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INSIGHT: A More Viable SALT Cap Workaround? Pass-Through Entity-Level Taxes

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Now that the Treasury Department and Internal Revenue Service have issued final regulations to address at least some variations of so-called ''SALT cap workarounds'' to the Tax Cuts and Jobs Act's limitation on individual state and local tax (SALT) deductions, we surveyed the states for one such attempted workaround—mandatory or elective entity-level taxes on (otherwise) pass-through entities (PTEs). The final regulations only address these new entity-level taxes in passing. However, based on public comments and private conversations, Treasury and the IRS are well aware of these efforts and we may see this sort of legislation addressed in the forthcoming proposed regulations referenced in the preamble to the final regulations. Siri Bulusu, *IRS Not Finished Viewing State Programs to Avoid SALT Cap*, Bloomberg Tax: Daily Tax Report (June 27, 2019).

Some tax practitioners and commentators believe this type of avowed SALT cap workaround could indeed survive IRS scrutiny, and both of the authors of this Insight are of that opinion, if the law is properly structured. Keshia Clukey and John Herzfeld, *States Stand by SALT Deduction Workarounds*, Bloomberg Tax: Daily Tax Report (Jun. 12, 2019).

A surprising number of states—at least 10—have explored these taxes, but only five have so far enacted them: Connecticut, Wisconsin, Oklahoma, Louisiana, and Rhode Island (in that order). The Parity for Main Street Employers coalition (PMSE) issued a model act for use by the states, following enactment of the Connecticut statute, but none of the four subsequent laws (discussed below) are identical to the PMSE model act. The Michigan legislature passed a proposal that was vetoed by then-Governor Rick Snyder on Dec. 28, 2018. His veto message regarding S.B. 1170 hinted at his concern over the elective nature of the tax and perhaps the easier target it presents in light of what were then the proposed Treasury SALT cap workaround regulations and related scuttlebutt. And so far, the Connecticut act is the only mandatory version; the other four are elective. An official from the Michigan Department of Treasury, referring to their new Governor's proposal (below), remarked recently: ''Other states (that have enacted these taxes) are more at risk than Michigan because they allowed the tax at the entity level to be optional.'' Clukey and Herzfeld, *States Stand by SALT Deduction Workarounds*, supra.

It seems ironic that only one of the so-called ''high tax states,'' that have complained the loudest about the SALT cap, has enacted a PTE tax as a SALT cap workaround, and only one other high-tax state legislature continues to consider it. To the authors' knowledge, the New York State Unincorporated Business Tax proposal touted last year hasn't even made it into legislative form yet. The other four states that have enacted these taxes so far wouldn't be considered high-tax states, but their legislative leadership nonetheless chose to enact these bills, reportedly at the behest of their small business community and tax practitioners. Odds are the bills that died this session will be re-introduced in similar form during the next session, and we expect to see a few new states dip their toe in the water. If the next set of Treasury regulations attempts to effectively nullify the avowed purpose behind these statutes, however, that

could have a chilling effect. Below is a brief summary of the reported efforts as of July 8:

Arkansas: H.B. 1714 (March 6, 2019) would provide a workaround for individual owners of PTEs whose state and local taxes exceed the $10,000 federal deduction cap. This proposal mirrors the Wisconsin legislation (discussed below) in that it is an elective entity-level tax, but is not an exact replica. The bill would allow specified PTEs to deduct their SALT, just as C corporations are currently allowed to. The bill died at the end of the 2019 session, but Arkansas SALT practitioner, Matt Boch, believes it will resurface in their 2021 biennial session and may then pass, especially in light of the actions of neighboring Louisiana and Oklahoma (discussed below).

Connecticut: As the first state to enact a PTE-level tax publicly touted as a SALT cap workaround, Connecticut now levies an income tax on partnerships and S corporations doing business in the state, effective for tax years beginning on or after Jan. 1, 2018. Individual resident and nonresident owners are allowed a corresponding tax credit against their Connecticut income taxes paid at the entity level. Laura Davidson, Lynnley Browning, Ben Steverman, *New York, Connecticut Taxpayers Have Plan B Options to Beat SALT*, Bloomberg News (Aug. 27, 2018).

The 2018 law generally relieves nonresident PTE owners from their Connecticut individual filing requirement when they have no other sources of Connecticut income and the entity has paid the tax on their behalf. Until recently, guaranteed payments were not included in the entity tax base, and there were no provisions in the law that allowed a partnership to file a composite return on behalf of partners receiving Connecticut-sourced income from guaranteed payments. Nonresident partners with guaranteed payments were still required to file a Connecticut individual income tax return. The Department of Revenue Services recently provided guidance allowing PTEs to enter into agreements to report and remit the tax on behalf of their nonresident partners receiving Connecticut sourced guaranteed payments from the PTE for the PTE's taxable year 2018. This option does not relieve the partner of its Connecticut filing obligation if the partner had other Connecticut-source income.

H.B. 7373, signed into law by Gov. Lamont on July 8, 2019, amends their PTE tax statute to include guaranteed payments as part of the tax base and eliminates the estimated tax payment requirement for PTEs with a tax liability of less than $1,000. In addition, the Connecticut budget bill, H.B. 7424, signed by Lamont on June 26, 2019, reduces a PTE owner's tax credit from 93.01% of the tax paid by the PTE to 87.5%, retroactively to taxable years beginning on and after Jan. 1, 2019. Taxpayers will not be held liable for estimated tax or underpayment interest for periods prior to the change taking effect.

Louisiana: On June 22, 2019, Gov. Edwards signed S.B. 223 into law, allowing PTEs to elect to treat themselves as state C corporations, retroactively effective to tax years beginning on or after January 1, 2019. In effect, the bill allows individual owners to exclude from Louisiana income the net income or losses received from the electing entity, with the election to last until the Louisiana Secretary of Revenue consents to its termination. Instead of the current corporate income tax rates (ranging from 4% to 8%), though, PTEs that elect state C corporation status will pay tax at the rate of 2% on the first $25,000 of taxable income, 4% on the next $75,000, and 6% on taxable income over $100,000. There are some indications that the three-tiered rate structure is designed to be revenue neutral.

Michigan: On March 5, 2019, Gov. Whitmer proposed a SALT cap workaround for PTEs that was eventually incorporated into H.B. 4781 and introduced on June 26, 2019. The bill would increase the PTE tax from a 4.25% income tax imposed at the individual level to an 8.5% tax imposed at the PTE level, with a corresponding individual tax credit, effective in 2020. The state corporate income tax rate would also increase to 8.5%. In contrast to last year's legislative proposal, the new tax would be mandatory and would raise substantial revenue.

According to Lynn Gandhi of the Honigman law firm, the new bill may have tough sledding due to its mandatory nature and relatively high rate of tax.

Minnesota: Similar to several other states' bills, S.F. 304 would allow certain federal PTEs to make a four-year election to file as a state C corporation. The Senate Committee on Taxes held a hearing on the bill on March 14, but the legislature adjourned in the meantime. Dale Busacker of Grant Thornton LLP predicts the bill will be re-introduced next session.

New Jersey: On May 16, New Jersey lawmakers introduced S.B. 3246 and its companion, A.B. 4807, to create an elective entity-level tax on PTEs. If a PTE were to elect to be taxed as a state C corporation under the bill, the owners would be entitled to claim a refundable gross income tax credit. The bill would establish four tiers of tax rates, beginning at 5.525% if the distributive proceeds of the PTE are less than $250,000 annually, and increasing to 10.75% if the distributive proceeds exceed $3 million. If enacted, the legislation would be retroactive to tax years beginning on or after Jan. 1, 2018. The legislation is similar to that of Oklahoma and Louisiana.

Oklahoma: On April 29, Gov. Stitt signed into law H.B. 2665, the ''Oklahoma Pass-Through Entity Tax Equity Act of 2019,'' which adopts an elective entity-level PTE income tax, coordinates provisions of that tax with the state individual income tax, and makes administrative and procedural changes to implement the tax. Entities seeking to be subject to the tax for taxable years beginning on and after Jan. 1, 2019 and prior to Jan. 1, 2020 were required to file elections *within 60 days of the date of enactment of the legislation,* i.e., no later than June 28. For taxable years beginning on and after Jan. 1, 2020, the election must be made (or revoked) during the preceding taxable year or as late as two months and 15 days after the beginning of the taxpayer's taxable year, and will relate back to the first day of the taxpayer's taxable year.

The tax is calculated by multiplying each PTE owner's distributive or pro rata share by their applicable tax rate: the highest individual marginal rate (currently 5%); 6% for corporations, pass-through entities, or financial institutions; or for exempt organizations, the highest marginal rate that would apply to any item of the electing pass-through entity's income or gain absent the election, and then aggregating the result.

Rhode Island: On Feb. 27, 2019, H.B. 5576 and companion bill, S.B. 564, was introduced and would allow a PTE to elect to pay an income tax at the entity level at a 5.99% tax rate. The proposal was later rolled into the

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omnibus budget bill, H. 5151 Substitute A. Gov. Raimondo signed the bill into law on July 5. Aaron Nicodemus, *Rhode Island Governor Approves SALT Deduction Cap Workaround*, Bloomberg Tax: Daily Tax Report (Jul. 5, 2019). The act also allows individual PTE owners to claim a state tax credit on their state personal income tax return. The bill was generally modeled after the Connecticut law but is elective. This makes the Ocean State the 5th state to enact an avowed SALT cap workaround and the 4th to make the PTE tax elective.

Wisconsin: As mentioned, Wisconsin was the second state to enact a PTE-level tax termed a SALT cap workaround. Act 2017-368 (Dec. 14, 2018) permits PTEs to elect into or revoke the election of a 7.9% pass-through entity tax, by a vote of at least 50% of the shareholders for an S corporation or at least 50% of the capital and profits interests of a partnership. The election became available for S corporations and LLCs taxed as S corporations effective Jan. 1, 2018, and for entities taxed as partnerships effective Jan. 1, 2019. If the election is timely made, PTE owners do not include the PTE's items of income, expense, gain, or loss in their individual income, and the PTE pays the tax on the items that would otherwise be taxed in the hands of the owners absent the election. Nonresident PTE owners' income attributable to Wisconsin is not included in the separate pass-through entity withholding tax base, and Wisconsin resident PTE owners cannot take a Wisconsin tax credit for taxes paid to other states by the PTE at the entity level on their individual returns if the PTE has elected to pay the tax and claimed the credit.

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Author Information *All opinions expressed in this Insight are those of the authors and not necessarily their respective law firms or the ABA Section of Taxation SALT Committee.*

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