

IRS Blesses SALT Cap Workaround: What's Next in 2021?

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Reprinted from *Tax Notes State*, December 21, 2020, p. 1323

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In this installment of Noonan's Notes, the authors review IRS and Treasury guidance on state passthrough entity workarounds to the SALT cap and how the issue may develop in the coming year.

As 2020 (thankfully) comes to a close, state and local tax practitioners can reflect on an unprecedented year. From a practitioner perspective, while there have been many pandemic-related hardships, there have also been interesting SALT developments. But can we not talk about the pandemic for once? One of the more recent changes — unrelated to the pandemic — is the indication of approval by the Internal Revenue Service and U.S. Department of the Treasury for state passthrough entity (PTE) workarounds to the federal state and local tax deduction limitation (the SALT cap).

Background

The Internal Revenue Code generally permits a federal deduction for taxpayers who pay state

and local taxes. Under code section 164(b)(6), which was added under the Tax Cuts and Jobs Act, the federal deduction of specific state and local taxes (including income taxes) is generally limited to \$10,000 per tax year for any tax year beginning after December 31, 2017, and before January 1, 2026. This limitation had a negative effect on many taxpayers who live in high-tax states, especially those with higher incomes.

In response, many states sought creative methods to reduce the SALT cap's impact on their residents and those doing business in their states. Connecticut was the first to enact what would come to be known as a PTE workaround. The principal theory behind these workarounds is that because the SALT cap applies only to individuals, state and local income taxes applied at the entity level should be fully deductible at the federal level without regard to the individual limitation. The concept is simple: The entity pays the tax and takes the deduction, but the law allows the owner a credit for the tax paid at the entity level. So the passthrough owner's federal taxable income goes down, in effect giving him the "deduction." And the owner is OK with this since he is allowed to reduce his state tax bill with the credit.

Other states followed Connecticut's example — Louisiana, Maryland, New Jersey, Oklahoma, Rhode Island, and Wisconsin — although each workaround was unique. For example, in Connecticut, for tax years starting on or after January 1, 2018, partnerships, S corporations, and some limited liability companies are *required* to pay a 6.99 percent entity-level tax. Louisiana, on the other hand, permits S corporations and other entities taxed as partnerships for federal tax purposes to *elect* to be taxed at the entity level. Maryland, New Jersey, Oklahoma, Rhode Island, and Wisconsin all adopted an elective PTE workaround regime similar to that in Louisiana.

Until recently, states with PTE workarounds (both elective and nonelective) had no IRS guidance to determine whether these attempts to circumvent the SALT cap would actually be successful, although many SALT experts had trouble understanding how the IRS might attack PTE workarounds given long-standing regimes — such as the New York City unincorporated business tax — that tax PTEs at the entity level. Still, the IRS's silence on the matter made practitioners uneasy, especially given that the IRS finalized Treasury regulations that effectively put the kibosh on some states' charitable SALT cap workarounds.¹

On November 9 the IRS issued Notice 2020-75, 2020-49 IRB 1 (the Notice). The Notice informed taxpayers that forthcoming proposed regulations would clarify that state and local income taxes imposed on and paid by a partnership or S corporation (a PTE) on its income are allowed as a deduction by the PTE in computing its non-separately stated taxable income or loss for the year of the payment — meaning that those payments are not taken into account in applying the SALT cap to any partner or shareholder in the PTE.² While the Notice is a victory for taxpayers, questions remain as to the implementation and usefulness of its rules.

Purpose of Notice and Forthcoming Proposed Regulations

By acknowledging state PTE workarounds, the Notice seemingly gives them the green light. Specifically, the Notice provides that Treasury and the IRS intend to issue proposed regulations permitting PTEs to deduct “specified income tax payments” when computing their non-separately stated income or loss. The Notice defines specified income tax payments to mean “any amount paid by a [PTE] to a State, a political subdivision of a State, or the District of Columbia [domestic jurisdictions — U.S. territories are not included] to satisfy its liability for income taxes imposed by the Domestic Jurisdiction” on the entity. This is

¹ See Sam McQuillan, “SALT Cap Pass-Through Workaround Holds Up After New IRS Rules,” *Bloomberg Tax*, Aug. 11, 2020. See also Treas. reg. section 1.170A-1(h)(3)(i); T.D. 9864; and 84 Fed. Reg. 27513 (June 13, 2019).

² See IRS Notice 2020-75.

true regardless of whether the imposition of and liability for the tax paid by the PTE is the result of an election by the entity. Similarly, it is immaterial whether the partners or shareholders of the PTE received a partial or full deduction, exclusion, credit, or other tax benefit based on their share of the amount paid by the PTE. When a specified income tax payment is made, the PTE is entitled to a deduction for that payment when computing its taxable income for the year the payment is made.

Finally, and most importantly, the Notice provides that “any Specified Income Tax Payment made by [PTE] is not taken into account in applying the SALT deduction limitation to any individual who is a partner in the partnership or a shareholder of the S corporation.” This effectively blesses PTE workarounds, and provides “certainty to individual owners of PTEs [and their advisers] in calculating their SALT deduction limitations.”

The forthcoming proposed regulations described by the Notice will apply to specified income tax payments made on or after November 9. However, the Notice also indicates that the proposed regulations will permit PTEs to apply these rules to specified income tax payments made in a tax year of a PTE ending after December 31, 2017, and before November 9 (provided that the specified income tax payment is made to satisfy the liability for income tax imposed on the PTE under a law enacted before November 9).

Miscellaneous Issues

While the Notice is clearly a win for states with PTE workarounds and those hoping to avoid the negative impact of the SALT cap, questions remain.

Questions Regarding Credits for Nonresident Partners/Shareholders

One of the most pressing concerns centers on resident tax credits and nonresident partners or shareholders. Specifically, partners or shareholders of PTEs with business operations in multiple states could face real struggles with the treatment of state taxes paid at the entity level. Will all states treat entity-level taxes as creditable for purposes of resident income taxes, or will nonresident partners and shareholders be harmed

by the resident credit rules of non-PTE workarounds states?

For example, assume a partnership (X) does business in Connecticut and pays all state income taxes on behalf of its partners under the state's PTE workaround. Would Partner Y, who lives in New York, be allowed a credit for the Connecticut tax paid by X under the New York resident credit rules? If not, this would defeat the benefit provided to Y by the PTE workaround, and could even result in a worse economic outcome than if X had never paid tax at the entity level. Under our view, there is some authority in New York for allowing a credit in the state, but this issue remains unsettled.³ New York has been largely silent on the issue, but that could be because it did not want to publicly announce that it would treat an entity-level tax like the Connecticut PTE as basically a tax that was borne by the individual for fear of undermining the deductibility argument at the federal level. But with the IRS blessing these PTE taxes, perhaps New York will be more willing to speak its mind on the issue. Whatever the case, this is a real problem that will need to be resolved by states individually for these types of workarounds to have a meaningful impact.

Effect on IRC Section 199A Deduction

In addition to the SALT cap, the TCJA also added code section 199A, which permits a 20 percent passthrough deduction for passthrough business owners and sole proprietors who have qualified business income. Section 199A qualified business income generally means the net amount of qualified items of income, gain, deduction, and loss from any qualified trade or business. As such, the Notice made some practitioners curious about whether payment of taxes under a PTE workaround would reduce qualified business income.

At the American Institute of CPAs' Fall Tax Division meeting on November 12, IRS associate chief counsel representatives indicated that although it was still a question of first impression, the passthrough deduction under code section 199A would be reduced by participation in a PTE

³ See Timothy P. Noonan, "Can a New York Resident Claim a Resident Tax Credit for the Connecticut Pass-through Entity Tax?" Hodgson Russ LLP, Noonan's Notes blog (Sept. 23, 2019).

workaround.⁴ IRS officials noted that practitioners with thoughts on this point should contact the IRS, but this initial IRS reaction is worth noting.

Possible Changes to SALT Deduction Limits

Potential changes to the SALT cap could reduce or eliminate the benefits of the Notice. First, the resolution of state litigation challenging the SALT cap adds uncertainty. For example, oral arguments were heard on December 3 in a case in the Second Circuit (*New York v. Mnuchin*) brought by states challenging the SALT cap as unconstitutional.⁵ In that case, Connecticut, Maryland, New Jersey, and New York argue that the SALT cap violates the federalism principles of the U.S. Constitution. This case was originally dismissed in district court, where it was held that the SALT cap was a legitimate exercise of the federal government's taxing power and did not have an impermissibly coercive effect on states.⁶

Even more uncertainty lies with the fate of the SALT cap itself. President-elect Joe Biden has discussed replacing the \$10,000 SALT cap with a 28 percent limit on all itemized deductions for those earning more than \$400,000. If such a change were to occur, or if the SALT cap were simply repealed, the usefulness of PTE workarounds could be eliminated. With Georgia's pending runoff election, the benefits provided by the Notice and forthcoming proposed regulations could be short-lived, at least compared with the SALT cap's current January 1, 2026 sunset.

Anticipated State Law Changes

Finally, it remains to be seen whether states without PTE workarounds (such as New York) will race to adopt them in light of the Notice. Given that these methods have effectively been blessed by the IRS, it would seem to follow that states will adopt elective PTE workarounds to

⁴ See Eric Yauch, "Passthrough Deduction Reduced by SALT Cap Workaround, IRS Says," *Tax Notes Federal*, Nov. 16, 2020, p. 1144.

⁵ See Second Circuit Argument Calendar for Dec. 3, 2020 (Courtroom 1703); see also Amy Hamilton, "Danger Ahead? IRS Greenlights Passthrough Workaround to SALT Cap," *Tax Notes State*, Nov. 16, 2020, p. 745.

⁶ *New York v. Mnuchin*, 408 F. Supp. 3d 399 (S.D.N.Y. 2019); see also Noonan and Craig Reilly, "Trump Tax Updates, End to SALT Cap Lawsuit," *Law360*, Nov. 7, 2019.

allow taxpayers to avail themselves of the benefits. Without further guidance from states and the IRS, this would only exacerbate the aforementioned uncertainties.

Conclusion

While questions remain, the Notice still represents a huge victory for PTEs in the here and now. While many practitioners and state officials were optimistic about the viability of PTE workarounds, the certainty provided by the Notice is a welcome clarification. Moving forward, taxpayers should assess the potential benefit of amended filings at both the state and federal levels and determine whether retroactive PTE workaround elections might be made. Practitioners should keep their eyes and ears open, as PTE workarounds are likely to see huge developments in the coming year. ■

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