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IRS Allows SALT Tax Deduction Workaround. . . For Some

By Ryan C. Sheppard, CPA, CFF*
Knight Rolleri Sheppard CPAS, LLP
Fairfield, CT

On May 31, 2018, the state of Connecticut implemented a 6.99% passthrough entity level tax (PET) on passthrough companies (partnerships and S corporations).¹ In no uncertain terms the Connecticut legislature made it clear this was to circumvent the state and local tax deduction limitation on an individual's personal return (\$10,000). Connecticut was not the only state to do so. At the time five other states did the same. Prior to this law an individual would pay state tax on their share of the companies' profits at the individual level. This was deductible on one's federal return but not to exceed a max cap of \$10,000.² Under the Connecticut state law the tax is effectively paid at the company's entity level, thus the company gets the deduction for the state tax paid. The company's share of profits is reported on the individual's return after the state tax was paid, thus getting the full benefit of the deduction.

At the time many CPAs, myself included, did not believe this would hold muster. While we complied

* Mr. Sheppard is a Partner with Knight Rolleri Sheppard CPAS, LLP located in Fairfield, CT. He has extensive experience in taxation, business consulting and planning for privately held companies, individuals, and not-for-profit organizations.

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¹ See CT Public Act No. 18-49 (May 31, 2018). (This provision is effective beginning January 1, 2018).

² See §164(a) for the Code section that governs state and local tax deductions. All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated. See also Rev. Rul. 2019-11.

with current law many of us felt this would eventually be overturned as a clear circumvention of the 2017 federal tax law limitation. Many tax professionals even warned their clients that if the IRS did overturn that law, they may owe the additional tax back. In fact there was some evidence to believe they would. I note that the IRS issued final rules³ in June of 2019 that killed a similar workaround on charitable deductions.

Ah but not so fast, in November of 2020, the IRS issued Notice 2020-75 providing that state taxes paid via a passthrough entity tax will be fully deductible on the federal return. Big news at the time. For one, it now gives taxpayers some comfort that their deductions will stand but secondly, creates a license to do so for other companies that may not be structured in a way to take advantage of this in states with an entity level tax. Since the IRS issued Notice 2020-75, many states have changed their laws concerning this PET and began implementation. This is due to the fact that there official guidance from the IRS. Some states make it optional while others are mandatory. Overall, this is very good news for taxpayers with ownership in passthrough entities.

EFFECT ON SOLE PROPRIETORS AND SINGLE MEMBER LLCs

Think of this however, you are a sole proprietor, a single member LLC and thus a disregarded entity, you are not subject to the state's PET, thus you pay your tax on the individual level, and thus your state income tax deduction is capped at \$10,000. But if you had a 1% partner for example, you would be subject to this entity level tax and thus deduction is uncapped. Let us take an example, AREGA Enterprises, LLC is a single member LLC located in Monroe, CT. AREGA will have \$1 million of net income for 2020. Their personal income tax would total \$372,094 in federal tax. Now let us say January 1, 2020, AREGA Enterprises, LLC adds a 1% partner, in this case their spouse as a that partner. The Connecticut income tax

³ T.D. 9864, Final Rule on Contributions in Exchange for State or Local Tax Credits, 84 Fed. Reg. 27,513 (June 13, 2019).

is paid by AREGA Enterprises, LLC in the amount of \$69,900. This tax paid reduces the federal taxable income in its entirety thus the amount the taxpayers will report on their federal return as income is \$930,100 and therefore the federal tax is \$344,124.

That is a federal tax savings of \$27,970! Just by adding your spouse in this example. Who says getting married costs more? I will add this, California⁴ is one of some states beginning to look at this and offering this tax to be allowed for sole proprietorships and single member LLCs.

If you are in a state that doesn't have this available because you are a sole proprietor, one should consider changing the structure to either a partnership or S corporation in states with an entity level tax. Yes there are other things to consider, additional costs of tax return preparation, accounting and legal fees, and setting up the structure, etc.

If one does not want to add a partner it may structure itself as an S corporation. If that approach is taken, you would not be able to pay the PET on the officer compensation in that example but the rest of the profits you can pay to the partner. Let's take a look at the same example only this time AREGA LLC decides to make an S election. For discussion purposes assume an officer salary of \$200,000. We previously established that if they remained a single member LLC their federal tax would be \$372,094.

As an S corporation with \$200,000 salary we are looking at net income of \$800,000. If the company pays the state tax on this that would total to \$55,920. Therefore, the taxpayer's share of K-1 income for reporting purposes will be \$744,080 (\$800,000 - \$55,920). In this instance the taxpayer's Form 1040, *U.S. Individual Income Tax Return*, would report a total of \$944,080 of income vs. \$1 million as a single member LLC. This equates to roughly \$20,000 federal tax savings.

OTHER MATTERS TO CONSIDER IN A PARTNERSHIP

Equity is king, giving away equity in a partnership situation is not always ideal. Despite the tax benefits via the PET tax, equity is a partner's most valuable asset. The tax savings via the PET tax discussed above may not outweigh the cost of equity. Adding a partner has consequences, even minority interest. In real estate LLCs for example, it's very common to have multiple partners. When those real estate partnerships attempt financing, the bank is generally going to want information on those who own 20% or more. In some cases they will request information on

those partners that own less than 20%. Furthermore, adding partners makes it harder to sell, as there are voting rights and options. In addition, certain LLC shares can have greater weight than others. The decision to bring in a partner is a major business decision, and is not to be made lightly.

Another item to note is if one adds a partner then have a partnership agreement prepared. Partnerships can bring about equally positive and negative consequences. For example, it is good to have a partner to bounce ideas off of, and/or provide financial support, operations support, and so on. If adding a partner, I strongly recommend a partnership agreement. I know of no partnership that is the same today as it was when it started, and the partnership agreement should be flexible in that regard and reflect as such, be adaptable and account for all the things that can come up during its operation. Failure to have an agreement means the governance of the partnership is determined by state law. This is not ideal, to put it more bluntly, this is a bad idea. This means if you enter into a partnership and there is a dispute with no operating agreement, you are subject to the provisions of your state law. The statutes as interpreted by a court will override any intentions that you may or may not have had related to the partnership. Examples include:

- When is property partnership property;
- Transfer of partnership property;
- Liability of partners;
- Rights and duties as a partner;
- Actions by partners and partnerships;
- Transfer of partners interest; and
- Right to wind up the partnership.

Therefore, while adding a partner for PET purposes might sound appealing consider all the facts and circumstances before jumping into this arrangement.

OTHER MATTERS TO CONSIDER IN AN S CORPORATION

Let's revisit our example above. AREGA, LLC, a single member LLC has decided to be an S corporation while still remaining the sole owner. We can do that so long as we pay reasonable compensation via a W-2 as described above. One should remember that going from a single member LLC to an S corporation while appealing from a PET deductibility standpoint has also added a lot of complexity. For starters S corporations have to file a separate tax return than its owner. That's additional cost. They also need a payroll service, also additional cost. They will need to file and remit quarterly payroll tax returns and annual

⁴ See Note 9, below.

W-2s, all at additional costs that they don't have as a disregarded entity. As an S corporation they also now need to track and keep a good set of books and records. While I would argue that's very important regardless of what entity you are, in an S corporation you generally have to report your balance sheet and reconcile equity. Not the case in a single member LLC. I would argue most simple Schedule Cs can be self-prepared, but once you convert to S corporation status these returns become much more complicated for the average taxpayer. Secondly S corporation officer compensation (or lack thereof) is a common IRS audit trigger. If adding an owner AND electing S corporation, one has now added even more complexity with disproportionate distribution matter to be cognizant of amongst other things.

OVERALL

On the surface it would appear paying the state and local tax through PET has definite federal tax advantages, at least with regard to SALT limitations under the 2017 Tax Cuts and Jobs Act (TCJA).⁵ It should be noted that as states have adopted this tax most are making the tax an elective passthrough tax, certain states such as Connecticut make it mandatory. As of the date of this article 19 states have passed a PET and others are pending. Listed below is the current status of PET rules by state:

- Alabama – An early adopter, as of 2020 their PET is elective.⁶
- Alaska – N/A.
- Arkansas – As of 2022 passthrough entities may elect to pay income tax at the passthrough entity level.⁷
- Arizona – As of 2022 passthrough entities may elect to pay income tax at the passthrough entity level. This will be elective.⁸
- California – From 2021-2025 passthrough companies may elect to pay tax at the passthrough entity level. However interestingly enough if the SALT limitation changes this law may be pulled back.⁹
- Colorado – As of 2022 passthrough entities may elect to pay income tax at the passthrough entity

level. Similar to California, this is only allowed if SALT limitation remains in effect.¹⁰

- Connecticut – Mandatory passthrough entity tax.¹¹
- Delaware – N/A.
- District of Columbia – Washington D.C. imposes a mandatory franchise tax.¹²
- Florida – N/A.
- Georgia – As of 2022 passthrough entities may elect to pay their income tax at the passthrough entity level.¹³
- Hawaii – N/A.
- Idaho – As of 2021 passthrough companies may elect to pay the PET.¹⁴
- Illinois – Passthrough entities are subject to a replacement tax effective in 2021 through 2025. They may elect to be subject to a PET of 4.95%.¹⁵
- Indiana – N/A.
- Iowa – N/A.
- Kansas – N/A.
- Kentucky – N/A.
- Louisiana – Partnerships may elect to be taxed as if they were a C corporation. For S corporations Louisiana allows an exclusion of taxable income to the extent owners pay the Louisiana taxes.¹⁶
- Maine – N/A. However S corporations are taxable corporations for Maine corporate income tax purposes, and are not considered passthrough entities.¹⁷

§19900(a)(1), Cal. Rev. & Tax. Cd. §23038.

¹⁰ Colo. Rev. Stat. §39-22-302, Colo. Rev. Stat. §39-22-343, Colo. Rev. Stat. §39-22-344.

¹¹ Conn. Gen. Stat. §12-699, Conn. Gen. Stat. §12-726.

¹² D.C. Code Ann. §47-1801.04(10), D.C. Code Ann. §47-1807.02(a), D.C. Code Ann. §47-1805.02(6), D.C. Code Ann. §47-1808.01, D.C. Code Ann. §47-1808.03.

¹³ Ga. Code Ann. §48-7-23; Form 600S (IT-611S Booklet) Instructions-S Corporation Tax Return, 14,505.

¹⁴ Idaho Code §63-3025(2), Idaho Code §63-3025A(2), Idaho Code §63-3025(3), Idaho Code §63-3025A(3), Idaho Code §63-3083, Idaho Code §63-3026B(2)(a); Idaho Form 65 Instructions, 14,514.

¹⁵ ILCS Chapter 35 §5/201(p)(1), ILCS Chapter 35 §5/201(a), ILCS Chapter 35 §5/201(c), ILCS Chapter 35 §5/201(p).

¹⁶ La. Rev. Stat. Ann. §47:287.12, La. Rev. Stat. Ann. §47:287.732.2, La. Rev. Stat. Ann. §47:287.14, La. Rev. Stat. Ann. §47:297.14.

¹⁷ Me. Rev. Stat. Ann. 36 §5102(10).

⁵ Pub. L. No. 115-97.

⁶ Ala Code §40-18-160; Ala. Admin. Code §810-3-24-01(1)(a); & L. 2021 1 §10(c), §10(b)(1).

⁷ Ark. Code Ann. §26-65-103.

⁸ Ariz. Rev. Stat. Ann. §43-1126; Arizona Corporate Tax Ruling No. 97-2 (Aug. 8, 1997); Ariz. Rev. Stat. Ann. §43-1411; Ariz. Admin. Code §R15-2G-101(B).

⁹ Cal. Rev. & Tax. Cd. §19900(a)(1), Cal. Rev. & Tax. Cd. §23802(b), Cal. Rev. & Tax. Cd. §23186, Cal. Rev. & Tax. Cd.

- Maryland – Allows passthrough companies to elect to pay the tax at the entity level.¹⁸
- Massachusetts – As of 2021 passthrough companies may elect to pay the PET, again unless the SALT limitation changes. Like Connecticut however, Massachusetts limits the credit on the personal return. The state allows a credit of only 90% of the tax, Connecticut is 87.5%.¹⁹
- Michigan – N/A. However they are subject to a corporate excise tax for S corporations. In addition, they have a pending bill, H.B. 5376, in early stages.²⁰
- Minnesota – Effective 2021, the state allows passthrough companies to elect to pay the tax at the entity level. Much like the states mentioned above, subject to SALT limitations.²¹
- Mississippi – N/A.
- Missouri – N/A.
- Montana – N/A.
- Nebraska – N/A.
- New Hampshire – Assesses a business profits tax. Not a passthrough entity tax.²²
- New Jersey – Effective 2020 passthrough companies can elect to pay the tax at the entity level.²³
- New Mexico – N/A.
- Nevada – N/A.
- New York – Effective 2021 for elections made by October 15, 2021 New York passthrough companies may elect to pay the tax at the entity level.²⁴
- North Carolina – N/A. However there is a bill currently in reconciliation committee (S. 105).²⁵
- North Dakota – N/A.
- Ohio – N/A. However there is a bill pending in committee (SB 246).²⁶
- Oklahoma – One of the early adopters effective 2019 passthrough companies may elect to pay the tax at the entity level.²⁷
- Oregon – Effective 2022, the state allows passthrough companies to elect to pay the tax at the entity level. Again subject to ongoing SALT limitations.²⁸
- Pennsylvania – N/A. However there is a bill pending in committee (H.B. 1709).²⁹
- Rhode Island – An early adopter effective 2019 passthrough companies may elect to pay the tax at the entity level.³⁰
- South Carolina – Effective 2020, the state allows passthrough companies to elect to pay the tax at the entity level.³¹
- South Dakota – N/A.
- Tennessee – Passthroughs are subject to excise and franchise tax; not income tax.³²
- Texas – N/A.
- Utah – N/A.
- Vermont – N/A.
- Virginia – N/A.
- West Virginia – N/A.
- Wisconsin – Is interesting in that effective 2018 S corporations can elect to be taxed at the entity level. Partnerships, however effective 2019 may

¹⁸ Md. Code Ann. Tax-Gen. §10-104(6), Md. Code Ann. Tax-Gen. §10-102.1(b), Instructions to Form 510, 14,509

¹⁹ Mass. Gen. L. Chapter 63 §32, Mass. Gen. L. Chapter 63 §32D(b), Mass. Regs. Code 830 CMR §62.17A.1(3)(b), Mass. Regs. Code 830 CMR §62.17A.1(3)(c); PPP and Coronavirus Relief Grant Funds FAQs, Mass. Dept. of Rev. (Mar. 1, 2021); Mass. Gen. L. Chapter 62 §17.

²⁰ Mich. Comp. Laws Ann.. §206.623(1), Mich. Comp. Laws Ann.. §206.611(5), Mich. Comp. Laws Ann. §206.605(1); Corporate Income Tax FAQs-Filing Requirements 23 (Apr. 11, 2012); Mich. Comp. Laws Ann. §208.1201, Mich. Comp. Laws Ann.. §208.1113(3), Mich. Comp. Laws Ann. §208.1117(5).

²¹ Minn. Stat. §290.9725, Minn. Stat. §289A.08, Subd. 7a, Minn. Stat. §290.31, Subdivision 1, Minn. Stat. §289A.08, Subd. 7a.

²² N.H. Rev. Stat. Ann. §77-A:6, I.

²³ N.J. Rev. Stat. §54:10A-5(c)(2), N.J. Rev. Stat. §54A:12-3(b)(2), N.J. Rev. Stat. §54:10A-4(h), N.J. Rev. Stat. §54A:12-3(a).

²⁴ N.Y. Tax Law §210(1)(d)(1), N.Y. Tax Law §860 *et seq.*, New York Technical Service Bureau Memo. No. TSB-M-21(1)C,

08/25/2021 & New York Department of Taxation & Finance Publication No. 20 (Oct. 1, 2007).

²⁵ N.C. Gen. Stat. §105-131.1.

²⁶ Ohio Rev. Code Ann. §5733.40, Ohio Rev. Code Ann. §5747.40 & Ohio Rev. Code Ann. §5733.41, Ohio Rev. Code Ann. §5747.41.

²⁷ Okla. Stat. 68 §2365, Okla. Stat. 68 §2358(A)(A.11), Okla. Stat. 68 §2355.1P-3(B).

²⁸ Or. Rev. Stat. §314.732, L. 2021 Chapter 589 §3, Or. Rev. Stat. §314.725, L. 2021 Chapter 589 §3.

²⁹ Pa. Stat. Ann. 72 §7307.8, Pa. Code 61 §153.1(a)(6), Pa. Stat. Ann. 72 §7306, Pa. Stat. Ann. 72 §7306.2, Pa. Code 61 §107.1.

³⁰ R.I. Gen. Laws §44-11-2(d)(1), R.I. Gen. Laws §44-11-2.3, R.I. Gen. Laws §44-30-1(b).

³¹ S.C. Code Ann. §12-6-590, South Carolina Information Letter No. 21-24, 09/15/2021 & S.C. Code Ann. §12-6-545(B)(2).

³² Tenn. Code Ann. §67-4-2007.

elect for a person who owns more than 50% of capital and profits to pay the entity level tax on behalf of that partner.³³

- Wyoming – N/A.

CONCLUSION

As we have seen, planning around PET can be fruitful and frustrating. For those taxpayers who oper-

ate in several states, this can be maddening. An analysis should be done by client to determine not only if to elect an entity level tax (if you have a choice) but also if to change one's entity structure as discussed above. Does adding a 1% partner makes sense to take advantage of some of these provisions? In many states yes it does. Does changing to S corporation status make sense if one wishes to keep single ownership? Possibly, but in each case new questions arise. This is an important time to meet with one's CPA to determine the best course of action for long-term and short-term tax planning.

³³ Form 5S Tax Option (S) Corporation Taxes (14,513); Wis. Stat. §71.365(4m)(a), Wis. Stat. §71.22(1k), Wis. Stat. §71.23, Wis. Stat. §71.21(6)(a).