

PASS-THROUGH ENTITY OWNERS IN THE TRI-STATE AREA AND BEYOND PLUS NEWS FROM NYC

Hodgson Russ Tristate Tax Alert
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SALT practitioners and owners of pass-through entities have been waiting anxiously since the passage of the Tax Cuts and Jobs Act (“TCJA”) to see if the IRS would go after the deduction for state-level entity taxes that were designed to work around the \$10,000 SALT deduction limitation at the individual level. Connecticut was one of the first states to enact a Pass-Through Entity Tax (“PET”), permitting partnerships and S corporations to pay tax at the entity level on either Connecticut-source income of the entity or on an alternative base calculated by the sum of Connecticut-source income plus intangible income distributed to individual owners. Owners would then get a credit on their Connecticut state returns for taxes paid by the entity and the entity would take a credit on its federal tax return for the state taxes paid, since the TCJA did not impose any limitations on SALT deductions by businesses.

At the time the legislation was enacted in 2018, it was unclear whether the IRS would try to disallow the deduction on an entity’s federal tax return. As we discussed here, although an entity’s entitlement to the deduction seemed fairly settled in Internal Revenue Code Section 164, the Treasury Secretary had made his position clear that taxpayers should not be permitted to work around the SALT deduction limitation imposed on individuals. Soon after the passage of the TCJA, the IRS issued proposed regulations disallowing charitable deductions that were in lieu of local property taxes and other state and local taxes.[1] Taxpayers of the Connecticut PET were especially concerned, since the tax was mandatory, although tax on the broader, alternative base remained elective.

In addition to Connecticut, a number of other states have enacted entity-level taxes, including Louisiana, Oklahoma, Rhode Island, Wisconsin, Rhode Island and New Jersey. These pass-through entity taxes generally require an election by all of the partners or shareholders to participate. Doubts about the IRS position on deductibility have made the decision about the election more complicated. But this month, the IRS issued Notice 2020-75 stating that the IRS intends to issue regulations clarifying that pass-through entities will be entitled to the business deduction under IRC § 164. The Notice acknowledges the uncertainty surrounding the deduction for mandatory or elective state-level pass-through entity taxes and

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states that the proposed regulations will permit deductibility of “Specified Income Tax Payments,” which include both mandatory and elective state and local income taxes paid by the entity, regardless of whether individual owners are entitled to or receive a credit or deduction on their state tax returns.

IRS Notice 20-75 is a huge relief for both owners of pass-through entities and the states that sold the new entity-level taxes to their legislatures as a benefit to their resident owners and pass-through businesses operating in their states. The guidance is particularly noteworthy for not differentiating between mandatory and elective taxes, the base used to calculate the tax, or whether the taxes are used to reduce the state individual income taxes of the owners.

Still, owners of pass-through entities that might now be more inclined to elect participation in the NJ BAIT or a similar tax should be cognizant of remaining questions about the state-level credit available to residents of states other than the taxing jurisdiction. For example, New York has made clear in the instructions to Form IT-112-R, the resident credit portion of its resident individual income tax return (IT-201), that an individual cannot take a credit for entity-level taxes paid to another jurisdiction by a corporation, partnership, or LLC. Thus, pass-through entities and their owners should still carefully calculate the impact of participating in the tax or, in the case of the Connecticut PET, using the broader, alternative base of the tax, on all of the owners.

News from New York City

Jacques Jiha is no longer the Commissioner of the NYC Finance Department. As of November 1, 2020, Mr. Jiha is Director of New York City Mayor DeBlasio’s Office of Management and Budget. Michael Hyman, who had been serving as first deputy commissioner since January 2015, has become Acting Commissioner of the Finance Department. We will have to see if, and when, Mayor Bill de Blasio will appoint a new Commissioner of Finance. As our readers know, a new Commissioner may result in new tax policy. In the interim, we wish our congratulations to Mr. Jiha and Mr. Hyman on their new positions.

Contact Debra Herman (646.218.7532) or Elizabeth Pascal (716.848.1622) if you have any questions about how these tax laws may impact you or your business.

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[1] <https://www.federalregister.gov/documents/2018/08/27/2018-18377/contributions-in-exchange-for-state-or-local-tax-credits>.