18, §18001-1.

²¹ Cal. Rev. & Tax. Code §18006(a). *See also* Cal. Rev. & Tax. Code §18001(b) (similar rule for S corporation shareholders).

²² Gen. Info., G. Pass-Through Entities.

²³ Conn. Agencies Regs. §12-704(a)-1(a).

jurisdiction by a pass-through entity if such pass-through entity is subject to a pass-through entity tax substantially similar to the PE Tax imposed in Connecticut. DRS will issue guidance if it identifies a qualifying jurisdiction that imposes an entity level tax that is substantially similar to the Connecticut PE Tax.

These instructions are helpful to support claiming a credit for a pass-through entity tax. However, they state the Connecticut DRS is to identify those states that have taxes “substantially similar” to Connecticut’s PE Tax, which are eligible for a credit, and no guidance has yet been issued. One difference between the approach of Connecticut and other states is the Connecticut tax is mandatory whereas the other states pass-through entity tax is elective. As a result, it is not clear whether they are substantially similar. Until Connecticut issues guidance, there is no certainty on this issue.

Some states who have adopted their own pass-through tax have changed their own law to allow their state residents a credit for pass-through entity taxes paid to another state. Maryland allows a credit for “income taxes” paid to another state.²⁴ On May 7, 2020, Maryland adopted its own pass-through entity tax.²⁵ At the same time, Maryland expanded its law to allow residents who are members of any pass-through entity to claim a credit against Maryland tax for taxes paid to other states equal to the member’s pro rata share of the tax paid by the pass-through entity in that other state.²⁶ As a result, a credit for a pass-through entity tax should be allowed in Maryland.

Some states do not allow a credit. New York allows a credit for any “income tax” paid to another state on income that is subject to New York income tax.²⁷ The Instructions to NY Form IT-112-R, which form is used to claim a New York tax credit, were recently updated to provide that:

A shareholder of a subchapter S corporation or a partner in a partnership is not allowed a resident credit for any income tax imposed upon or payable by the S corporation or partnership to another state, local government, or the District of Columbia. However, a shareholder or partner is allowed a resident credit if taxes are calculated on the income of the S corporation or partnership but are imposed upon and payable by the shareholder or partner.

As a result, New York does not currently allow a credit for a pass-through entity tax.²⁸ However, if New York chooses to adopt a pass-through entity tax, which is being considered, then they could also change their view on creditability.²⁹

Some states do not impose a state income tax such as Florida.³⁰ In those states, a credit is not needed, and this is really only a timing issue as any overpayment of state tax by the partner to the state in which the partnership pays a pass-through entity tax will be refunded once a return is filed and credit is claimed for its share of the pass-through entity tax.

PLANNING TIPS

Individuals using single member LLCs to conduct business could admit a second member, which can make the LLC into a tax partnership³¹ that can take advantage of this new tax. The second member can have a small interest in the LLC (one percent) so the individual still retains control and most of the cash flow from the business. Alternatively, the individual can incorporate his or her business³² and then elect to treat it as an S corporation,³³ which may also take advantage of this new tax. However, some states such as California,³⁴ and Texas³⁵ as well as New York City³⁶ do not recognize S corporations, so state or local corporate level will apply in those locations that can reduce or eliminate the benefit of using an S corporation.

CONCLUSION

The good news is there is now an avenue for some taxpayers who are members of pass-through entities

²⁸ In reviewing the statutory support for such position, New York tax law provides that a creditable income tax does not include any income tax imposed on the corporation. NY Tax Law §620(d). There is no similar statutory provision addressing the treatment of tax imposed on a partnership. Despite that fact, the Instructions make clear NY’s view on this issue is not allowing a credit for a pass-through entity tax.

²⁹ See Note 5, above.

³⁰ Alaska, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming have no individual income taxes.

³¹ Rev. Rul. 99-5 (conversion of single member LLC taxed as a disregarded entity into a partnership upon admission of second member).

³² Rather than incorporate the business, a check the box election can be made on IRS Form 8832, *Entity Classification Election*, to treat the entity as a corporation for income tax purposes.

³³ S corporation status can be achieved by timely filing IRS Form 2553, *Election by a Small Business Corporation*. However, a separate state S corporation election may also need to be filed. For example, New Jersey requires filing a Form CBT-2553, *New Jersey S Corporation or New Jersey QSSS Election*.

³⁴ Cal. Rev. & Tax. Code §23802(b).

³⁵ Tex. Tax Code Ann. §171.002.

³⁶ N.Y.C. Admin. Code §11-604(1)(E), §11-602.1.

²⁴ Md. Code Ann., Tax-Gen. §10-703(b).

²⁵ Md. S.B. 523.

²⁶ Md. Code Ann., Tax-Gen. §10-703(d)(2).

²⁷ NY Tax Law §620(a).

to reclaim a SALT deduction through this new pass-through entity level tax. Other states may look to follow the lead of these seven pioneering states and adopt their own pass-through entity tax. Like many other tax changes, its use will not be simple, and it may not work to the benefit of all taxpayers such as nonresident partners or S corporation shareholders. Any entity that has a choice to elect or not elect to pay this new tax needs to “crunch the numbers” to see if the new law makes sense for it and all its owners.

Lastly, President Biden and leaders of the Democratic Party have indicated receptiveness to restoring full deductibility of SALT deductions.³⁷ Even if the

³⁷ Senator Charles Schumer Press Release, *Schumer unveils plan to restore Long Island Homeowners’ Full SALT tax Deduction in Upcoming, ‘COVID-4’ Coronavirus Response Legislation* (July 14, 2020), available at [https://www.schumer.senate.gov/newsroom/press-releases/schumer-unveils-plan-to-restore-long-](https://www.schumer.senate.gov/newsroom/press-releases/schumer-unveils-plan-to-restore-long-island-homeowners-full-salt-tax-deduction-in-upcoming-covid-4-coronavirus-response-legislation-the-harmful-cap-on-the-deduction-is-costing-liers-tens-of-thousands-of-dollars-and-they-need-that-money-now-more-than-ever_)

SALT deduction should be restored by the 117th Congress, the pass-through tax may still be of lasting benefit for partners and S corporation shareholders who have few existing itemized deductions (such as home mortgage interest expense, medical deductions, charitable contributions). Those persons can continue to use the pass-through entity tax as a way to get a SALT deduction without having to itemize deductions and be able to claim the standard deduction³⁸ to obtain further tax benefits. The standard deduction is \$25,100 for married couples filing a 2021 joint return.³⁹

[island-homeowners-full-salt-tax-deduction-in-upcoming-covid-4-coronavirus-response-legislation-the-harmful-cap-on-the-deduction-is-costing-liers-tens-of-thousands-of-dollars-and-they-need-that-money-now-more-than-ever_](https://www.schumer.senate.gov/newsroom/press-releases/schumer-unveils-plan-to-restore-long-island-homeowners-full-salt-tax-deduction-in-upcoming-covid-4-coronavirus-response-legislation-the-harmful-cap-on-the-deduction-is-costing-liers-tens-of-thousands-of-dollars-and-they-need-that-money-now-more-than-ever_).

³⁸ §63(c).

³⁹ Rev. Proc. 2020-45.

Crack the (C)ode

**Research to
software, leave
no Code unturned.**

From our library of Tax Management Portfolios to editors' notes on the complete IRC, we'll help you decipher any section of the code.

Our practical solutions include easy-to-use practice forms, charts, and compliance and planning software along with expertise and guidance that you can employ in the 'real world' of tax and accounting - every day.

Bloomberg Tax & Accounting

pro.bloombergtax.com