

State Tax Observations

Rhode Island: Combating the Federal Cap on SALT Deductions with a Pass-Through Entity Tax

By Sandy Weinberg, JD, Principal and Brenda Russell, CPA, Manager

Rhode Island has joined the ranks of states responding to the \$10,000 federal limitation on the state and local tax (SALT) deduction that individuals can take on their federal income tax returns.

How? By passing legislation signed into law this month by Governor Gina Raimondo. The new law adds an elective pass-through entity-level tax effective for tax years beginning on or after January 1, 2019. In so doing, Rhode Island joins Connecticut, Louisiana, Oklahoma and Wisconsin which also recently enacted pass-through entity level taxes. Other workarounds attempted have included state charitable deductions and payroll taxes.

Why a new tax to save taxes?

Why would Rhode Island enact a new state tax in order to save individuals federal tax? The answer is that until 2018, individuals itemizing deductions on their federal income tax returns were permitted to deduct the entire amount of SALT paid each year in computing their regular tax liability. (The SALT deduction has historically been an addback for those paying the Alternative Minimum Tax.) The SALT amount includes state, city and local income taxes as well as real estate taxes paid. The 2017 Federal Tax Cuts and Jobs Act (TCJA) capped the annual SALT deduction amount at \$10,000. This part of the TCJA, which also includes provisions that benefit individual taxpayers, is slated to sunset after 2025.

How does the tax work?

The Rhode Island pass-through entities that may choose the voluntary election – made annually – include S corporations, partnerships, limited liability companies, limited liability partnerships, trusts and sole proprietorships. The new tax is imposed at a rate of 5.99% of the pass-through entity's net ordinary income less certain deductions. After making the election, the pass-through entity no longer needs to comply with provisions regarding the state tax withholding of non-resident owners.

If elected by the pass-through entity, the tax is paid to Rhode Island and deducted federally at the entity level. The individual owners, partners or members of the entity would then take a credit against their Rhode Island personal income tax for their pro rata portion of the entity level tax paid. Since entities have no SALT deduction limitation on their income taxes, they take the full SALT deduction instead of the entity's individual owners being limited on their federal personal income tax returns.

Has the IRS reacted?

IRS officials have communicated that they are looking further into prohibiting some of the SALT limitation workarounds that various states have enacted. It is yet to be seen if the pass-through entity tax workarounds will be among those challenged. In September 2018, the IRS clarified that businesses can still

deduct business-related taxes in full as a business expense on their federal tax returns. This may support the viability of Rhode Island's and the other states' entity-level taxes on pass-throughs. But, for certainty, stay tuned.

Contact Us

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