

SALT cap work-arounds for pass-through entities can decrease individual taxes.

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Prior to 2018, an individual taxpayer was allowed to deduct state and local property tax as well as either state and local income or sales taxes, as itemized deductions, without limitation (other than the Pease limitations¹).

The SALT Cap

The 2017 Tax Cuts and Jobs Act (TCJA) imposed limits on the total deduction an individual taxpayer can claim for personal state and local taxes to \$10,000 for 2018 through 2025. This SALT cap only applies to individuals and does not apply to business entities, and will expire at the end of 2025 under the terms of the TCJA, unless subsequent legislation is enacted to extend or make it permanent.

For example, if a taxpayer paid state income tax of \$11,000, real property tax of \$10,000, and state sales tax of \$8,000, in 2017 the taxpayer could deduct \$21,000 (\$10,000 in property tax and income tax of \$11,000, since this amount is larger than the sales tax of \$8,000). If the same taxes are paid in 2022, the total deduction would be limited to \$10,000. The \$10,000 limit on personal state and local taxes is reduced to \$5,000 in the case of a married individual filing a separate return.

Work-arounds for pass-throughs

After 2017, many states began looking for ways to alleviate the increased tax burdens on their residents due to the SALT cap. As of March 2022, twenty-two states have



enacted legislation allowing a pass-through entity (PTE) to elect to pay the tax and provide an owner a credit or deduction for the tax paid by the pass-through entity.

The first state to enact a SALT cap work-around was Connecticut. Other states with work-arounds include Alabama, Arizona, Arkansas, California, Colorado, Georgia, Idaho, Illinois, Louisiana, Maryland, Michigan, Massachusetts, Minnesota, North Carolina, New Jersey, New York, Oklahoma, Oregon, Rhode Island, South Carolina, and Wisconsin.

Seven additional states that have introduced PTE tax bills include Iowa, Mississippi, Ohio, New Mexico, Pennsylvania, Utah, and Virginia.

Work-arounds are different for each state, and taxpayers who want to take advantage of the work-arounds

should discuss the specific rules for their state, or other states in which they pay taxes, with their accountants or attorneys. Many states have deadlines for making an election and making estimated tax payments, so early planning and implementation is critical.

Entity Level Taxation

Since the SALT cap only applies to individuals and not to business entities, the work-arounds usually impose an entity level income tax on pass-through entities such as partnerships, limited liability companies taxed as partnerships, and Subchapter S corporations. When the individual owners of the PTEs report their share of the entity's

¹ Pease limitations reduced certain itemized deductions for taxpayers whose AGI exceeded stated amounts (in 2017, \$261,500 for single taxpayers/\$313,800 for taxpayers filing a joint return).

income on their individual income tax returns, the entity level work-arounds shift state taxes on PTE income to the PTE and away from the individual owner.

While the specific requirements vary from state to state, the states have generally adopted one of two approaches, either an exclusion from income or a credit for the state and local taxes paid.

- Under the exclusion method, income that is taxed at the PTE level is excluded from the owner's state taxable income.
- Under the credit method, the PTE owner's share of distributed income is passed through in the usual method and the individual owners are allowed a credit for the tax paid by the PTE.

The information below highlights the New York credit and the Georgia exclusion as examples of how each method works.

New York Pass-Through Entity Tax (PTET)

Eligible entities include partnerships and New York S corporations. An eligible entity must make a timely election to pay the PTET. For 2022, the election must have been made by March 15, 2022.

- The New York PTE pays an entity level tax at the same personal income tax rate on that income which would have been subject to New York personal income tax by its owners on a flow-through basis.
- Payments are made in quarterly installments on March 15, June 15, September 15, and December 15.
- Credit is then allocated among the owners in the same percentages in which the income taxable in New York would have been allocated to those owners.

- Credit is claimed on the New York state personal income tax returns of each owner.

EXAMPLE. Assume a New York partnership, NYS, has three equal partners: Hudson, Della, and Larry. The partnership makes the election and has income of \$1,500,000 before any New York state income tax. Quarterly installments totaling \$102,750 ($\$1,500,000 \times 6.85\%$ NY tax rate) are paid.

For federal income tax purposes, the amount of ordinary income allocated to each partner would have been \$500,000 ($\$1,500,000/3$) if no election was made.

With the election in place, ordinary income allocated to each partner's federal income tax return is now \$465,750 ($\$500,000 - \$34,250$). Since the partnership paid the tax, the partners are not required to report the tax paid as SALT for purposes of personal itemized deductions on their individual federal income tax returns.

For New York state individual income tax purposes, the amount of tax paid by the partnership allocated to each partner would be a New York state add-back. Assuming no other add-backs, each partner would report a New York state taxable income of \$500,000 and then report a credit of \$34,250.

See example below.

Georgia PTE Work-around

Eligible entities include S corporations and partnerships that are 100% directly owned and controlled by individuals. Accordingly, PTEs with corporate shareholders or partners are not eligible to make the election in Georgia.

Upon making the election, the PTE is subject to the entity level tax at the maximum Georgia individual tax rate of 5.75%. Under Georgia's workaround, the individual owners subtract (exclude) the income subject to the entity level income tax from their individual Georgia income tax return.

EXAMPLE. Assume a Georgia partnership, ATL, with two equal partners: Cobb, and DeKalb. The partnership makes the election and has income of \$2,000,000 before taxes. Georgia income tax of \$115,000 ($\$2,000,000 \times 5.75\%$ GA tax rate) is paid on business income.

For federal income tax purposes, the amount of ordinary income allocated to each partner would have been \$1,000,000 ($\$2,000,000/2$) if no election was made, and each partner would be limited to a deduction of \$10,000.

With the election in place, ordinary income allocated to each partner's federal and state income tax return is now \$942,500 ($\$1,000,000 - \$57,500$).

New York PTET Example		
Tax Summary / Partner	No election	Election
New York PTE tax	-0-	\$34,250
New York tax - paid by owners	\$34,250	-0-
Federal AGI	\$500,000	\$465,750
Standard deduction (single filer)	(\$12,400)	(\$12,400)
Taxable income (federal)	\$487,600	\$453,350
Federal tax - paid by owners	\$145,204	\$133,217
Total tax paid	\$179,454	\$167,467
Estimated savings		\$11,988

Georgia PTET Example

Tax Summary / Partner	No election	Election
Georgia PTE tax	-0-	\$57,500
Georgia tax - paid by owners	\$57,500	-0-
Federal AGI	\$1,000,000	\$942,500
Standard deduction (single filer)	(\$12,400)	(\$12,400)
Taxable income (federal)	\$987,600	\$930,100
Federal tax - paid by owners	\$329,484	\$308,209
Total tax paid	\$386,984	\$365,709
Estimated savings		\$21,275

If the election is made, federal income tax is \$308,209 (maximum tax rate of 37%, with taxable income of \$930,100).

If no election is made, federal tax is \$329,484, with taxable income of \$987,600 (\$1,000,000 – standard deduction of \$12,400). Federal taxes are based on 2022 rate schedule for a single taxpayer. See example above.

These examples are fairly simple, and it should be noted that if the taxpayer is itemizing his or her deductions, results may vary depending on the

types and amounts of deductible expenses.

Additionally, non-resident filers, taxpayers who pay state taxes in several states, or taxpayers who do not owe state taxes, may find that the work-around is more complex and may not be advantageous.

IRS Notice 2020-75

IRS issued this Notice in November 2020 and stated that it intended to issue proposed regulations clarifying that specified income tax payments

are deductible by a PTE corporation in computing its non-separately stated income or loss. A specified income tax payment is defined as any amount paid by a partnership or an S corporation to a state, a political subdivision of a state, or to the District of Columbia to satisfy its liability for income taxes imposed by such state or local government on the partnership or S corporation.

While the IRS has not recognized individual work-arounds to the SALT cap deduction, Notice 2020-75 gave states a green light to enact their own PTE taxes.

Conclusion

Taxpayers should work with their financial advisors to determine whether a work-around could reduce their federal income tax liability. Those who itemize and pay more in state and local property taxes and income or sales taxes than they are allowed to deduct on their federal income tax return due to the SALT limitations may benefit.



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