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IRS Guidance Sanctions SALT Cap Workarounds Using Entity-Level Taxes on Passthroughs

On November 9, 2020, the IRS issued Notice 2020-75, announcing that Treasury and the IRS plan to issue proposed regulations that clarify that state and local income taxes imposed on and paid by partnerships and S corporations are not subject to the $10,000 SALT cap for their partners or shareholders. The regulation will confirm that the deduction for such income tax payments will be included in the partners' or shareholders' distributive share of non-separately stated income or loss for the tax year. The taxpayer-friendly notice appears to endorse workarounds to the SALT cap that have been adopted by several states. While it is too early to say whether this latest guidance will lead to a rush of additional states imposing entity-level income taxes on passthroughs, owners of partnerships and S corporations are advised to monitor developments in the states in which they conduct business.

The SALT Cap and Workarounds Involving Charitable Contributions

The Tax Cuts and Jobs Act (TCJA), enacted on December 22, 2017, limited an individual's deduction for state and local taxes paid during the calendar year to $10,000 (SALT Cap) for tax years beginning after December 31, 2017 and before January 1, 2026. The TCJA did not limit the SALT deduction for business entities but did put passthrough entities at a disadvantage. State and local income taxes on the income of passthroughs are generally not paid at the entity level, but rather by the individual owner, and are therefore subject to the $10,000 SALT cap. The new SALT cap was one of the more controversial provisions of the TCJA, and taxpayers began looking for ways to avoid the limitation.

Some states attempted to enact workarounds to the federal law by allowing individuals to make contributions to either a state-run fund, or to private charities or private schools, in exchange for a federal deduction and a state tax credit. However, Treasury and the IRS quickly announced their intent to disallow the SALT cap workarounds involving charitable contributions made in exchange for state or local tax credits. The final regulations issued on August 12, 2019 provide that if a taxpayer receives or expects to receive a state or local tax credit in return for a payment to a charitable entity, the tax credit constitutes a return benefit to the taxpayer, or *quid pro quo*, reducing their charitable contribution deduction.

The final regulations do allow for certain payments to charities to be ordinary and necessary business expenses. A payment made to a charitable organization that bears a direct relationship to the taxpayer's trade or business, and is made with a reasonable expectation of financial return commensurate with the amount of the payment, may be deducted as a trade or business expense rather than a charitable contribution. The regulations also include safe harbors that permit C corporations and passthrough entities making payments to charitable entities, in exchange for state tax credits that reduce state or local taxes imposed on the companies, to deduct those payments as ordinary and necessary business expenses.

Workarounds Involving Entity-Level Taxes on Passthroughs

While efforts to circumvent the SALT deduction cap through charitable contribution mechanisms were shut down, several states chose a different route by enacting entity-level taxes on passthrough entities. The intention of this strategy is to shift the tax on the passthrough entity's income from the owner to the entity, thereby allowing the entity to fully deduct its state and local income taxes as business expenses.

Connecticut introduced the workaround less than two months after the TCJA was enacted. Taking advantage of the fact that the $10,000 SALT cap applies only to individuals and not to businesses, their workaround included an entity-level tax on the net income of passthroughs and an offsetting income tax credit for passthrough entities' owners. Practitioners pointed out this workaround, while benefitting resident owners, could work to the disadvantage of nonresident owners. Connecticut's plan included a credit to an individual for taxes paid to another state with a similar tax or regime, but for the strategy to work, every other state would need to go along.

The potential harm to a nonresident owner of a passthrough is illustrated by the following example:

> Assume individual R is a resident of state A who is a partner of partnership P conducting business in state B and each year pays tax of $1,000 to state B on R's distributive share of P's net taxable income. Also assume that R does not receive a federal deduction for the $1,000 payment because R has already exceeded the $10,000 SALT cap, but R does receive a full resident state tax credit of $1,000 for the tax paid to state B. With the workaround, P, rather than R, pays the $1,000. The payment is fully deductible by P, and therefore R receives a federal tax benefit of $370 assuming the highest marginal federal tax rate. R still bears the economic burden of the $1,000 payment. However, because the payment is made by P, R does not pay nonresident tax to state B and therefore may not receive a resident state tax credit of $1,000. With the workaround regime, R is out-of-pocket in the amount of $630 (i.e., $370 federal tax benefit less $1,000 lost resident state tax credit).

To avoid the double counting of income, Georgia law currently allows residents to exclude partnership income that is subject to an entity-level tax in another state. Georgia provides similar relief to S corporation shareholders, but only where another state does not recognize an S corporation, so it is not clear how a Georgia owner of an S corporation will be impacted by this workaround.

While Connecticut was the first state to enact this SALT cap workaround, it was followed by Wisconsin, Louisiana, Oklahoma, Rhode Island, Maryland and New Jersey. The plans adopted by these other states differ from Connecticut's in that the entity-level state tax on passthroughs is optional rather than mandatory. These programs have attracted relatively little participation, except in Connecticut where it is mandatory. Does the lack of enthusiasm suggest that taxpayers are not as concerned about the SALT deduction cap? Or does it reflect the fact that the SALT cap is a temporary policy, scheduled to expire at the end of 2025?

The hesitancy to use these workarounds may have been more attributable to uncertainty as to whether they would be respected. The IRS was aware of this strategy to avoid the SALT cap, but until Notice 2020-75, remained silent regarding whether these workarounds would survive scrutiny. Some practitioners viewed the IRS's silence as a sign of approval, while others wanted more clarity regarding whether the workarounds would be respected by the IRS. Their principal concern was that the IRS might adopt a substance-over-form argument and say that an entity-level tax was merely a payment of the owner's tax liability by the passthrough entity.

Notice 2020-75

Notice 2020-75 does not use the word "workaround" but does reference the government's awareness of the strategies involving elective or mandatory entity-level taxes on passthroughs and a corresponding owner-level benefit, such as a full or partial credit, deduction or exclusion. The notice also acknowledges the uncertainty as to whether the entity-level payments in these strategies must be considered in applying the SALT cap limitation at the owner level. The IRS' answer is "no," as the purpose of the coming proposed regulations will be to provide certainty to owners of passthroughs that direct taxes imposed on and paid by a partnership or S corporation at the entity level are fully deductible in computing the entity's non-separately stated income or loss and therefore will not impact the owner's SALT deduction limitation.

Notice 2020-75 therefore appears to endorse the workarounds involving entity-level state income taxes on passthroughs devised to avoid the $10,000 SALT cap. The proposed rules will apply to payments of entity-level income taxes made on or after November 9, 2020, but taxpayers may elect to apply them to such taxes paid in a passthrough entity's tax years ending after December 31, 2017 and made before November 9, 2020.

The notice's taxpayer-friendly conclusion may come as a surprise - why would Treasury and the IRS sanction a strategy explicitly designed to circumvent the $10,000 SALT cap? They may have decided that no other conclusion was possible given the relevant authorities. The legislative history to the TCJA clearly indicates that the SALT cap does not apply to state and local taxes imposed on passthrough entities. Further, prior IRS rulings had concluded that such taxes are deductible in computing a passthrough's non-separately computed income and are not treated as itemized deductions subject to limitations at the individual level.

Will all states now consider imposing some type of entity-level tax on passthroughs? Thus far, only seven states have enacted a new entity-level income tax in response to the TCJA, and as explained above, the regimes will need to be carefully structured to avoid potentially harming nonresident owners. It is too early to say whether Notice 2020-75 will lead to a further wave of states imposing an entity-level tax on passthrough entities, but we recommend that owners of partnerships and S corporations keep abreast of developments in the states in which they conduct business.

Contact Us

Bennett Thrasher will continue to monitor developments related to Notice 2020-75 and will communicate any significant changes that will impact our clients. For further questions or guidance regarding your State and Local Taxes, please contact your BT advisor by calling 770.396.2200.