

# **A Generous Pinch of SALT**

**Passthrough Entity Taxes and  
Administrative Grace**

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National Tax Association Spring Symposium

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# Overview

- 27 states have enacted **passthrough entity taxes (PETs)** since 2017 that allow partnerships and S corporations to elect into paying an entity-level income tax, with partners and shareholders receiving offsetting individual-level state income tax credits
- Promoters of PETs believe that the entity-level taxes and offsetting credits will (somehow) allow passthrough owners to circumvent the \$10,000 SALT cap under the Tax Cuts and Jobs Act

# Overview

- **The problem:** Under the plain text of TCJA and longstanding statutes and regulations, the \$10,000 SALT cap clearly applies to all state and local income taxes regardless of whether those taxes are paid at the entity level or the individual owner level
- **In other words: The PET workaround doesn't work**

# Overview

- **Puzzle:** Notwithstanding clear statutory and regulatory text to the contrary, the IRS has blessed the PET workaround in informal guidance
  - **Why?**
    - 1. Legal explanations**
    - 2. Political explanations**

## Overview

# Why Should You Care?

1. **Horizontal equity:** Relative to passthrough owners, wage-earners are getting a raw deal
2. **Distortions:** Preferential treatment of passthrough owners exacerbates the tax system's bias against employer-employee relationships
3. **Revenue consequences:** PETs will cost the federal government **tens of billions of dollars** in revenue between now and 2026.
4. **Rule of law:** Treasury and IRS are ignoring the plain text

# A Tale of 2 SALT Workarounds

1. **State/local charitable credits**
2. **Passthrough entity taxes (PETs)**

# A Tale of 2 SALT Workarounds

- 1. State/local charitable credits**
- 2. Passthrough entity taxes (PETs)**

ECONOMIC POLICY

# Gov. Cuomo tries shielding New Yorkers from GOP tax law, in possible model for Democratic-controlled states



Analysis by [Jeff Stein](#)

Staff writer

April 2, 2018



New York Gov. Andrew M. Cuomo (D) spearheaded a plan designed to shield New Yorkers from tax hikes under the GOP tax law, but some experts doubt it will work. (AP Photo/Mary Altaffer, File)



# State/Local Charitable Credits

- **Example: New York**
  - Individuals who contribute \$1 to state-designated charity would receive state tax credit of 85¢
    - Attractive to high-bracket itemizers who otherwise would run into the \$10k SALT cap
      - For top-bracket taxpayer, \$1 contribution → federal charitable contribution deduction worth 37¢ + state tax credit worth 85¢ (\$1.22 total)

# State/Local Charitable Credits

- Did it work?

# State/Local Charitable Credits

## Pre-2017



- Did it work?
  - Yes
  - Chief Counsel Advice 20110501 explicitly said that a taxpayer could make a contribution to a state charitable fund, receive a state tax credit, and treat the contribution as a charitable contribution deductible under § 170 without reducing the deduction for the “quid pro quo” benefit of the tax credit

# State/Local Charitable Credits

## Pre-2017



- **Why it mattered:**
  - Alternative minimum tax avoidance
  - First Amendment/Blaine Amendment arbitrage

# State/Local Charitable Credits

## Pre-2017

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for married filing jointly

## State Responses to Federal Tax Reform: Charitable Tax Credits

by Joseph Bankman, David Gamage, Jacob Goldin, Daniel Hemel, Darien Shanske, Kirk J. Stark, Dennis J. Ventry Jr., and Manoj Viswanathan

Joseph Bankman is the Ralph M. Parsons Professor of Law and Business and Jacob Goldin is an assistant professor of law at Stanford Law School; David Gamage is a professor of law at Indiana University School of Law; Daniel Hemel is an assistant professor of law at the University of Chicago Law School; Darien Shanske and Dennis J. Ventry Jr. are professors of law at the University of California, Davis, School of Law; Kirk J. Stark is the Barrall Family Professor of Tax Law and Policy at the University of California, Los Angeles, School of Law; and Manoj Viswanathan is an associate professor of law at the University of California, Hastings, College of the Law.

In this report, the authors explain how a long-standing principle of federal tax law provides authority for donors to claim a full charitable contribution deduction for gifts entitling them to a state tax credit. They argue that it thus may be possible for states to give their residents a way to preserve the effects of a state and local tax deduction, at least in part, by granting a charitable tax credit for federally deductible gifts, including gifts to the state or one of its political subdivisions.

For a partial inventory of state charitable tax credits, see the appendix to the version of this report published in a coming *State Tax Notes* issue. The appendix describes more than 100 state charitable tax credits in 33 states.

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### I. Introduction

Many states provide tax incentives for charitable giving, typically to encourage private donations to targeted activities, such as natural resource preservation,<sup>1</sup> private school tuition

### JURISPRUDENCE

## Deduct This

How states can undo one of the most potentially destructive elements of the Republican tax law.

BY JOSEPH BANKMAN, DANIEL HEMEL, DARIEN SHANKE, AND KIRK STARK

JAN 11, 2018 • 4:35 PM



<sup>1</sup>See Jeffrey O. Sundberg, "State Income Tax Credits for Conservation Easements: Do Additional Credits Create Additional Value?" Lincoln Institute of Land Policy, at 26, Table 1 (2011) (Table 1 lists state tax credits as of 2011).

## POLITICS

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# Treasury Moves to Block New Yorkers' Path Around Cap on State Tax Deductions

New regulations would blunt high-tax states' efforts to bypass a new limit on state and local tax deductions with donation programs



Treasury Secretary Steven Mnuchin said the move would prevent 'attempts to convert tax payments into charitable contributions.'

PHOTO: EITAN ABRAMOVICH/AGENCE FRANCE-PRESSE/GETTY IMAGES

By [Richard Rubin](#) 

Updated Aug. 23, 2018 6:48 pm ET

The advertisement features the brand name 'TECOVAS' in large, bold, sans-serif letters at the top. Below it is a photograph showing a person's legs in blue jeans and brown leather Chelsea boots. The bottom half of the ad shows a single brown leather Chelsea boot against a white background. The price '\$225' is displayed in red at the bottom left, and the model name 'THE CHANCE' is at the bottom right.

## State/Local Charitable Credits

### Treasury's Response

- Under regulations proposed in August 2018 and finalized in June 2019, if taxpayer receives a state/local tax credit worth **>15%** of the amount of a charitable contribution, the credit will be treated as a return benefit (or “quid pro quo”) that reduces the taxpayer’s federal charitable contribution deduction

# State/Local Charitable Credits

## Observations

- Treasury regulations killing the charitable credit workaround were a **reasonable** exercise of agency discretion
  - I.R.C. §§ 164 and 170 **did not require** the credit-killing regulations (Treasury could have rolled over)
  - **But:** I.R.C. § 7805 gives Treasury the authority to promulgate the credit-killing regs
    - **I.R.C. § 7805(a):** “[T]he Secretary shall prescribe all **needful rules and regulations** for the enforcement of this title ....”

# State/Local Charitable Credits

## Observations

- Treasury had good reasons for adopting the credit-killing regulations, even though it required Treasury to reject pre-TCJA IRS guidance and even though it involved drawing an arbitrary line in the sand at 15%
  - Treas. Dec. 9864 emphasized 2 reasons:
    1. “Significant federal tax revenue losses”
    2. “Would undermine the limitation on the deduction for state and local taxes in section 164(b)(6)”

# A Tale of 2 SALT Workarounds

1. State/local charitable credits
2. Passthrough entity taxes (PETs)

♦ WSJ NEWS EXCLUSIVE | NEW YORK

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# New York Business Owners Sidestep Billions in Federal Taxes With State's Help

Pass-through business owners paid \$11 billion to state that will escape federal SALT deduction cap



Business advocates are calling on New York City to make a similar allowance for its local income tax.

PHOTO: ANGELA WEISS/AGENCE FRANCE-PRESSE/GETTY IMAGES

By [Richard Rubin](#) [Follow](#) and [Jimmy Vielkind](#) [Follow](#)

Updated Jan. 10, 2022 4:51 pm ET



# Passthrough Entity Tax (PET)

- **Example: New York**

- Partnerships and S corporations elect into paying entity-level tax
- Partners/S corporation shareholders receive offsetting credit against individual-level state income tax

<b>Passthrough entity taxable income</b>	<b>Passthrough entity tax</b>
\$2 million or less	$6.85\% \times \text{taxable income}$
>\$2 million but $\leq$ \$5 million	$\$137,000 + 9.65\% \times \text{excess over } \$2 \text{ million}$
>\$5 million but $\leq$ \$25 million	$\$426,500 + 10.3\% \times \text{excess over } \$5 \text{ million}$
>\$25 million	$\$2,486,500 + 10.9\% \times \text{excess over } \$25 \text{ million}$

# Passthrough Entity Tax (PET)

- **Does it work?**

# **Text (unchanged by TCJA)**

## **I.R.C. § 164**

### **(a) General Rule**

Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

- (1)** State and local, and foreign, real property taxes.
- (2)** State and local personal property taxes.
- (3)** State and local, and foreign, income, war profits, and excess profits taxes.
- (4)** The GST tax imposed on income distributions.

In addition, there shall be allowed as a deduction State and local, and foreign, taxes not described in the preceding sentence which are paid or accrued within the taxable year in carrying on a trade or business ....

# **Text (unchanged by TCJA)**

## **I.R.C. § 164**

### **(a) General Rule**

Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

- (1)** State and local, and foreign, real property taxes.
- (2)** State and local personal property taxes.
- (3)** State and local, and foreign, income, war profits, and excess profits taxes.
- (4)** The GST tax imposed on income distributions.

In addition, there shall be allowed as a deduction State and local, and foreign, taxes not described in the preceding sentence which are paid or accrued within the taxable year in carrying on a trade or business ....

**Observation:** Income taxes paid or accrued in carrying on a trade or business are taken into account under § 164(a)(3), not under the flush text

## **Text (added by TCJA)**

### **I.R.C. § 164**

**(b)(6)** ... In the case of an individual and a taxable year beginning after December 31, 2017, and before January 1, 2026—

... the aggregate amount of taxes taken into account under paragraphs (1), (2), and (3) of subsection (a) ... for any taxable year shall not exceed \$10,000 ....

The preceding sentence shall not apply to any foreign taxes described in subsection (a)(3) or to any taxes described in paragraph (1) and (2) of subsection (a) which are paid or accrued in carrying on a trade or business ....

## **Text (added by TCJA)**

### **I.R.C. § 164**

**(b)(6)** ... In the case of an individual and a taxable year beginning after December 31, 2017, and before January 1, 2026—

... the aggregate amount of taxes taken into account under paragraphs (1), (2), and (3) of subsection (a) ... for any taxable year shall not exceed \$10,000 ....

The preceding sentence shall not apply to any foreign taxes described in subsection (a)(3) or to any taxes described in paragraph (1) and (2) of subsection (a) which are paid or accrued in carrying on a trade or business ....

**Observation: State and local income taxes paid or accrued in carrying on a trade or business are subject to the \$10,000 cap**

- Foreign taxes described in § 164(a)(3) are exempt
- Real/personal property taxes paid/accrued in carrying on a trade/business are exempt
- **Taxes other than foreign taxes that are described in § 164(a)(3) and that are paid/accrued in carrying on a trade/business are subject to cap**

## POLITICS

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# Some Business Owners Can Avoid Cap on Deductions for State and Local Taxes, Treasury Says

Forthcoming rules would sanction state laws that let partnerships, other businesses deduct all of their state taxes



The 2017 law that revamped the U.S. federal tax system imposed a \$10,000 cap on the state and local tax deduction, pinching residents of high-tax states.

PHOTO: ANDREW HARRER/BLOOMBERG NEWS

By [Richard Rubin](#) 

Updated Nov. 9, 2020 7:24 pm ET



# Passthrough Entity Tax (PET) IRS's Response

Notice 2020-75

## SECTION 1. PURPOSE

This notice announces that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to issue proposed regulations to clarify that State and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment.

## Passthrough Entity Tax (PET)

### Non-Separately vs. Separately Stated Items

- Subchapters K and S distinguish between items that factor into non-separately stated taxable income and separately stated items
- An item must be separately stated if separate treatment could affect the tax liability of any partner/shareholder (Treas. Reg. § 1.702-1(a)(8)(ii); I.R.C. § 1366(a)(1)(A))
- If a deduction is subject to an individual-level limitation, then it must be separately stated
  - **E.g.:** Charitable contribution deductions must be separately stated

## Passthrough Entity Tax (PET)

### Non-Separately vs. Separately Stated Items

- So the non-separate vs. separate statement question is just a rehash of the initial question: **Are state and local income taxes paid or accrued in carrying on a trade or business subject to the \$10,000 SALT cap?**

## Passthrough Entity Tax (PET)

### Non-Separately vs. Separately Stated Items

- So the non-separate vs. separate statement question is just a rehash of the initial question: **Are state and local income taxes paid or accrued in carrying on a trade or business subject to the \$10,000 SALT cap?**
  - And the answer is (**clearly**) yes!

# **Passthrough Entity Tax (PET)**

## How To Explain the IRS's Position?

- Legal explanations?
- Political explanations?

# How To Explain the IRS's Position? Legal Explanations?

## 1. Prior IRS guidance

- **Rev. Rul. 58-25:** City of Cincinnati partnership tax—computed on the basis of partnership’s net profits from business conducted in Cincinnati—is deductible in computing non-separately stated taxable income of partnership
- **Text:** I.R.C. § 62 allows above-the-line deductions that are “attributable to a trade or business carried on by the taxpayer” other than “the performance of services … as an employee”
- **Upshot:** Partnership can claim deduction at entity level and partner can claim standard deduction at the individual level

# How To Explain the IRS's Position?

## Legal Explanations?

- **But:** Revenue Ruling 58-25 addresses I.R.C. § 62, not I.R.C. § 164(b)(6)
  - \$10,000 cap under I.R.C. § 164(b)(6) clearly applies to state and local income taxes paid or accrued in carrying on a trade or business, even if those taxes are deductible above-the-line under I.R.C. § 62

# How To Explain the IRS's Position?

## Legal Explanations?

### 2. Legislative history

- **H.R. Rep. No. 115-466, at 260 n.172:** “[T]axes 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.”
- **But:** Begs the key question—whether state/local income taxes paid/accrued in carrying on a trade or business are reflected in the partner/shareholder’s distributive share of income/loss

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BRANDON CASEY,  
MINORITY CHIEF OF STAFF

November 9, 2017

The Honorable Earl Blumenauer  
1111 Longworth House Office Building  
Washington, D.C. 20515

Dear Mr. Blumenauer:

I am writing in regards to your request during the November 8th Committee mark-up on H.R. 1, the *Tax Cuts and Jobs Act*, for clarification with respect to the ability of individual owners of pass-through businesses (e.g., subchapter S corporations and partnerships) to claim a deduction for state and local taxes.

# How To Explain the IRS's Position? Legal Explanations? Legislative History

In summary, taxes imposed on and paid by a pass-through business, such as sales taxes and certain property taxes, would continue to be deductible by the business, to the extent related to business property. State and local income taxes paid by an individual owner of such a business would not be deductible on the individual's tax return.

Sincerely,

A handwritten signature in black ink, appearing to read "K. Brady".

Kevin Brady  
Chairman

# How To Explain the IRS's Position? Legal Explanations?

## 2. Legislative history

- **Also:** “[W]e do not resort to legislative history to cloud a statutory text that is clear.” Ratzlaf v. United States, 510 U.S. 135, 147–48 (1994) (Ginsburg, J.)

# How To Explain the IRS's Position?

## Political Explanations?

- **Trump administration**
  - Catering to high-income passthrough owners
- **Biden administration**
  - Also catering to high-income passthrough owners
    - **Hertel-Fernandez and Skocpol (2015):** Passthrough owners (organized as “small business” lobby) have emerged as major force driving policy positions for both parties
  - Responding to concerns of high-tax blue states regarding tax flight
  - Reducing revenue estimate for SALT cap repeal/reform

# What Should Treasury and the IRS Do Now?

- Rescind Notice 2020-75!
- Promulgate regs clarifying that income taxes paid or accrued in carrying on a trade or business are subject to the \$10k cap
- And if Congress doesn't like that, it should revise the law