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THE CONNECTICUT PASS-THROUGH ENTITY TAX AND THE FEDERAL SALT DEDUCTION: A PERFECT MATCH?

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On May 31, 2018, Connecticut enacted Public Act 18-49, establishing the Pass-Through Entity Tax. As has been written about in this publication and elsewhere, the PET, as it's known, responds to the $10,000 limitation on an individual's federal state and local tax (SALT) following passage of the 2017 Tax Cuts and Jobs Act (TCJA). The idea is to push the incidence of the state tax from the individual, where the tax burden usually falls with a pass-through entity, but who is now limited in the available federal deduction for state taxes, to the entity itself, which is not subject to the $10,000 limitation on deductions for state and local taxes.

SALT Deduction Workarounds and the PET

High-tax states, including New York and New Jersey, have taken other routes to reduce the pain of the SALT deduction limitation to its residents. Most popular among the workarounds has been the charitable contribution in lieu of a variety of state and municipal taxes, such as property taxes. As has been well publicized, these workarounds operate by allowing individuals to make a contribution to a state or municipal fund—some of them predating the TCJA and others created in response—and then receiving a credit towards their property taxes or other type of tax. This was also a clever response, but perhaps too clever. The IRS quickly stepped in to clarify that it would not consider such contributions as charitable and thus eligible for a deduction. As stated in the proposed regulations, Treasury and the IRS made clear that because the individual receives a benefit by making a contribution to a fund—snow-plowed roads, free public schools, for example—she has not made a charitable contribution that would be fully deductible.

But the Connecticut PET is different than the charitable workarounds. And quite cleverly, it has been designed to provide maximum benefits to high-income Connecticut residents who might suffer the largest consequences of the SALT deduction limitation. Here's how it works. The tax is imposed on all pass-through entities (other than disregarded entities, which by definition, are disregarded for income tax purposes and publicly traded partnerships) at the highest personal

income tax rate (6.99%). Most entities will pay tax using the standard base, which is all Connecticut source income. Individual shareholders/partners/members then take a credit of 93.01% of the tax on their distributive share of the income against their Connecticut tax liabilities. Thus, a nonresident of Connecticut who only pays tax to Connecticut on the source income distributed to it from the pass-through entity, likely will owe no tax (and does not even have to file a return according to the law) to Connecticut when all is said and done. This alleviates the individual's need for the federal deduction, at least on the Connecticut tax on that income.

But Connecticut also offers an alternative means for calculating the PET, designed to benefit entities with a significant amount of intangible income (that wouldn't be included in the standard base) and a substantial number of individual resident partners. Under the alternative base, pass-through entities calculate the Connecticut source income received directly or indirectly by all individual owners (leaving out all corporate owners) and add to that the share of the intangible income received only by *Connecticut resident individuals*. For example, take a Connecticut hedge fund in Greenwich (I'm assuming there are still a few of those remaining!). Let's say the LLC receives $1,000,000 of management fees that are sourced to Connecticut—perhaps an unlikely scenario given Connecticut's new customer-based sourcing, but let's stick with the example for the sake of easy math. It also receives $1,000,000 in interest and dividends having no source. Three of its members are Connecticut resident individuals, one member is a nonresident individual, and one member is a corporation. Each of the five members receives a 20% distributive share of the LLC's income. If the LLC elects to pay the PET using the alternative base, it will calculate its base as .80 x $1,000,000 [the share of Connecticut-source income received by individuals] *plus* .60 x $1,000,000 [intangible income received by Connecticut resident individuals]. The individuals then get a credit against their Connecticut taxes of 93.01% of the tax paid by the entity on their share of the income. In other words, the Connecticut resident owners of the hedge fund get a huge credit against their Connecticut tax liability on sourced and non-sourced income. The limitation on the SALT deduction just became much less expensive for them. Brilliant!

But the value of the PET and specifically the alternative base only exists ***if*** the entity can take a federal deduction for the taxes paid. Otherwise, Connecticut gets its tax, the shareholder/partner of the entity benefits individually, but the entity and therefore its owners are far worse off. To date, the IRS has not issued any guidance specifically directed at the PET or this type of workaround, which is also being considered by New York and New Jersey. The assumption has generally been that as an income tax paid by the business, the deduction should be available as a valid business expense. But in the tax arena, assumptions can be dangerous. Thus, let's look at the specific federal laws and regulations underpinning the assumption to make sure it's sound.

Taxes As a Deductible Business Expense

Under IRC Sec. 164(a), state income taxes are allowed as a deduction in the year they are paid or accrued. Of course, this deduction was limited for individuals beginning in 2018 under IRC Sec. 164(b)(6). In a footnote to the TCJA conference report discussing the limitation on the SALT deduction for individuals, the report notes, "[T]axes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner's or S corporation shareholder's distributive or pro-rata share of income or loss on a Schedule K-1 (or similar form), will continue to reduce such partner's or shareholder's distributive or pro-rata share of income as under present law." The Joint Committee on Taxation's General Explanation of the TCJA contains the same note.

So, this seems like an easy answer. Entity-level income taxes generally are deductible and not subject to the $10,000 SALT deduction limitation, which only applies to individuals.

Now, let's make the question a little more complicated. An investment partnership with Connecticut resident partners elects to pay the PET under the alternative base. Is it still as easy a question as it seems based on Section 164? Maybe yes, maybe no.

Prior to 2018, expenses allocable to portfolio income were deductible under Code section 212 and subject to the 2% floor under Code section 67(a). Treasury Regulation section 1.67-2T essentially provided that if a partnership paid expenses allocable to portfolio income, then the individual partners separately accounted for those expenses, to ensure that the 2% floor limitation was not avoided simply because a partnership paid those expenses. The TCJA then eliminated miscellaneous itemized deductions subject to the 2% floor.

But is an income tax included in the definition of an "expense allocable to portfolio income?" Section 67(b) explicitly excludes income taxes from the definition of miscellaneous itemized deductions. But strangely, the Form 1065 Instructions (pre-2018) state that "Taxes allocable to portfolio income" do get reported like miscellaneous itemized deductions. This raises some concerns that an investment partnership, like in our example above, might face scrutiny from the IRS in its deduction of the PET under the alternative base. Nevertheless, denying the deduction would seem inconsistent with the straightforward treatment of state income taxes under Section 164(a) and the note mentioned above in the TCJA Conference Report.

And what of the voluntary nature of the alternative tax base? Could the IRS argue that if an entity chooses to pay more tax to Connecticut by electing the alternative base, this is not a deductible tax but a workaround, similar to the "charitable" contributions in lieu of state taxes? It's entirely possible that the IRS could issue such guidance, but it would first need to develop the underlying authority to justify it. Historically, entities have been able to choose whether to be subject to state income tax at the entity-level or the shareholder-level, without scrutiny from the IRS (e.g., a corporation that is treated as a federal S corporation but that chooses to be treated as a C corporation for New York state income tax purposes). Thus, such IRS guidance in response to Connecticut's PET alternative tax base would need to distinguish why it's permissible to choose entity-level taxation in some situations but impermissible to use Connecticut's PET alternative tax base. That might be a difficult task and certainly could be subject to challenge.

High-tax states and the IRS are in an uneasy standoff, with taxpayers caught in the middle. States are looking for ways to keep wealthier residents from seeking new low-tax/no-tax homes without losing the revenues they depend on. The current administration in Washington does not appreciate states' efforts to work around the SALT deduction limitation. The Connecticut PET may have found a sweet spot, providing maximum benefits to its residents while making it more difficult for the IRS to challenge the deduction at the entity level.