THE FEDERAL TAX DEDUCTION WORKAROUND FOR STATE AND LOCAL TAXES

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Since the 2018 tax law change, the Schedule A itemized deduction for state and local taxes (SALT) has been capped at $10,000 ($5,000 if married filing separately) for 2018-2025. For those of us living in high-tax states and localities, the cap is significant. With top state and local income tax rates such as 10.75% in New Jersey, 10.9% in New York and 12.3% in California, high-income individuals paying tens and hundreds of thousands of dollars face significant increases to their Federal tax liability.

As we've discussed with many of our clients impacted by the SALT cap, where there's a will, there may be a way. Several states have created workarounds that allow individuals to receive a federal deduction for at least a portion of the taxes they pay to that state. While it may seem odd that states are actively creating Federal tax avoidance strategies, the SALT cap made living in expensive states a little (or a lot) more expensive. Combined with a wave of individuals leaving high-tax states and cities to work remotely, it appears the states are engaging in damage control.

Pass-through Entity Election

Typically, income from a pass-through entity is passed through to its owners for both Federal and state income tax purposes. Owners file state income tax returns and pay state income tax on their share of the entity's taxable income. Sometimes, the pass-through entity pays the state taxes on the on the owners' behalf, either through withholding or along with a composite return. Either way, the owners then deduct their state income tax payments (whether made directly to the state or paid on their behalf by the pass-through entity) on Schedule A, where they are subject to the SALT cap.

Several states have passed legislation that allows pass through entities (generally, partnership and S corporations) to elect to make state income tax payments at the entity level, rather than passing the income through to the entity owners for state income tax purposes. This allows the entities to deduct the state income tax as an expense on their Federal return. At the state level, the tax payments are passed to the partner not as tax withheld or composite tax paid, but as either refundable or nonrefundable state tax credits. Or, sometimes, in lieu of a state tax credit, the state allows for the income taxed at the entity level to be deducted from the owner's state taxable income.

Example: State X has a 7% income tax rate. Tax E. Vader, who is married and files a joint Federal income tax return, is a partner in Wasta Partnership, which does all its business in State X. For 2022, Wasta allocates James $200,000 of taxable income. State X has not enacted a pass-through entity election. James pays $14,000 ($200,000 x 7%) of state income tax to State X. He also pays $9,000 of real property taxes for $23,000. But, due to the SALT cap, he can only deduct $10,000 on his Federal income tax return. No Federal deduction is available for the remaining $13,000 of SALT.

Variation: Assume State X is now New Jersey (rounding off the marginal tax bracket) which provides for a pass through entity election and Wasta makes the election. Now, Wasta pays New Jersey income tax at the entity level. Tax E. Vader's share of that tax (regardless of the amount) reduces the income that Wasta passes through to him for Federal income tax purposes. If Tax E. Vader's share of the state tax paid by the partnership is $14,000, Wasta passes through $186,000 ($200,000 - $14,000) of taxable income to James for Federal income tax. In addition, he can deduct his $9,000 of property taxes on Schedule A. So, Wasta's pass through entity election in New Jersey reduced Tax E. Vader's 2022 federal taxable income by $13,000 ($14,000 decrease in pass through income from Wasta combined with a $1,000 reduction in Sch A SALT deduction).

The pass-through entity election can also benefit owners who don't receive a benefit for an itemized state income tax deduction because they use the standard deduction. The state taxes paid at the entity level effectively become business deductions that otherwise would have been lost as itemized deductions. At Abo and Company's last count, we noted 19 states had passed legislation allowing pass-through elections (sorry Pennsylvania). The laws are generally effective for 2021 or earlier. Each state approaches the pass through entity election differently. Some differences include:

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- Whether the pass through entity owner receives a state credit or a state income tax deduction for income taxed at the entity level.
- Whether any credit is refundable or nonrefundable.
- Whether nonrefundable credits can be carried forward and if so, for how long.
- How and when the pass through entity makes the election.
- The tax rate at which the entity pays the taxes-typically it's the highest individual rate.

It's hard to believe but on November 9, 2020, the IRS issued Notice 2020-75 which stated its intention to issue proposed regulations to clarify that State and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment. In the notice, the IRS asserts that state taxes owed and paid at the entity level are deductible against income by the pass through entity.

Abo and Company Tip

Remember that this is a relatively new tax strategy. States are still trying to flesh out regulations and guidance to address loopholes, abuses, and ambiguities. As this is much on the IRS' and Congress' radar and the SALT cap is a hot topic and bargaining chip in Congress, it's important to stay updated on the developments regarding pass through entity elections at both the federal and state levels.

Abo and Company Caution

It is not clear how the pass-through entity election will affect owners that are not residents of the state allowing the election. For example, if the state tax is paid at the entity level, owners that are not residents of that state probably cannot claim a credit for taxes paid to other states on their resident state income tax return if their state of residence does not have a pass-through entity election provision. Likewise, if the nonresident state allows for a deduction of income taxed at the entity level, the owner will still have to pay state taxes on the resident return on the total income from the entity. Unless states without pass-through entity elections enact some provision to avoid double taxation, de facto double taxation is definitely a concern for those in such a situation.

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