

IRS Silence Encourages Pass-Through SALT Cap Workaround

By Maria Koklanaris

Law360 (September 6, 2019, 2:56 PM EDT) -- The Internal Revenue Service's silence on the treatment of entity-level state taxes on pass-throughs has contributed to numerous workarounds to the state and local tax deduction cap and could make these relatively unheard-of taxes much more commonplace.



The IRS so far has remained silent on whether the government will accept states taxing pass-throughs at the entity level. (AP)

The IRS and the U.S. Department of the Treasury thus far have been mum on whether they will accept a recent trend of states taxing pass-throughs at the entity level, a change clearly meant to be a workaround to the \$10,000 SALT cap. Under such programs, the state tax paid generates a federal deduction at the entity level and a state tax credit at the partnership level. Five states — Louisiana, Oklahoma, Connecticut, Wisconsin and Rhode Island — have enacted these SALT workarounds since the 2017 federal tax overhaul.

If the federal agencies give their OK or continue to maintain their silence, there would be advantages for states to reform their traditional methods for taxing pass-throughs, which is to individually tax partners on the business income that flows down to them. Besides giving pass-through members a SALT workaround, states may simply find it easier and more efficient to tax entities, said Bruce Ely of Bradley Arant Boult Cummings LLP.

"I would certainly expect to see more states jump on the bandwagon," Ely said, adding that entity-level taxes would be easier for the state to impose, particularly on businesses with nonresident partners.

And there is already evidence additional states would do just that. In addition to the five states that have established entity-level taxes on pass-throughs to act as SALT workarounds, Arkansas, Michigan, Minnesota and New Jersey also proposed similar bills, but they did not survive the 2019 legislative sessions. However, in the absence of the IRS saying no, lawmakers in these states already have a blueprint for what they want to do and they could easily revive these bills next year.

Meanwhile, at least one other state is experimenting with another type of SALT workaround involving pass-throughs. The Georgia Department of Revenue **announced Wednesday that by year-end** it would propose amendments to existing regulations dealing with various credits for charitable donations. Pass-through entities in Georgia would be allowed to make charitable contributions, with the entity's members claiming the resulting tax credits.

The proposed changes in Georgia would amend regulations for the state's qualified education expense credit, the qualified education donation tax credit and the qualified rural hospital organization expense tax credit. The proposed regulations, which would be effective for the 2019 tax year, would allow Georgia tax credits to be considered earned by a pass-through entity's members, shareholders or partners when the entity makes a charitable contribution, the state tax agency said.

But even as states move forward, they are still left guessing what the IRS and Treasury will do. The Treasury's Office of Tax Policy and the IRS published on June 17 a third-quarter update to their priority guidance plan, which added applying the SALT cap to pass-throughs to the list, but so far nothing has been released.

That contrasts with the **definitive thumbs-down** the federal agencies have given to other types of SALT workarounds, those in which states allowed individuals to make contributions to either a state-run fund or to private charities or private schools in exchange for a federal deduction and a state tax credit. Such schemes, the IRS and Treasury said, are disallowed under a doctrine of quid pro quo: If an individual is making a true charitable contribution, the individual should have no expectation of getting something in return.


A big question for the agencies is if they will regard pass-through entity taxation in the same way, said Louis Schatz of Shipman & Goodwin LLP, who said barring the SALT cap workarounds for individuals was a relatively easy call for the IRS and Treasury, but disallowing taxation of pass-through entities is a much higher hurdle.

"On the pass-through entity tax approach, I don't think the answer is as clear as it is for the charitable contributions," for individuals, Schatz said. "There are substantial reasons why this workaround should work."

Schatz said the agencies could look to their own guidance suggesting the pass-through entity tax would be OK. For example, the IRS and Treasury issued a **September 2018 statement** saying that business owners who make payments to nonprofits in exchange for a state tax credit and a federal deduction can continue to do so and deduct the payments as a business expense, even though such arrangements for individuals are disallowed or curtailed.

There is also footnote 296 in the Joint Committee on Taxation's Bluebook **issued in December 2018**, which states that taxes "imposed at the entity level ... will continue to reduce each partner's or shareholder's distributive or pro rata share of income as under prior law," suggesting that entity-level taxes would be deductible.

"The IRS is obviously aware of the legislative history," Schatz said.

And there is a history of the IRS allowing the deduction of entity-level taxes. Until the **Tax Cuts and Jobs Act** , such taxes on pass-throughs were rare and fairly esoteric, but they did exist. New York City's unincorporated business tax, Texas' margins tax, New Hampshire's business profits tax and Tennessee's excise and franchise tax serve as a few examples. But as rare and esoteric as those taxes are, they do exist, and the federal agencies know that, noted Mariano Sori of BDO USA LLP.

Sori said he wondered whether the agencies would be able to differentiate between those established taxes and the new proposals just by saying the new ones are not acceptable because they are meant as SALT workarounds.

"Everybody knows these pass-through entity taxes are being set up as a way to do a

workaround," Sori said. "But it's going to be harder for them to say no" than it was to bar the individual SALT workarounds, Sori said of the IRS and Treasury.

Finally, time is also a factor, noted Timothy Noonan of Hodgson Russ LLP. Connecticut's pass-through entity tax, for example, is more than a year old and has been in use. Noonan said the priority guidance plan's mention of pass-through entities and the SALT cap should be taken as a note of caution, but he thought the tax would survive.

"If I had to guess I would say the IRS would leave these things alone," Noonan said.

--Editing by Tim Ruel and Neil Cohen.

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