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SALT Relief on the Horizon

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The Treasury Department has announced plans to issue proposed regulations to clarify that state and local income taxes ("SALT") imposed on and paid by a partnership/S corporation on its income are allowed as a deduction by the partnership/S corporation in computing its non-separately stated taxable income. In other words, the proposed regulations will give individual taxpayers, who have substantial income from flow-through operating entities, an ability to work around the $10,000 limitation on the deductions of SALT.

Since the institution of the federal income tax in 1913, individual taxpayers have been allowed to deduct their SALT as well as state and local real estate taxes as part of their itemized deductions. With the implementation of the Tax Cuts and Jobs Act ("TCJA") in 2017, that deduction is currently limited to $10,000. Real estate taxes, alone, could easily reach that limit, effectively eliminating entirely the deduction for SALT. Higher income taxpayers with large state and local income tax bills were simply out of luck experiencing potential federal tax increases.

Many states and localities responded to this limitation by creating workarounds, such as advising homeowners to prepay their 2018 real estate taxes in 2017 or creating charitable funds for payments to be made to in lieu of taxes. These proposals were quickly shot down by the IRS. Other states implemented other workarounds specifically for the owners of small businesses, such as partnerships and S corporations. For instance:

Connecticut, in 2018, implemented a pass-through entity tax imposed on partnerships and S Corporations at the maximum individual marginal rate of 6.99%. The partners and shareholders were then entitled to a credit against their Connecticut individual tax liability for that same amount.

New Jersey, earlier this year, introduced the Pass-Through Business Alternative Income Tax Act, which established an elective entity-level alternative income tax to be paid by partnerships and S corporations. Similar to Connecticut's proposal, the partner or shareholder would be entitled to a refundable credit on their state individual income tax return for their pro-rata share of the entity level tax paid. New Jersey also specifically allows a credit for similar taxes paid to other states.

As of October 2020, the following states had enacted some form of pass-through entity tax: Connecticut, Louisiana, Maryland, New Jersey, Oklahoma, Rhode Island, and Wisconsin. Only Connecticut's is mandatory, all of the others are elective and revocable.

The following states have proposed, but not yet enacted, a pass-through entity tax: Michigan, Minnesota, and New York.

The IRS is proposing new regulations that would clarify that other similar state and local taxes should be treated similarly as deductions at the entity level and, therefore, allowable as a reduction of the partner's or shareholder's share of the entity's net income. Proposed Regulations have no legal authority until adopted as either Temporary or Permanent Regulations. They serve merely as guidance as to the direction in which the Treasury Department is headed.

Spielman Koenigsberg & Parker will continue to monitor the regulation until it is passed as law. Small business owners, partners and shareholders should consult with their tax advisors about the options available to them in the various states in which they operate.