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Hesitancy to Use Workarounds Could Imperil State Efforts to Beat SALT Cap

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By Lauren Loricchio

Taxpayers' hesitancy to use optional passthrough entity taxes designed to bypass the federal limit on the state and local tax deduction could imperil state efforts to beat the cap.

"I'm seeing reticence for companies to get themselves into this," said Timothy Noonan, partner at Hodgson Russ LLP.

The federal Tax Cuts and Jobs Act imposed a $10,000 limit on the SALT deduction. The cap was decried by blue state politicians as a partisan assault on their tax bases. Some states sought to circumvent the cap by adopting workarounds.

New York, New Jersey, and Connecticut were among the states that enacted legislation to establish charitable donation funds that taxpayers could donate to in exchange for a tax credit. However, those workarounds were shut down under guidance issued by the IRS.

Connecticut was the first state to adopt a passthrough entity-level tax with an offsetting income tax credit to allow passthrough members to bypass the SALT cap. Last year, the Connecticut Department of Revenue Services commissioner said more than 110,000 passthroughs were participating in the workaround.

Unlike Connecticut, which adopted a mandatory workaround, other states have adopted optional workarounds for passthroughs, including Wisconsin, Oklahoma, Rhode Island, Louisiana, and New Jersey.

Jaye Calhoun of Kean Miller LLP told *Tax Notes* she isn't seeing Louisiana's workaround being used a lot.

"Part of the reason is how complicated it is to track this type of information separately for federal and state purposes," Calhoun said.

"The accountants who I have spoken to have not really been encouraging their clients to do this," Calhoun said. "One issue is that it helps some owners and doesn't help others, so it can have a disparate impact."

The Louisiana workaround (S.B. 223), signed by Gov. John Bel Edwards (D) in 2019, created a SALT cap workaround for S corporations and partnerships. It allows S corporations and entities that are taxed as partnerships at the federal level to elect to pay corporate income taxes at the entity level.

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Jared Walczak of the Tax Foundation said the taxpayer benefits of the Louisiana workaround are limited and "may well be more than offset by the disadvantages of operating under a corporate income tax structure."

Louisiana allows passthrough businesses to elect to be taxed as C corporations under an alternative corporate income tax rate structure to allow their owners to avoid the SALT deduction cap, Walczak explained.

Other states have adopted entity-level taxes on passthrough businesses with offsetting income tax credits and tax exclusions.

The Louisiana Department of Revenue issued regulatory guidance that imposed additional requirements for the entities making the election.

"If an entity is going to make the election, they basically have to . . . provide a laundry list of information including information about who all the owners are, their taxpayer identification numbers, [and] their addresses," Calhoun said.

Compliance with the regulations may be viewed by a taxpayer as having to provide all the information that would be requested in an actual audit without any of the protections available, according to Calhoun. The information required by the regulations is "expensive to pull together and is not required under the statute and could reasonably cause a taxpayer to be concerned that making the election is going to open them up to audit activity or worse," she explained.

Kevin Herzberg, state and local tax partner at Grant Thornton LLP, told *Tax Notes* that he hasn't seen a lot of interest in the Louisiana workaround either.

"The election could have started as of February 1. We've done some rough numbers for our clients, but nothing that would have excited them to move forward, at least before the COVID-19 crisis," Herzberg said.

Noonan, who writes a column for *Tax Notes State* magazine and is a member of its advisory board, said the passthrough workarounds work in only a very narrow set of circumstances. For example, if you have a New Jersey business with New Jersey owners, the workaround would be beneficial. But in a situation in which there are nonresidents of the company and those nonresidents live in a state with an income tax, it wouldn't be helpful, he explained.

Jamie Yesnowitz, principal and SALT national tax office leader at Grant Thornton, said that part of the hesitancy is "because the law is so new, [and] part of that is because there is some question as to whether the IRS will respect these types of optional arrangements."

The IRS has yet to address the SALT workarounds for passthrough businesses. Some practitioners said they view the IRS's silence on the matter as a sign of approval, but others want more clarity about whether the workarounds will be respected.

Noonan said that while the passthrough workarounds are a noble idea, he's unsure that they will work as intended. "Because it impacts such a limited class of people and because some folks are a little concerned about whether it works, it's just not going to get used a lot," he said.

Carl Davis of the Institute on Taxation and Economic Policy, who has been critical of the workarounds, said he thinks the lack of enthusiasm in the business community for these types of workarounds suggests that taxpayers are less concerned about the SALT deduction cap than some politicians seem to think.

"It may also partly be a reflection of the fact that the SALT cap is only a temporary policy, scheduled to expire at the end of 2025," Davis said.

Practitioners said the best situation for taxpayers would be to get the full SALT deduction restored by Congress.

House Speaker Nancy Pelosi, D-Calif., raised the idea of retroactively lifting the SALT cap to help stimulate the economy amid the COVID-19 pandemic. However, the idea was met with criticism from congressional Republicans and policy experts.

In the meantime, Noonan said the best solution for taxpayers is to leave high-tax states like New York, New Jersey, and Connecticut for lower-tax states like Florida.

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