

State Tax Observations

IRS Signals Pass-Through Entity SALT Cap Workarounds Are Allowed

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The pass-through entity tax workarounds, enacted in certain states to combat the federal income tax limitation on the state and local tax (SALT) deduction are allowed, as stated by the Internal Revenue Service (IRS).

The IRS recently released Notice 2020-75 (IRS November Notice) stating that it will issue proposed regulations allowing the deductibility of state and local income taxes paid by pass-through entities.

Partners and S corporation shareholders in states including Connecticut, New Jersey, and Rhode Island, in essence, are allowed the equivalent of a full deduction for state and local income taxes from their taxable income. These owners take a credit at the personal income tax level for their distributive share of taxes paid at the entity level. Not all states have the workaround in place. For example, there is no opportunity yet in New York.

How Did We Get Here?

The 2017 Tax Cuts and Jobs Act limited the SALT deduction at the personal income tax level to \$10,000 (\$5,000 for married individuals filing separately) which severely impacted taxpayers who typically itemize their deductions. In an attempt to eliminate this impact, states including Connecticut, Louisiana, Maryland, New Jersey, Oklahoma, Rhode Island, and Wisconsin enacted laws creating either a mandatory or elective pass-through entity (PTE) tax.

Until the IRS November Notice, uncertainty existed as to whether the IRS would treat PTE taxes as withholding (which would have defeated the PTE tax purpose) or as a deduction. The IRS November Notice answers this question. It states that if a partnership or an S corporation (i.e., a pass-through entity) makes a Specified Income Tax Payment during a tax year, the pass-through entity is allowed a deduction for the Specified Income Tax Payment in computing its taxable income for the year in which the payment is made.

What are Specified Income Tax Payments? They are defined as amounts paid by a pass-through entity on to a State, State subdivision, or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the pass-through entity.

The IRS November Notice provides that the Specified Income Tax Payment is not a separately passed-through item but rather reflected in the partner or shareholder's distributive or pro-rata share of non-separately stated income or loss as reported on Schedule K-1. The Notice adds that these rules apply retroactively to years ending after 2017 and before the official publication of the proposed regulations. The IRS is expected to issue the proposed regulations consistent with these rules.

Which States Have Pass-Through Entity Taxes?

The following states have enacted SALT cap workarounds for pass-through entities, and are impacted by the IRS November Notice:

Connecticut – The PTE is mandatory with a tax rate of 6.99% on the PTE's taxable income or alternative base. The shareholder, partner, or member obtains a refundable credit equal to 87.5% of its proportional share of the tax paid by the PTE. In addition to the PTE tax, the PTE may elect to remit composite income tax on behalf of nonresidents. Nonresidents are not required to file a return if they have no other Connecticut source income other than from electing PTEs.

Louisiana – The PTE is optional and is imposed on a graduated rate ranging from 2% to 6% as it were a federal C corporation. The election is not available if a composite return is filed. Once made, the election is valid for succeeding years unless revoked. If the PTE election is made, the shareholder, partner, or member excludes its share of income from the PTE from its Louisiana taxable income.

Maryland – The PTE is optional with a tax rate of 8.25% on a corporation's share of PTE's taxable income and 8% for all other PTE members. The election doesn't eliminate the filing requirement. The members of the PTE may take a state tax credit on their personal income tax return for their pro-rata portion of the entity level tax paid.

New Jersey – The PTE is optional and is imposed on a graduated rate ranging from 5.675% to 10.9%. The election is made annually. The owners of the PTE receive a credit against their gross income tax equal to the member's tax on the share of distributive proceeds paid by the PTE. Nonresident individuals will still be required to file a tax return if their income exceeds the filing thresholds. In addition to the PTE tax, the PTE may elect to remit composite income tax on behalf of nonresidents.

Oklahoma – The PTE is optional with a tax rate of 6% on a corporation's or other PTE's share of Oklahoma's net income and at the highest marginal rate or individuals, trusts, estates PTE's taxable income. Once made, the election is valid for succeeding years unless revoked. If made, the shareholder, partner, or member excludes its share of income from the PTE from its Oklahoma taxable income.

Rhode Island – The PTE is optional with a tax rate of 5.99% on the PTE's taxable income. The individual owners of the PTE may take a state tax credit on their Rhode Island personal income tax return for their pro-rata portion of the entity level tax paid. An individual owner may also take a credit for similar entity-level taxes imposed and paid to other states.

Wisconsin – The PTE is optional with a tax rate of 7.9% on the PTE's taxable income. The election is annual, and if made, the shareholder, partner, or member excludes its share of income from the PTE from its Wisconsin taxable income.

In addition to the above states, Arkansas and Michigan introduced PTE tax bills in legislation sessions but these have not yet been adopted. Alabama is expected to introduce a bill when its Legislature meets.

Why the Notice is Significant

The SALT \$10,000 cap was a political hot-button issue of the 2017 law. It was opposed by high-tax states. With the IRS November Notice, uncertainty has been removed. It should be anticipated that more states will enact some form of PTE tax.

Until the IRS November Notice, there was concern that the PTE tax workarounds would be short-lived because the IRS could have shut them down. In fact, in 2019, the IRS killed off a different workaround some states tried which would have allowed state tax credits for donations made to charitable funds. It is unclear why it took the IRS three years to push something out.

Contact Us

If you have questions or need assistance regarding the IRS November Notice or its impact in specific states, contact your client partner or the following:

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