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IRS Clarifies That SALT Deduction Cap Does Not Apply to Passthrough Entities

Summary

In a welcome notice (Notice 2020-75) released on November 9, 2020, the IRS announced that proposed regulations will be issued to clarify that state and local income taxes imposed on and paid by a partnership or an S corporation (i.e., pass-through entities or PTEs) on its income are allowed as a deduction by the PTE in computing its non-separately stated taxable income or loss for the taxable year of payment. As a result, state and local income taxes, whether mandatory or elective, will be deductible at the level of the PTE and not passed through to individual partners or shareholders of the PTE who are subject to the state and local tax (SALT) deduction limitation that applies to individuals who itemize deductions for federal income tax purposes.

Notice 2020-75 applies to payments of these types of PTE income taxes ("Specified Income Tax Payments") made on or after November 9, 2020. Taxpayers are allowed to apply these rules to Specified Income Tax Payments made in a taxable year of a partnership or an S corporation ending after December 31, 2017 and before the date the forthcoming proposed regulations are published in the Federal Register.

TCJA and the $10,000 SALT Cap

Section 164 of the Internal Revenue Code (IRC) generally allows a deduction for state and local taxes paid. However, for individual taxpayers who itemize their deductions, the Tax Cuts and Jobs Act (TCJA) introduced a $10,000 limit on state and local taxes paid that an individual can deduct during the year ($5,000 for married individuals filing separately). This SALT cap was added under IRC Section 164(b)(6) and it applies to tax years beginning on or after December 31, 2017 and before January 1, 2026.

The limitation for individuals itemizing deductions—including PTE owners—typically results in more federal taxable income than pre-TCJA because an individual can no longer fully deduct state income taxes paid for federal income tax purposes. The effect is amplified for individuals, including PTE owners, that reside in states with high personal income tax rates.

State Responses to the $10,000 SALT Cap

States and municipalities imposing entity-level taxes on PTEs are not new. The District of Columbia, New Hampshire, New York City, Tennessee and Texas have imposed mandatory entity-level income or franchise taxes on PTEs for years. While most states continue to conform to federal pass-through tax treatment, the TCJA caused several states to reconsider entity-level taxes on PTEs.

In response to the TCJA, some states sought out ways to help their residents manage the federal $10,000 SALT deduction limitation under amended IRC Section 164. To date, seven states (Connecticut, Louisiana, Maryland, New Jersey, Oklahoma, Rhode Island and Wisconsin) have enacted some type of PTE taxing regime. While Connecticut's regime is mandatory, the other six states have an elective regime, under which the PTE has the option to be taxed at the entity level. This entity-level election is generally made in one of two ways:

- The electing PTE calculates its tax base and pays state income tax. The owner of the PTE is not taxable and does not include a distributive share of income for these state tax purposes. Louisiana, Oklahoma and Wisconsin fall under this category.

- The electing PTE calculates its tax base and pays state income tax, but it retains certain pass-through features. For example, an individual partner or S corporation shareholder still includes a distributive share of PTE income in his or her individual state income tax base, but is granted a state credit equal to (or a percentage of) the partner or shareholder's share of the state's PTE tax paid by the entity. The partner or shareholder uses the tax credit to offset his or her state personal income tax liability, and the credit may be refundable or eligible for carryforward if the amount of the credit exceeds the

tax liability. Maryland, New Jersey and Rhode Island fall under this category (as does Connecticut, although its PTE tax is mandatory rather than elective.)

Taxpayers and practitioners alike have been concerned with the uncertainties of the federal tax treatment of these new regimes enacted by the states, both as to the PTE and the individual owners. In Notice 2020-75, the IRS acknowledges these uncertainties. Now that the validity of these taxes has been confirmed by the IRS, it is possible that more states may enact some form of passthrough entity tax as the SALT cap was generally opposed by many in high state taxing jurisdictions. The timing of the Notice could be a way to provide relief to business owners operating in the form of a partnership or S corporation ahead of a larger package, which could be delayed pending finalization of the 2020 election results and may provide refund opportunities for some taxpayers in earlier years.

IRS Notice 2020-75

Notice 2020-75 announces that Treasury and the IRS intend to issue proposed regulations to clarify that state and local income taxes imposed on and paid by (which the IRS has coined Specified Income Tax Payments) 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 taxable year of payment.

A state's PTE tax must be a direct income tax imposed on and paid by the entity. The Notice defines Specified Income Tax Payments as:

- [A]ny amount paid by a partnership or an S corporation to a State, a political subdivision of a State, or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or the S corporation.

- [A] Specified Income Tax Payment includes any amount paid by a partnership or an S corporation to a Domestic Jurisdiction pursuant to a direct imposition of income tax by the Domestic Jurisdiction on the partnership or S corporation, without regard to whether the imposition of and liability for the income tax is the result of an election by the entity or whether the partners or shareholders receive a partial or full deduction, exclusion, credit, or other tax benefit that is based on their share of the amount paid by the partnership or S corporation to satisfy its income tax liability under the Domestic Jurisdiction's tax law and which reduces the partners' or shareholders' own individual income tax liabilities under the Domestic Jurisdiction's tax law.

The Notice states that the forthcoming proposed regulations will allow a PTE a deduction for its Specified Income Tax Payments, regardless of whether the state regime is mandatory or elective. IRS Section 703(a) provides generally that the taxable income of a partnership is computed in the same manner as an individual's taxable income, although certain items must be separately stated and certain enumerated deductions are not allowed to the partnership. For example, under Section 703(a)(2)(B), a partnership may not deduct taxes paid or accrued to U.S. possessions, which are included in the definition of state and local taxes under Section 164(b)(2). Under Sections 1363(b)(1) and 1363(b)(2), S corporations generally follow the same rules as partnerships for computing taxable income.

Therefore, Notice 2020-75 states that the PTE tax does not constitute an item of deduction that a partner or S corporation shareholder takes into account separately under IRC Section 702 or Section 1366. Further, "[a]ny Specified Income Tax Payment made by a partnership or an S corporation 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."

While the IRS has not indicated when the proposed regulations will be issued, as noted above, the proposed regulations will apply to Specified Income Tax Payments made by a PTE on or after November 9, 2020. Taxpayers may apply the rules in the Notice to Specified Income Tax Payments made in a taxable year of the PTE ending after December 31, 2017.

Insights

- A PTE may claim the Section 164 deduction for income taxes imposed on and paid by the PTE to satisfy its liability to a state or local jurisdiction, regardless of whether the PTE tax is mandatory or elective. The PTE's deduction is not affected if individual members receive a benefit, such as a tax credit to apply against the member's state personal income tax liability.

- To properly take a Section 164 deduction, the state or local income tax must be a direct imposition on the PTE. Consequently, income tax payments made by a PTE on composite returns or withholding taxes that the PTE must remit on behalf of members are not covered by Notice 2020-75 nor are they deductible under Section 164 for the PTE.

- The specifics of state PTE tax regimes vary. While Notice 2020-75 is welcome and has been widely anticipated by taxpayers and practitioners, there may be some areas of uncertainty that are not resolved by the Notice. For example, among certain other issues, it may be unclear in some states whether the state's "PTE tax" is a direct imposition on the entity or whether it remains a state tax paid "on behalf of" the partners or shareholders by the PTE. Likewise, states often require the add-back of the federal deduction for state taxes for corporate or personal income taxes, and the applicability of this requirement, or the lack thereof, must be addressed with respect to state PTE taxes.

- Although the state PTE tax elections are recent enactments, because Notice 2020-75 and the proposed regulations will apply to tax years beginning after December 31, 2017, taxpayers should consider whether retroactive state elections are permitted and whether amended state and federal returns could be filed.