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Trials & Transactions

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Forthcoming Proposed Regulations Will Allow SALT Work-Around by Allowing Income Taxes Imposed on Partnership or S Corporation as a Deduction in Calculating the Entity's Non-Separately Stated Taxable Income or Loss

In Notice 2020-75, the IRS announced that forthcoming proposed regulations will clarify that State and local income taxes imposed on and paid by an S Corporation or a partnership are allowed as a deduction by the entity in computing its non-separately stated taxable income or loss for the taxable year of payment. Thus, these income taxes will not be counted as part of the $10,000 limitation on deductibility of State and local taxes imposed under Section 164(b)(6) that applies to individuals for taxable years beginning after December 31, 2017 and before January 1, 2026. This is significant to Louisiana taxpayers because Louisiana enacted a SALT work-around in 2019 as discussed below.

The Law

Section 164(b)(6) was added by the Tax Cuts and Jobs Act[1] and imposes a limitation on the deduction by an individual of State and local real property taxes, State and local personal property taxes and State and local income, war profits and excess profits taxes. For taxable years beginning after December 31, 2017 and before January 1, 2026, an individual is limited to an aggregate deductible amount of $10,000 ($5,000 in the case of married taxpayers filing separately).[2] The $10,000/$5,000 limitation does not apply to foreign income taxes deductible under Section 164(a)(1), or to State and local real property taxes or personal property taxes that are paid or accrued in carrying on a trade or business or an activity engaged in for the production of income under Section 212.

Under Section 703(a) the taxable income of a partnership is computed in the same manner as an individual with certain enumerated exceptions. For example, the items described in Section 702(a) must be separately stated and certain enumerated deductions are not allowed to the partnership. One of the enumerated deductions is the deduction under Section 164(a) for taxes paid or accrued to foreign countries or U.S. territories. The Code provides similar rules for an S corporation.

Under Section 702(a), for purposes of computing a taxpayer's income tax, a partner is required to take into account the partner's distributive share of certain separately stated items of income, gain, loss, deduction or credit in accordance with the rules of Section 702(a), as well as the partner's non-separately computed income or loss. Similarly, for an S corporation shareholder, under Section 1366(a)(1)(A), he must take into account his pro rata share of items of income, gain, loss, deduction or credit, the separate treatment of which could affect the liability for tax of any shareholder, and under Section 1366(a)(1)(B), his pro rata share of any non-separately computed income or loss.

The Guidance

Notice 2020-75 recognizes that certain jurisdictions have enacted or are contemplating work-arounds to effectively accommodate the statutory scheme, and thus allow the deduction of income taxes that might otherwise have limited deductibility at the individual owner level. The Notice states:

Certain jurisdictions described in section 164(b)(2) have enacted, or are contemplating the enactment of, tax laws that impose either a mandatory or *elective* entity-level income tax on partnerships and S corporations that do business in the jurisdiction or have income derived from or connected with sources within the jurisdiction. *In certain instances, the jurisdiction's tax law provides a corresponding or offsetting, owner-level tax benefit, such as a full or partial credit, deduction, or exclusion.*

(Emphasis added).[3]

In order to provide certainty to individual owners of partnerships and S corporations, the Notice states that Treasury and the IRS intend to issue proposed regulations on the calculation of the SALT limitation by these owners.

Notice 2020-75 announces that the regulations will apply to Specified Income Tax Payments, which are defined as any amount *paid* by a partnership or S corporation to a State, a political subdivision of a State, or the District of Columbia (a domestic jurisdiction) to satisfy the entity's liability for income taxes imposed by the domestic jurisdiction. A Specified Income Tax Payment does not include income taxes imposed by U.S. territories or their political subdivisions. The payment must be for a direct payment of income tax imposed on the entity, determined without regard to whether the income tax is the result of an election by the entity or whether the entity's owners receive a partial or full deduction, exclusion, credit, or other tax benefit that is based on their share of the amount paid by the entity to satisfy its income tax liability under the domestic jurisdiction's tax law and which reduces its owner's individual income tax liabilities under the law of the domestic jurisdiction.

Under Notice 2020-75, a Specified Income Tax Payment is allowed as a deduction to the partnership or S corporation in computing its taxable income for the taxable year in which the payment is made. The Specified Income Tax payment is not a separately stated item for purposes of Sections 702 or 1366 and must be reflected in a partner's or S corporation's distributive or pro-rata share of the non-separately computed income or loss of the entity. Finally, a Specified Income Tax Payment is not taken into account in applying the Section 164(b)(6) limitation to the entity owner.

Applicability Date

The proposed regulations described in Notice 2020-75 will apply to Specified Income Tax Payments made on or after November 9, 2020. Additionally, the proposed regulations will allow taxpayers to apply the rules described in Notice 2020-75 to Specified Income Tax Payments made in a taxable year of the partnership or S corporation ending after December 31, 2017 and before November 9, 2020, provided that the payment is made to satisfy the entity's liability for income tax imposed pursuant to a law enacted prior to November 9, 2020. Finally, prior to issuance of the proposed regulations, taxpayers may rely on the provisions of Notice 2020-75.

The Louisiana Work-Around

In 2019, Louisiana enacted an elective provision that allows partnerships and S corporations to effectively be treated as a C corporation for Louisiana state corporation income tax purposes.[4] Under this provision, an S corporation or entity taxed as a partnership for federal income tax purposes may elect to be taxed and comply with the Louisiana corporation income tax provisions as if the entity had been required to file an income tax return with the IRS as a C corporation.

The election may be made for taxable years of the entity beginning on or after January 1, 2019, and once made can only be terminated with the consent of the Secretary of the Department of Revenue.

If the election is made, the income tax is computed at a rate that generally mimics the individual income tax rates in Louisiana rather than the corporation income tax rate.

Generally, a Louisiana resident pays Louisiana individual income taxes based on the taxable income shown on his federal income tax return, which includes the flow-through of items of income, gain, loss and deduction and non-separately stated income or loss reported to the individual from partnerships and S corporations on his federal income tax return. However, if the partnership or S corporation makes the election to pay corporation income tax, in computing Louisiana net income, the individual excludes the net income or net losses received from an entity provided the entity properly filed a Louisiana corporation income tax return pursuant to the election allowed by La. R.S. §47:287.732.2.[5]

Louisiana taxpayers should be cautioned that making the election to have a partnership or S corporation taxed as a C corporation for Louisiana income tax purposes can have significant collateral effects. For example, the election could eliminate the ability to use the net capital gain deduction that is available in connection with the sale of a business that has maintained its commercial domicile in Louisiana for at least 5 years, where the taxpayer has held his interest in the business for at least 5 years.[6]

Thus, taxpayers are advised to consult with their personal tax advisor when considering whether the Louisiana work-around makes sense for their own situation.

[1] Pub. L. 115-97, 131 Stat. 2054, Section 11042(a) (12/22/2017).
[2] Under Sections 164(b)(5) and (6), the $10,000/$5,000 limit also applies to State and local sales taxes if the taxpayer has elected to deduct State and local sales taxes in lieu of State and local income taxes.
[3] Notice 2020-75, Section 2.02(3).
[4] La. Acts 2019, No. 442.
[5] La. R. S. §47:287.732.2.
[6] La. R. S. §47:293(9)(a)(xvii), 47:293(10)

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About Sher Garner

Sher Garner Cahill Richter Klein & Hilbert, L.L.C., located in New Orleans, Louisiana, is a nationally recognized full service law firm delivering sophisticated legal representation in both litigation and transactional matters.

Our talented team of attorneys provides our clients with the astute knowledge of a large firm practice, but with responsiveness, personal attention and sensible staffing of a smaller firm, all while delivering quality legal services effectively and efficiently.

The hallmark of our service is our attention to the needs of our clients that goes beyond the rules of professional responsibility. When representation requires litigation, we are aggressive trial lawyers, who are not afraid to fight to protect our clients' rights. We also believe in reasonableness and cooperation, however, and adjust our representation to suit the needs of any particular client. A client who brings us a transactional matter can expect an honest and accurate appraisal of the matter and a resolution in the most practical, direct and economically feasible manner.
