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State Law & State Taxation Corner

States Turn to Passthrough Entity Taxes for SALT Deduction Workaround 2.0

By John A. Biek*

Introduction

Many of our readers who have prepared their 2018 federal income tax return (or at least signed it) are painfully aware that the federal itemized deduction for an individual's payments of state and local income taxes, sales taxes and property taxes is now capped at $10,000 ($5,000 for married, filing separately taxpayers). The Tax Cuts and Jobs Act of 2017[1] made this controversial change to Code Sec. 164(b)(6) to help Congressional Republicans hold the overall cost of the tax cuts to $1.5 trillion over 10 years. But the Tax Cuts and Jobs Act did not limit the ability of businesses to deduct their state and local taxes, an indication of how heavily this 2017 federal tax legislation focused on reducing tax burdens on businesses.

The new $10,000 cap on the state and local tax deduction for individuals is unquestionably a serious blow to residents of so-called "blue states" with relatively high income tax rates. The Treasury Inspector General for Tax Administration issued a report on February 22, 2019, estimating that the $10,000 cap will prevent nearly 11 million taxpayers from deducting approximately $323 billion of state and local taxes each year.[2] This will undoubtedly result in a significant federal tax increase for many of those taxpayers.

In 2018, some of the blue states tried to save their taxpayers from this federal tax hit by writing legislation that would allow an individual to make a contribution to a state or local government fund in return for a corresponding credit against the individual's state personal income taxes or property taxes, with the hope that the individual would also be allowed to claim a charitable deduction for the amount of the contribution on the individual's federal tax return. After the IRS announced in May 2018 that it will deny the charitable deduction for this type of payment to a government fund, the SALT deduction workaround legislation became problematic.

A couple of states have now attempted to finesse the $10,000 SALT deduction cap by enacting legislation that couples an entity-level income tax on passthrough entities with a tax credit or an exclusion of the distributive share of the passthrough entity's income on the partner's or shareholder's state personal income tax return. As a business, the passthrough entity should presumably be allowed to deduct the entire amount of its entity-level tax payment on its federal tax return, while the tax credit or exclusion would correspondingly reduce the amount of income tax that the partner or shareholder has to pay to the state. Although the IRS has not yet given its view of this second round of state SALT workaround legislation, it appears to have a much better chance of achieving its federal and state tax objectives than the first round of such workaround legislation did.

Taxpayer Contributions to Government Funds *In Lieu* of State Taxes

In 2018, California, Illinois, New Jersey, New York and Oregon considered, and in some instances enacted, legislation that would allow an individual to make a contribution to a designated government fund that would then be credited against the individual's state or local tax liability. The credit would reduce the amount of taxes that the individual was required to pay to the state or local government. The obvious goal of this workaround legislation was to convert state and local tax payments that would exceed the new federal $10,000 cap on the state and local tax deduction into contributions to a government fund that, it was hoped, could be deducted as a charitable contribution on the individual's federal tax return.

Enacted into law on May 4, 2018, New Jersey S. 1893[3] allows municipalities, counties and school districts in New Jersey ("local units") to adopt an ordinance or resolution establishing charitable funds that support specified public purposes of the local unit.[4] The ordinance or resolution will establish an annual limit on the total amount of donations to the charitable fund that can qualify for property tax credits, as well as a limit on the amount of tax-credit-eligible donations that a particular property owner will be allowed to make to the charitable fund.[5] The property owner must make the donation to a charitable fund in the local unit where the owner's property parcel is located. The fund administrator will then provide a receipt to the property owner confirming the amount of the donation and notify the municipal tax collector of both the donation amount and the amount of tax credit available to the property owner as a result of the donation.[6] The property tax credit equals 90 percent of the donation amount, and excess credits can be carried forward for five years.[7] This New Jersey legislation was the first of the state SALT deduction workarounds to be enacted into law in 2018.

At about the same time, the California legislature was considering S.B. No. 539, which would have expanded the existing State College Access Tax Credit Fund program to help California taxpayers work around the new $10,000 cap on the federal itemized state and local tax deduction. Specifically, S.B. No. 539 would have, for tax years 2018 through 2023, increased the amount of the income tax credit arising from taxpayer contributions to the College Access Tax Credit Fund from 50 percent to 75 percent of the amount of the contribution.[8] S.B. No. 539 would have imposed a $1 billion annual cap on credit-eligible contributions to the College Access Tax Credit Fund, and the California Educational Facilities Authority would have certified the tax credits on a first-come, first-served basis.[9] Unused income tax credits could be carried forward for five years.[10]

California S.B. No. 539 was approved by both chambers of the state legislature on August 31, 2018. As discussed below, California Governor Jerry Brown vetoed this legislation two months later, in reaction to the IRS's announcement that contributions made to government funds *in lieu* of state tax lability will not qualify as charitable deductions on the donor's federal income tax return.

Not to be outdone by California, the Illinois legislature was working on H.B. 4237 in early 2018. This legislation would have established the Illinois Educational Excellence Fund to support public education in Illinois.[11] Taxpayers making contributions to the Illinois Educational Excellence Fund during tax years 2018 through 2025 would have received an income tax credit equal to the entire amount of the contribution.[12] Unused tax credits could be carried over for five years. The Illinois House of Representatives approved H.B. 4237 by a 93-15 vote on April 18, 2018, and sent the bill to the Senate, where it was amended and approved by a 54-1 vote on May 24, 2018. H.B. 4237 was then returned to the House, where it languished for the remainder of the 2018 legislative term.

Oregon S.B. 1528 created an Opportunity Grant Fund, contributions to which give rise to tax credits against the donor's Oregon income tax liability. Governor Kate Brown signed this legislation on April 13, 2018.

New York took a more comprehensive approach to state SALT deduction workaround legislation with S. 7509. Part LL of this legislation took the familiar path of creating a special fund known as the "charitable gifts trust fund" under the joint custody of the Commissioner of Taxation and Finance and the State Comptroller.[13] This fund supports health care and elementary and secondary education in New York.[14] Starting in tax year 2019, contributions to the charitable gifts trust fund will give rise to an income tax credit equal to 85 percent of the amount of the contribution made in the preceding tax year.[15] S. 7509 also authorizes municipalities to establish educational funds to which property owners can make contributions to earn a real estate tax credit equal to as much as 95 percent of the amount of that contribution.[16]

The more imaginative facet of S. 7509 is its elective employer compensation expense tax that takes advantage of the Tax Cuts and Jobs Act not imposing a cap on the deduction of state and local taxes paid by businesses. An employer is allowed to make an annual election, by December 1 for the following tax year, to be subject to the employer compensation expense tax on the amount of wages and compensation in excess of $40,000 paid to each of its "covered employee" working in New York.[17] The rate of the employer compensation expense tax is 1.5 percent in 2019, three percent in 2020 and five percent starting in 2021.[18] S. 7509 makes it clear that this tax is imposed *on the employer*, by prohibiting it from withholding the tax from the covered employee's wages and compensation.[19]

The covered employee is then given a credit against his or her New York personal income tax liability, the amount of which is determined by the following formula: the amount of the covered employee's wages and compensation exceeding $40,000 for the tax year, multiplied by the rate of the employer compensation expense tax paid for that tax year, multiplied by 1 minus the fraction of the covered employee's New York personal income tax liability divided by that employee's New York taxable income.[20] It appears that the New York legislature assumed that many employers electing to pay the employer compensation expense tax will reduce the wages and compensation of their covered employees by the cost of the tax that the employer pays with respect to that covered employee. To make that covered employee whole for his or her lost wages and compensation, the tax credit correspondingly reduces the covered employee's New York personal income tax liability, dollar for dollar, by the after-tax amount of the lost wages and compensation.

We are still in the early innings, but employers may find it difficult to convince their covered employees that they are better off with a combination of reduced wages and compensation and correspondingly less New York personal income tax liability than if the covered employee received the full amount of his or her wages and compensation, but has to make New York personal income tax payments that are not deductible on the covered employee's federal tax return. This economic analysis will probably depend on each covered employee's financial circumstances, and not all covered employees may benefit from the employer's election to be subject to the New York employer compensation expense tax. It appears that the New York employer compensation expense tax may be better suited for a small closely held business where the covered employees could be educated and brought on board with the company's decision to participate in the New York employer compensation expense tax regime.

Many state and local tax practitioners were skeptical that the IRS would allow taxpayers to claim the federal charitable tax deduction for their contributions to a government fund in exchange for a credit that significantly reduces the taxpayer's state and local tax liability, because the charitable tax deduction is normally reduced by the amount of any benefit the taxpayer receives for making the contribution. On May 23, 2018, the IRS proved to be the skunk at the party when it issued a brief notice that this state government fund workaround legislation will not achieve its federal tax objective of a charitable deduction for the individual's payment to the government fund. Notice 2018-54 observed that "[i]n response to this new limitation [on the federal state and local tax deduction for individuals] some state legislatures are considering or have adopted legislative proposals that would allow taxpayers to make transfers to funds controlled by state or local governments, or other transfers specified by the state, in exchange for credits against the state or local taxes that the taxpayer is required to pay. The aim of these proposals is to allow taxpayers to characterize such transfers as fully deductible charitable contributions for federal income tax purposes, while using the same transfers to satisfy state or local tax liabilities."[21] The IRS warned that "[d]espite these state efforts to circumvent the new statutory limitation on state and local tax deductions, *taxpayers should be mindful that federal law controls the proper characterization of payments for federal income tax purposes.*"[22] The IRS advised that the Treasury Department planned to propose a regulation denying individual taxpayers the charitable deduction for contributions made to government funds in exchange for a credit against state or local tax liability of the taxpayer.

On August 27, 2018, the Treasury Department followed through by issuing a proposed regulation under Code Sec. 170 providing that "if a taxpayer makes a payment or transfers property to or for the use of an entity listed in section 170(c), the amount of the taxpayer's charitable contribution deduction under section 170(a) is reduced by the amount of any state or local tax credit that the taxpayer receives or expects to receive in consideration for the taxpayer's payment or transfer."[23]

Notice 2018-54 had its intended effect. In October 2018, the California governor vetoed California S.B. 539, citing concerns that the forthcoming Treasury regulations would make this state SALT deduction workaround legislation moot. Meanwhile, the Illinois General Assembly allowed H.B. 4237 to die at the end of the 2018 legislative session.

Passthrough Entity Tax Payments Coupled with a Personal Income Tax Credit or Exclusion

New York S. 7509 showed foresight when it created a business entity-level tax payable on wages or compensation of its employees and gave those employees an offsetting credit that reduced their New York personal income tax liability. The employer compensation expense tax payment by the employer should be fully deductible under Code Sec. 164. Meanwhile, the covered employee pays a correspondingly smaller amount of New York personal income tax after application of the credit, resulting in the employee having a smaller amount of state and local taxes that exceed the $10,000 cap on the federal itemized deduction for state and local taxes. The New York employer compensation expense tax appears to be a viable SALT deduction workaround, albeit a rather complicated one.

The Connecticut legislature followed suit by crafting a state SALT deduction workaround bill, S.B. 11, that the Connecticut governor approved on May 31, 2018, one week after the IRS issued Notice 2018-54.[24] Because this legislation was drafted prior to this notice, S.B. 11 included a provision allowing municipalities to provide a residential property tax credit in return for donations by property owners to a community supporting organization designated by the municipality.[25] This part of S.B. 11 became problematic after the IRS announced that such a donation would not qualify as a tax-deductible charitable contribution on the property owner's federal income tax return.

However, S.B. 11 also included a new elective 6.99 percent entity-level tax on the Connecticut-sourced income of a partnership or S corporation (an "affected business entity") that is credited against the Connecticut tax liability of the partners or shareholders of the affected business entity.[26] The amount of the credit equals 93 percent of the partner or shareholder's *pro rata* share of the affected business entity's tax payment.[27]

The Arkansas legislature is considering a similar passthrough entity tax and offsetting credit for partners and shareholders of a partnership, LLC or S corporation.[28]

Wisconsin took a slightly different approach to passthrough entity taxes in S.B. 883, which was enacted on December 14, 2018.[29] This legislation allows a partnership, LLC or S corporation to elect to pay a 7.9 percent entity-level tax on the Wisconsin-sourced income of that passthrough entity, and its partners or shareholders are then allowed to exclude their distributive share of the passthrough entity's income from the partner's or shareholder's Wisconsin taxable income.[30] Again, the passthrough entity should be allowed to deduct the amount of its entity-level tax payment on its federal tax return, while the exclusion reduces the amount of Wisconsin personal income taxes that the partner or shareholder might otherwise have to pay in excess of the $10,000 cap on the federal itemized deduction for state and local taxes. Interestingly, the 7.9 percent rate of the Wisconsin passthrough entity tax is pegged to the highest marginal rate of the Wisconsin corporate income tax, rather than the Wisconsin marginal personal income tax rates, which top out at 7.65 percent. Wisconsin passthrough entities will need to consider the rates of personal income tax that their partners or shareholders are paying to Wisconsin to decide whether it makes economic sense for the passthrough entity to elect into this new Wisconsin passthrough entity tax regime.

Conclusion

The new $10,000 federal cap on the federal itemized state and local tax deduction has created a lot of tax gymnastics at the state level. Once the IRS announced in May 2018 that it will not allow the federal charitable deduction for contributions that an individual makes to a state or local government fund to the extent of the tax credit the individual is provided to reduce his or her state or local tax liability, that sealed the fate of the first round of state SALT deduction workaround legislation.

This second round of legislation shows greater promise by coupling a passthrough entity-level tax payment to the state with a corresponding tax credit or exclusion that reduces the partner's or shareholder's personal income tax liability to the state. Code Sec. 164 continues to allow a business to deduct state and local tax payments in full, and it does not appear that the state tax benefit that the partner or shareholder realizes from the credit or exclusion should deprive the passthrough entity of its federal tax deduction for its passthrough entity tax payment. Meanwhile, the states are free to reduce the amount of tax liability that the partner or shareholder owes to the state through application of the tax credit or exclusion. The partner or shareholder is not claiming any federal tax deduction in connection with the passthrough entity tax payment that the IRS could deny in light of the partner or shareholder having received a tax credit or exclusion that reduced the partner's or shareholder's state tax liability. The exclusion is probably the preferable route for this second round of state SALT deduction workaround legislation because the exclusion prevents the partner or shareholder from having state income tax liability in the first place, whereas the tax credit offsets the amount of state and local tax liability of the partner or shareholder.

Unfortunately, this second round of state SALT deduction workaround legislation only benefits owners of passthrough entities, leaving employees looking for relief from the $10,000 cap on the federal itemized deduction for state and local taxes. The New York employer compensation expense tax could provide a solution for employees of public and privately owned companies, but this New York tax and credit is rather convoluted. Employees may want to stay tuned for a SALT deduction workaround legislation 3.0—or await 2026, when state and local taxes will once again be fully deductible on the federal individual tax return.

ENDNOTES

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[1] Tax Cuts and Jobs Act, P.L. 115-97, §11042, 131 Stat. 2054 (2017) (codified as Code Sec. 164(b)(6)).

[2] Joshua Rosenberg, *SALT Cap Will Prevent $323B in Deductions, TIGTA Says* (Feb. 26, 2019), available online at *www.law360.com/tax/articles/1133347*; U.S. Treasury Inspector General for Tax Administration, Review of the Issuance Process for Notice 2018-54 (reference no. 2019-14-019) (Feb. 22, 2019), available online at *www.treasury.gov/tigta/auditreports/2019reports/201914019fr.pdf.*

[3] N. J. S. 1893, enacted as P.L. 2018, ch. 11 (eff. May 4, 2018).

[4] N. J. Rev. Stat. §54:4-66.7(a).

[5] N. J. Rev. Stat. §54:4-66.7(d).

[6] N. J. Rev. Stat. §54:4-66.8.

[7] N. J. Rev. Stat. §54:4-66.9.

[8] Cal. S.B. No. 539, §2 (amending Cal. Rev. & Tax Code §12207 and §17053.87).

[9] *Id.*

[10] Cal. S.B. No. 539, §2 (amending Cal. Rev. & Tax Code §17053.87(c) and §23687(c)).

[11] Ill. H.B. 4237 (introduced on Jan. 11, 2018).

[12] *Id.* (proposing new 35 ILCS 5/228).

[13] N.Y. S 7509, Part LL §1 (adding new N.Y. Finance Law §92-gg).

[14] *Id.*

[15] N.Y. S 7509, Part LL §4 (adding new N.Y. Tax Law §606).

[16] N.Y. S 7509, Part LL §9 (adding new N.Y. Real Property Tax Law §980-a).

[17] N.Y. Tax Law §851.

[18] N.Y. Tax Law §852.

[19] N.Y. Tax Law §853.

[20] N.Y. Tax Law §606(ccc) and §855.

[21] Internal Revenue Service Notice 2018-54 (May 23, 2018), 2018 IRB Lexis 338, 2018-24 IRB 750.

[22] *Id.* (emphasis added).

[23] Proposed Reg. §1.170A-1(h)(3)(i).

[24] Conn. S.B. 11, P.A. 18-49 (approved May 31, 2018).

[25] Conn. S.B. 11, §10.

[26] Conn. S.B. 11, §1.

[27] *Id.*, §1(g)(1).

[28] Ark. H.B. 1714.

[29] Wis. S.B. 883, 2017 Wis. Act 368 (approved Dec. 14, 2018).

[30] Wis. S.B. 883, §§2, 7, 8 and 11.