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State and Local Tax Deduction – Planning and Possibilities

Over the past several years, the individual income tax deduction for state and local taxes (the "SALT deduction") has been a focus of individuals, particularly those living in states with high income tax rates.

Historically, the SALT deduction under IRC Section 164(a) was generally unlimited and not subject to any dollar limitations.[1] With the enactment of the Tax Cuts and Jobs Act of 2017 (the "TCJA"), came the introduction of IRC Section 164(b)(6), which capped the SALT deduction at $10,000 per year for individuals (including married taxpayers filing joint returns) and non-grantor trusts. Since the passage of the TCJA many states have subsequently strived to implement work arounds to help residents realize federal tax benefits in connection with their state income tax payments.

What follows is a summary of some of those workarounds, a discussion of potential changes in store for the $10,000 SALT deduction cap and a potential planning opportunity for such potential change.

SALT Deduction Limit Workarounds

1. State Charitable Funds

The first workaround attempts came from New York, New Jersey and Connecticut. These states passed legislation that would allow municipalities to create charitable funds to pay for local services and offer property tax credits to incentivize homeowners to give to such charitable funds. In turn, those taxpayers could then deduct the payment as a charitable deduction on their federal income tax return. In effect, it was turning non-deductible SALT deductions (due to the $10,000 cap on the SALT deduction) into potentially deductible charitable contributions (subject to adjusted gross income limitations). The IRS quickly cracked down on this workaround by generally requiring a taxpayer to reduce their federal charitable contribution deduction by the amount of any state or local tax credit the taxpayer receives, or expects to receive, in consideration for the charitable payment or transfer.[2]

2. Pass-Through Entity Level Taxation Regimes

Despite being largely shut down by the IRS on state charitable funds, states continued to try and find SALT deduction workarounds for their residents. The plain language of IRC Section 164(b)(6), which states that SALT deduction cap only applies to individuals, and the legislative history of IRC Section 164(b)(6) provided that opportunity. The legislative history provides that "taxes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner's or S corporation shareholder's distributive or pro-rata share of income or loss on a schedule K-1, will continue to reduce such partner's or shareholder's distributive or pro-rata share of income as under present law."

1. Ignoring the Alternative Minimum Tax and any adjusted gross income limitations.
2. Under a de minimis rule, the federal deduction is not reduced on account of a state credit, if the state credit does not exceed 15% of the taxpayer's charitable contribution. In addition, if the taxpayer receives or expects a deduction, instead of a credit, on the state tax return, no reduction to the federal deduction is required, unless the amount of the state tax deduction exceeds the amount of the charitable contribution.

This language created an opportunity for states to enact a mandatory or elective entity-level tax on pass-through entities (partnerships, S corporations and some LLCs (Limited Liability Companies), collectively known as "PTEs"), where the state taxes are paid at the entity level, not the entity owner level, with the PTE owner receiving a corresponding or offsetting full or partial income tax credit, deduction, or exclusion on their individual state income tax returns. Such an entity-level tax allows owners of PTEs to prepay their state taxes at the entity level and have their pro rata share of income, net of the state PTE tax, reported on their federal income tax return. In effect, the PTE owner is getting a full federal deduction for the state taxes paid on their PTE income, generally without increasing their state income tax on such income.

Despite objecting to the State Charitable Fund workaround, the IRS issued guidance[3] that blessed this workaround and states have been jumping on the bandwagon to implement PTE level tax regimes. As of August 2021, eighteen (18) states have passed legislation to approve the workaround and there is pending legislation in another five (5) states. Please see the attached chart for a complete list of states that have passed PTE taxation legislation or have pending legislation.

<u>Hypothetical Fact Pattern</u>

Client, a New Jersey resident, is the sole shareholder of XYZ Business, a New Jersey S corporation. For tax year 2020, XYZ reports taxable income of $2 million on its federal S corporation income tax return (Form 1120S).

XYZ's income is solely New Jersey source, and the Client has already reached the $10,000 SALT deduction limit on her personal income tax return with real estate taxes.

Without PTE Level Tax Election

If XYZ does not elect PTE level taxation, all $2 million of XYZ taxable income would flow through to her federal income tax return and her New Jersey income tax return. Based on New Jersey's top individual tax rate of 10.75% (ignoring graduated rates), client would pay $215,000 of New Jersey income tax and because she has already reached the $10,000 SALT deduction cap with her real estate taxes, she would get no federal income tax benefit from her $215,000 income tax payment to New Jersey. Ignoring other deductions and other potential tax situations, client would then pay another $740,000 in federal taxes ($2,000,000 x 37% top marginal federal tax rate), for a total tax bill of $955,000.

With PTE Level Tax Election

If XYZ elected PTE level taxation, XYZ would pay tax at 9.12% (ignoring graduated rates) to New Jersey, totaling $182,400. Client would then use this $182,400 as a credit again her previously calculated $215,000 New Jersey individual income tax, leaving an individual balance due of $32,600. From an individual and XYZ perspective, client is essentially paying the exact same amount of total New Jersey income tax. From a federal perspective though, XYZ would get a deduction for the $182,400 entity tax paid to New Jersey and client would report $1,817,600 of flow through income from XYZ on her Form 1040. Ignoring other deductions and other potential tax situations, client would end up paying $672,512 in federal taxes ($1,817,600 x 37% top marginal federal tax rate). This results in a net savings of $67,488.

3. IRS Notice 2020-75

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	New Jersey Tax (individual)	New Jersey Tax (entity)	Federal tax	Total Taxes
Without PTE Level Tax Election	$215,000	$0	$740,000	$955,000
With PTE Entity Level Tax Election	$32,600	$182,400	$672,512	$887,512
Benefit	-	-	-	$67,488

Additional PTE Level Taxation Regime Considerations

Each of the states with PTE level tax regimes have their own nuances but below is a list of some common general considerations that should be kept in mind for entities considering electing into a PTE level tax regime. A detailed review of the New York State PTE level tax regime can also be found here.

Entity Type & Tax Classification

The type of entity and how it is classified for tax purposes can have an impact on the eligibility to qualify for PTE level taxation. For example, sole proprietorships and single-member limited liability companies, despite generally being thought of as passthrough entities, would not be eligible for PTE level taxation in most states as they are considered disregarded entities. In addition, publicly traded partnerships may also not be eligible under certain state regimes.

Individuals using single member LLCs to conduct business could admit a second member, which makes the LLC into a partnership for tax purposes, that can take advantage of the PTE level tax. The second member can have a small interest in the LLC (1%), so the individual still retains control and most of the cash flow from the business. Alternatively, the individual can incorporate his or her business and elect to treat it as an S Corporation, which can also take advantage of the PTE level tax.

Mandatory vs Elective

Another consideration is how the business becomes subject to the PTE level tax. Of the 18 states that have already passed PTE level tax legislation, only 1 state, Connecticut, makes the PTE level tax mandatory on all PTEs. The 17 states where the PTE level tax is elective have varying rules on who, and how many partners/members/shareholders (“owners”) are required, to consent to the election. In addition, these states have varying rules on the implications of an individual owner not consenting to the election. Finally, these states have different rules on whether the election must be made annually or whether it is a permanent election, until otherwise revoked.

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Ramifications for Non-Resident Owners and PTEs with Multi-State Operations

The effect on non-resident owners and PTEs operating in multiple states must also be considered. Specifically, owners of PTEs with business operations in multiple states could face real struggles with the treatment of state taxes paid at the entity level. Generally, if a business owner pays individual income taxes to a nonresident state on business income, the taxpayer is afforded a credit on their resident state individual income tax return to avoid the negative effect of double taxation. Will all states treat PTE level taxes as creditable for purposes of resident income taxes, or will nonresident owners be harmed by the resident credit rules of non-PTE workaround states? In short, each PTE should model out the impact on all its owners to determine if it should elect to be subject to this new PTE level tax.

Effective Dates, Election Dates, Estimated Tax Payments & Sunset Dates

It is also important to review the effective date and the election date for the varying states. Some states have made the PTE level tax retroactive to tax year 2021 (or earlier), while others have made the tax effective for tax years beginning in 2022. Of the 17 states which have made the PTE level tax elective, it is just as important to review and confirm the election date deadline and procedure for the particular tax year. In addition, it is extremely important to review and confirm whether the PTEs and/or their owners will have to make estimated payments and potentially claims for refunds throughout the year.

It is also important to note that a lot of these PTE level tax regimes will expire upon the earlier of: (i) December 31, 2025, or (ii) the repeal of the SALT deduction cap. If a repeal of the SALT deduction cap does happen, it may still be advantageous to see if a particular state's PTE level tax regime is still valid as you can deduct business expenses from gross income versus itemized deductions subject to potential Alternative Minimum Tax limitations and/or "Pease limitations" that effectively phase out a portion of some deductions for high income taxpayers.

Pending Legislation and Potential Planning Opportunity - Q3 State Estimates due 9/15/21

The current $10,000 cap on the SALT deduction was widely viewed as a politically motivated attack on Democrats, and it was assumed that once the Democrats regained control of the Presidency and Congress they would seek to raise or eliminate the cap on the SALT deduction. Up until the Senate Democrats passed a $3.5 trillion budget blueprint on August 11, 2021 (the first step in the process of enacting legislation which will almost assuredly increase tax law changes), there had been no mention of any changes to the SALT deduction cap in the Biden Administration's tax proposals. The Budget Resolution Agreement Framework released to the public states that "SALT cap relief" is one item the budget resolution is designed to fund and account for. While there are no additional details provided, one can assume Congressional Democrats will attempt to raise or completely eliminate the current $10,000 cap on the SALT deduction.

This change could have important implications for Q3 2021 state estimated tax payments due 9/15/21 and any Q4 2021 payments prepaid in December of 2021. If the SALT deduction cap is raised or eliminated for tax year 2022, deferring these state tax payments until January 2022 could make them at least partially, if not fully, deductible, saving the taxpayer federal taxes for tax year 2022.

Assuming the SALT deduction cap is eliminated for tax year 2022, the amount of federal tax savings generated by deferring the Q3 2021 state estimated payment into January 2022 could be as much as: **the amount of the Q3 payment times the taxpayer's federal tax rate at the time (which could be 39.6% in 2022).**[4] The savings could be impacted by a taxpayer's specific facts and circumstances, including if the taxpayer pays the Alternative Minimum Tax.

The above strategy, however, is not without risk or potential financial consequences. First and foremost, there is no guarantee that the SALT deduction cap is actually raised or eliminated for tax year 2022. Even if it is raised or eliminated, such a raise could be minimal and offer no or minimal tax benefit to certain taxpayers. Further, any such raise or elimination could only apply to taxpayers under certain income limitations, which could also limit the tax benefit to certain taxpayers. Finally, delaying a state quarterly estimated payment could subject the taxpayer to interest and/or penalties that must be factored into the cost/benefit analysis.

4. This calculation assumes the taxpayer itemizes their deductions and has already reached the $10,000 SALT deduction cap for tax year 2021.

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States with Passed or Pending PTE Tax Legislation:

State	Mandatory or Elective Entity Tax	Entity Tax Rate	Effective Tax Year
Alabama	Elective	5%	2021
Arkansas	Elective	5.9%	2022
Arizona	Elective	4.5%	2022
California	Elective	9.3%	2021
Colorado	Elective	4.55%	2022
Connecticut	Mandatory	6.99%	2018
Georgia	Elective	5.75%	2022
Idaho	Elective	6.925%	2021
Illinois	Elective	4.95%	2022
Louisiana	Elective	2.00%-6.00%	2019
Maryland	Elective	8.00% (8.25% for any corporate owners)	2020
Massachusetts (pending)	Elective	5.00%	Pending
Michigan (pending)	Elective	4.25%	Pending
Minnesota	Elective	9.85%	2021
New Jersey	Elective	5.675%-10.90%	2020
New York	Elective	6.85%-10.90%	2021
North Carolina (pending)	Elective	4.99% (proposed)	Pending
Oklahoma	Elective	5.00% (for individuals members, will be reduced to 4.75%) 6.00% (for corporate owners, will be reduced to 4%)	2019
Oregon (pending)	Elective	9.00% -9.90%	Pending
Pennsylvania (pending)	Elective	3.07% (assumed)	Pending
Rhode Island	Elective	5.99%	2019
South Carolina	Elective	3.00%	2021
Wisconsin	Elective	7.90%	2018/2019

Rockefeller Insights - NY State PTE Tax Regime

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