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Partial Repeal Could Resolve Biden's SALT Cap Dilemma

By **Joseph Mandarino** (April 9, 2021, 6:04 PM EDT)

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The Biden administration has proposed a large-scale infrastructure program, along with a number of tax law changes meant to fund it.[1] Not included is a repeal of the so-called SALT cap, the limitation on deduction of state and local taxes included in the 2017 Tax Cuts and Jobs Act.[2] Several members of Congress have already announced that they will block the infrastructure plan if the SALT cap is not repealed.[3]

Repeal of the SALT cap is controversial because it may cost more than $600 billion and would appear to benefit the wealthiest taxpayers.[4] This article discusses a pathway to partial repeal of the SALT cap that may resolve many of these tensions and which could be done on a revenue-neutral basis.

This article provides background on the SALT cap, discusses how a substantial portion of the SALT cap could be mitigated if the various states themselves acted, and outlines some proposals for changes to the federal tax code that could jump-start the state efforts, possibly on a retroactive basis, and argues that such proposals would likely cost nothing under traditional budget scoring principles.

Background on the SALT Cap

Section 164(b)(6) of the Internal Revenue Code was enacted as part of the 2017 Tax Cuts and Jobs Act. Under this limitation, individual taxpayers generally cannot deduct more than $10,000 in state and local taxes, or $5,000 if filing a separate return. The limitation, or SALT cap, does not apply to C corporations and does not apply to certain foreign taxes, or to property taxes incurred in a trade or business or for investment.[5]

The SALT cap has generated a large amount of controversy, particularly from political leaders in high-tax states.[6]

In general, there are three sets of taxpayers who are harmed by the SALT cap. The first group are investors in pass-through entities, or PTEs. In contrast to a regular corporation, the income of a PTE is taxed to its owners.

Most real estate projects are organized in PTEs. Assume an individual is considering investing $1 million in two competing real estate projects, one in New York and one in Nevada. Nevada does not levy an income tax, while New York does.

Under current law, the investor may be unable to deduct the New York income taxes that she would be obligated to pay if she invested in that first project. While that may not tip the scales, it will be one factor that would weigh against going forward with the New York investment. If income taxes, like the PTE's other expenses, were fully deductible, then the New York investment might be more attractive.

Another set of taxpayers are those who operate a trade or business in a PTE. Lawyers, accountants and other professionals often use PTEs to provide their services. In contrast to the first group, these are individuals who work on a day-to-day basis and provide services as a substantial part of their income.

For example, assume a CPA is a partner in a large accounting firm, which operates in various states. While he may only operate in one state, he receives an allocation of the partnership's income and will have state income tax obligations as a result. The effect of the SALT cap is that he will be restricted in the amount of state income tax that he can deduct for federal income tax purposes.

The final set of taxpayers are W-2 employees who make substantial amounts of income. For example, assume the president of a company in California is paid $1 million and incurs state income taxes in excess of the cap amount. As a result, she will not be able to fully deduct such taxes and her marginal tax rate will be higher than otherwise. This situation is contrasted with the previous case because she is a W-2 employee, rather than an owner of a PTE.

The legislative history of the SALT cap makes clear that entity-level taxes are not subject to the cap. Some observers have suggested that states may be able to convert owner-level income taxes to entity-level taxes as a workaround to the cap.[7]

Thus it appears possible that entity-level taxes on PTEs would not be subject to the SALT cap. Indeed, soon after enactment of the cap the state of Connecticut enacted such a workaround.[8] Under the Connecticut approach, a PTE can elect to pay income tax at the entity level. The owners, in turn, receive a credit against their personal income taxes based on the taxes paid by the PTE.

While the Connecticut approach appears to conform to legislative history, the matter was not certain. Thankfully, the Internal Revenue Service recently released guidance suggesting that an entity-level tax on a PTE does work.

Notice 2020-75 states that the IRS will issue regulations to confirm that an entity-level income tax on a partnership or S corporation is not subject to the SALT cap. This much appears to be consistent with the legislative history of the SALT cap. In enacting Section 164(b)(6), Congress provided that:

> taxes 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.[9]

The notice goes on to state that in such a case, the tax reduces the nonseparately stated income of the partners. This is a critical finding.

The IRS could have taken the position that an entity-level income tax should be treated as a separately stated item. In that case, it is possible that an individual partner would still be required to subject that item to the SALT cap.

The notice makes clear that such taxes are included in the pool of nonseparately stated items. As a consequence, entity-level taxes are fully netted at the entity level and are not caught up in an individual owner's SALT cap.

Moreover, the logic of this position follows from the nature of the SALT cap. The cap generally only applies to individuals and not entities. State and local taxes on income generated by pass-throughs such as partnerships or S corporations are not generally assessed on such entities, but on the owners of these entities. If such income is, instead, taxed at the entity level, then it would follow that the same income would not also be taxable to the entity's owners. Accordingly, it makes sense that if a state converts a flow-through tax into an entity-level tax then the SALT cap should not apply.

The following example may be helpful.

Newco is a partnership with two partners, Alpha and Beta. Alpha and Beta are individuals and are residents of Blue State. Each partner has other sources of income and their resulting state and local tax liabilities fully utilize their SALT caps before consideration of taxes on Newco income. Newco earns income from rental real estate in Blue State.

In 2021, Newco generates $2 million of taxable income. Blue State imposes a 10% income tax. Assume that, like most states, this tax is imposed on the owners of a PTE. Thus, while the tax is measured by the income of Newco, it is a liability of Newco's partners.

Under the terms of its partnership agreement, Newco allocates $1 million to each partner. Thus, Alpha includes $1 million on its Blue State income tax return. Assume that this inclusion increases Alpha's state income tax liability by $100,000. In addition, Alpha must include the $1 million on her federal income tax return. As noted, Alpha has no room under her SALT cap, so none of this $100,000 is deductible for federal income tax purposes. If Alpha's marginal federal tax rate is 35%, Alpha would owe $350,000 in federal taxes.

Now assume that Blue State has amended its income tax laws so that partnerships are directly taxable on their earnings. Because Newco has $2 million of taxable income earnings, it pays $200,000 in Blue State income taxes. Notice 2020-75 provides that Newco can net this amount against its overall income in computing the amounts allocated to Alpha and Beta. Thus, rather than allocating $2,000,000 to its owners, Newco nets the entity-level income tax levied by Blue State against its income.

This reduces Newco's net income to $1.8 million, and $900,000 is allocated to Alpha. Alpha now pays only $315,000 in federal tax on this amount.

Note that under this new set of facts, Alpha's federal income tax liability is the same as if the SALT cap did not apply. That is, because the income allocated to Alpha is directly reduced by the entity-level state income tax burden, Alpha is in the same position as if she had been able to fully deduct those taxes. Because of this benefit, Alpha's after-tax yield under these facts is $585,000 compared to $550,000 if Blue State's income tax was imposed directly on Alpha, an increase of about 6.4%.

The notice also makes clear that Newco is permitted to net an entity-level tax against net income regardless of whether the tax is mandatory or optional. For example, assume that Blue State's income tax laws provide that the income of pass-through entities is taxed to the owners of those entities. Blue State amends it laws to provide an option under which a pass-through entity can elect to pay tax directly on its income.

Note that under either a mandatory or optional entity-level tax, it will generally be necessary to provide a credit or exclusion to owners of pass-through entities so that they are not subject to double taxation. In the example above, the K-1 issued by Newco to Alpha for $900,000 reflects the netting of Blue State's entity-level tax against the rest of its income. This, as shown, is advantageous for federal income tax purposes.

However, in the absence of any other rules, Alpha would also have to pay Blue State income tax on the K-1 amount. For example, Connecticut law specifically provides that owners of PTEs that elect to pay state income tax at the entity level get a credit against their state income tax liability for their share of the entity-level tax.[10]

State-Based Solutions to the SALT Cap

Notice 2020-75 suggests that states may be able to undo the SALT cap for the first two sets of taxpayers identified above. Thus, PTE investors and owners of PTE firms should be able to completely avoid the SALT cap.

However, while Notice 2020-75 implicitly outlines a solution to the SALT cap for many — and perhaps the majority of — taxpayers who are currently affected by it, this solution requires a speedy and enlightened response by each state that levies an income tax. Some have already pointed out that a switch to entity-level taxes on PTEs will only be effective if each state that levies an income tax gives a credit for such taxes against what would otherwise be the tax liability of the owners of such PTEs.[11]

It is unclear that states will move quickly enough to enact entity-level taxes on PTEs or that they will grant appropriate owner-level tax credits. As a result, while the path to a SALT cap workaround is there, it is less certain that the states will be able to do their part.

Federal Proposal to Partially Repeal the SALT Cap

As the foregoing discussion should make clear, the legislative history of the SALT cap has always provided a pathway to eliminating the cap for two of the three groups of taxpayers affected. The risk, however, is that the states will not act quickly enough, or will enact changes that do not provide offsetting credits to PTE owners.

Given this, Congress could act to federalize the issue and eliminate the risk that the states will not be able to quickly and evenhandedly pass their own workarounds.

For example, Congress could condition any number of spending programs on a state's enactment of model PTE tax legislation. This legislation would provide that any income taxes levied at the PTE level by any state would be creditable against any state income tax liabilities of an owner.

By conditioning federal spending on PTE conformity, Congress would provide a very strong incentive for all states to pass such legislation. And by dictating the terms of the legislation, Congress could ensure that SALT cap reform would not be undone by the vagaries of interstate tax credit mechanics.

Note that this SALT cap fix would not appear to cost anything under general budget scoring principles. Because PTE-level income taxes are clearly not subject to the SALT cap, any federal legislation to coordinate states in enacting such an option should not be viewed as a federal expenditure because the states have always had this ability, and therefore the original enactment of the SALT cap could not have taken such revenues into account.

In addition, Congress could pass legislation that clarifies the treatment of taxes paid through a composite state tax return. State composite returns permit a PTE to directly pay state income taxes on behalf of the owners without the necessity of the owners filing their own returns.

Based on the legislative history of the SALT cap there is already an argument that a state income tax payment via a state composite return should be treated as an entity-level tax that is not subject to the cap. Indeed, given that Notice 2020-75 specifically holds that elective entity-level income taxes are not subject to the SALT cap, it is difficult to describe a cognizable difference between a composite return and an entity-level income tax.

Accordingly, Congress could pass legislation clarifying that taxes paid via a composite return are not subject to the SALT cap. Presumably such a clarification could be retroactive to the enactment of the SALT cap. Again, under general budget scoring principles this legislation should not cost anything. That is because the clarification does not constitute new law, but simply follows from the legislative history of the SALT cap.[12]

Conclusion

Based on the legislative history of the SALT cap and Notice 2020-75, it seems reasonably clear that the states can provide relief from the cap for PTE investors and PTE firms. While this would not provide any relief to highly compensated employees, it would also avoid the distributional equity and budget scoring issues that complete repeal would entail.

Moreover, Congress can act to ensure that partial repeal can be effectuated in a speedy and even-handed manner, and could even provide retroactive clarifying legislation that would be advantageous to some, if not most, of the taxpayers who currently struggle with the cap. Finally, it would appear that legislation to effectuate a partial repeal would not cost anything under general budget scoring principles.

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[1] The American Jobs Plan (https://www.whitehouse.gov/briefing-room/statements-releases/2021/03/31/fact-sheet-the-american-jobs-plan/).

[2] IRC Section 164(b)(6) .

[3] See, e.g., L. Davison, SALT-Cap Foes Threaten Biden Tax Plan as Repeal Bid Gains Steam, https://www.bloomberg.com/news/articles/2021-03-30/salt-cap-repeal-advocates-near-numbers-to-block-biden-tax-plan.

[4] See, e.g., K. Pomerleau, Eliminating the SALT Deduction Cap Would Reduce Federal Revenue and Make the Tax Code Less Progressive, https://taxfoundation.org/salt-deduction-analysis.

[5] IRC Section 164(b)(6).

[6] See, e.g., Gov. Andrew Cuomo, Governor Cuomo Outlines 2018 Agenda: Realizing the Promise of Progressive Government, (Jan. 3, 2018).

[7] J. Mandarino, State Efforts to Combat Cap on Deductibility of Local Taxes, Tax Notes Today (Feb. 19, 2018).

[8] See, e.g., Conn. Gen. Stat. § 12-699 .

[9] H.R. Rep. No. 115-466, at 260 n. 172 (2017); IRS Notice 2020-75, §2.02(2).

[10] Conn. Gen. Stat. § 12-699(g).

[11] See, e.g., W. Hellerstein and A. Appleby, State Tax Credit Issues Raised by SALT cap Workaround Legislation, Tax Notes Today (Jan. 14 2021).

[12] Indeed, even without such legislation it is likely that some taxpayers will file amended returns back to 2018 to recoup composite taxes as itemized deductions. Legislative clarification could actually save significant compliance expenditures at the IRS.
