



IRS Enables States to Create Programs for State and Local Tax (SALT) Workarounds

WRITTEN ON APRIL 26, 2021

Federal tax reform which passed on December 22, 2017 forever changed the way we look at itemized deductions found on Schedule A of Form 1040 for individual tax returns. The reform effectively limited the state and local tax deductions taken previously on real estate taxes paid, state and local withholding on wages and other income, and all other state and local tax payments to a measly \$10,000 cap. While some individual tax filers were not utilizing the full benefit of the taxes paid either due to itemized deduction phase outs or alternative minimum tax computations kicking in, the effects were still far reaching, only offset by some modest tax rate cuts that are now proposed to be eliminated in 2021.

Several strategies developed by states and localities to restore the effects of state and local tax (SALT) deduction cuts were deployed, only to be met with challenges by the IRS.

In November of 2020, in IRS Notice 2020-75, the Treasury has essentially given a green light to state and local jurisdictions, allowing them to work around the individual itemized deduction tax cap of \$10,000. States including New Jersey and Connecticut, in 2020, and New York for 2021, have now developed programs to allow individuals the benefit of state and local tax deductions, without being limited. There are some limitations to these programs, but overall, they work well for profitable pass-through businesses with shareholders who would benefit from the additional state and local tax deductions.

The state programs generally require an electing business to pay the state and local tax on behalf of the taxpayer, and cause a federal tax deduction for such payment, thereby reducing the overall federal taxable income passed through on the form K-1 of the S corporation or partnership tax return.

The general provisions for each of the New York, New Jersey and Connecticut programs are described herein.

New Jersey – as established by PL 2019, c.320, the Pass-Through Business Alternative Income Tax was created for passthrough entities doing business in New Jersey on or after January 1, 2020. The program is elective, and such election is made annually. The election is available for Partnerships, NJ S Corporations and Limited liability companies. At least one member must be liable for tax on their share of NJ gross income. Single member LLCs and sole proprietorships do not qualify to participate in this program. The election must be made on or before the original due date of the entity's return.

In the first year of election for this program (2020), taxes are due based upon computations set forth by the program, on the due date of the return, without extension and filed on Form PTE-200T. Taxes liable under the program are set at tax rates mandated under the program and range from 5.675% for the first \$250,000 of each members share of income and increase to 6.52% for amount from \$250,000 to \$1,000,000, 9.12% from \$1,000,000 to \$5,000,000 and max out at 10.9% on amounts over \$5,000,000.



The amount paid is allocated to each member based upon each member's share of distributive proceeds (income). The tax payment reflects on the federal return and Form k1 as an ordinary deduction, or reduction of ordinary taxable income, giving the individual a full deduction for the taxes paid.

In subsequent years, estimated tax payments are required to be paid in quarterly, on form PTE-150.

Connecticut – for tax years beginning on or after January 1, 2018, put into law a mandatory entity level tax. The Pass-through Entity Income Tax (PET) is imposed on Connecticut taxable income of the pass-through entity (also defined as partnerships and S corporations – and LLC's treated for tax as partnerships or S corporations) at the highest personal income tax rate of 6.99%. The tax would be considered a business tax and reduce federal taxable income. Individual taxpayers will then take a credit of 87.5% of their distributive share of income against their Connecticut tax liability. To note, the credit was originally a higher amount, and thus there is some loss of benefit to utilizing a credit that is not equal to the entire amount of the taxes paid in.

The Connecticut PET is imposed on the Form CT-1065/CT-1120SI and allocated to members/shareholders on the Form K1 as well as CT-1065/CT-1120SI RRS (Recharacterization Request Summary Sheet).

Payments of tax are due quarterly, and the balance, if any is due with the return or extension, when due and filed.

New York – coming later to the game, on April 7, 2021, the New York legislature reached an agreement with Governor Cuomo, to release its program comparable to that of New Jersey's. The law stipulates an optional election for the business whereby the pass-through entity can elect to pay an entity level tax at the partnership and S corporation level. The tax paid, again, is a deduction on the federal level, and then is added back on the state individual tax level for that shareholder or partner's income. The New York State return for that partner or shareholder is entitled to a credit against the total income for the taxes paid at the entity level.

The required withholding in New York is consistent with the individual tax rates – 6.85% for amounts under \$2,000,000, 9.65% for amounts over \$2,000,000 and not over \$5,000,000, 10.3% for income over \$5,000,000 but less than \$25,000,000 and 10.9% on income over \$25,000,000.

The election to pay a pass-through tax is made annually, by the due date of the first estimated tax payment date. Since this program started late in 2021, the election to pay the Pass-Through Entity Tax must be made by October 15, 2021, and therefore the first-year election would not require estimated tax payments. Subsequent years estimated tax payments would be due March 15th, June 15th, September 15th, and December 15th of each year.



Pitfalls for these programs include:

Nonresidents are not guaranteed a credit for taxes paid to other jurisdictions on their resident tax return for their portion of the tax paid in the pass-through entities SALT workaround state, inasmuch as the law for each resident's state needs to specifically include an allowable credit for the new pass-through entity tax payment.

Taxes paid for the pass-through entity do not cover taxes paid in for the remainder of the individual's other income and care is needed to monitor estimated tax payments for those income sources.

In some states, the pass-through entity tax is not refundable.

The tax rates determining the payments may be higher than the individual tax rates (dependent on each states program) than the individual would have paid to SALT workaround state if they paid the tax directly.

Louisiana, Maryland, Oklahoma, Rhode Island, and Wisconsin also have proposed or enacted similar programs. Careful planning for electing a pass-through entity tax on these or other states requires professional tax help. We highly recommend reaching out to your SKP team to discuss the effectiveness of employing this SALT tax workaround. In certain circumstances, this program can be an effective and powerful tool to reduce your tax liabilities.

As always, Spielman Koenigsberg & Parker, LLP is here to assist you with your needs. Please feel free to reach out to your SKP tax professionals for guidance and planning opportunities.