SALT cap workarounds

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Before 2018, an individual generally could deduct an unlimited amount of state and local property and income taxes from income for federal income tax purposes.[1] The Tax Cuts and Jobs Act changed that, effectively increasing taxes on many individuals who work or reside in high-tax states. Since 2018, an individual generally can deduct no more than $10,000 of state and local property and income taxes.[2] This limitation will continue to apply until 2026.[3]

In response to this cap on the deductibility of state and local taxes (SALT), more than 30 states have enacted a workaround involving an entity-level tax and a (generally) offsetting tax benefit for its owners. The state imposes an income tax on a pass-through entity, such as a partnership, a limited liability company that's classified as a partnership for federal tax purposes, or an S corporation. This tax is sometimes called a pass-through entity (PTE) tax. In most states, this tax is elective.

How does the workaround work?

For federal tax purposes, the pass-through entity deducts the PTE tax when calculating its taxable income, thereby reducing each member's allocable share of the taxable income. (For simplicity, let's refer to the owner of a pass-through entity as a member.) The pass-through entity isn't subject to the SALT deduction limitation, so it deducts the PTE tax in full. Importantly, an individual member doesn't take into account the PTE tax that the pass-through entity pays when applying the SALT deduction limitation to which the individual is subject.

For state tax purposes, the PTE tax generally shifts the incidence of tax from the pass-through entity's members to the entity, preserving the single layer of tax (which has been a key advantage of pass-through entities). The states take two different approaches to how the entity's payment of the PTE tax offsets the state tax that its members otherwise would pay. Some states have adopted a credit approach, while other states have adopted an income exclusion approach.

Credit approach

In some states, each partner or shareholder gets a credit for the partner's or shareholder's allocable share of the PTE tax. In some cases, it's full credit.[4] In other states, it's only a partial credit.[5] States that have adopted the credit approach include California, Massachusetts, New Jersey, and New York.[6]

This credit is a dollar-for-dollar reduction of the individual's personal taxes. Consequently, for each member, the pass-through entity's payment of the PTE tax usually is a wash or, at least, nearly so. It wouldn't fully wash in a state that only offers a partial credit, and it might not fully wash in a state in which the credit is nonrefundable.[7]

In states like Massachusetts and New York, the credit is refundable, so a member receives a refund for the amount by which the credit exceeds the member's state income tax. In states like California, however, the credit is not refundable.

Income exclusion approach

In some states, a member's income for state tax purposes isn't taxed on the income on which the entity paid the PTE tax. Instead of getting a credit for the PTE tax that the entity paid, a member just excludes the member's allocable share of the entity's income from the member's income. This exclusion applies only for state income tax purposes and doesn't affect the calculation of the member's income for federal income tax purposes. States that have adopted the income exclusion approach include Colorado, Georgia, and South Carolina.[8]

[1] IRC §§ 164(a) and (b) (before amendment by Pub. Law 115-97, § 11042).
[2] IRC § 164(b)(6)(B). In the case of a married individual filing separately, the cap is $5,000.
[3] Id.
[4] For example, it's 100% credit in California and New York. Calif. Rev. and Tax. Code § 17052.10(a); and N.Y. Tax Law § 863.
[5] For example, it's a 90% credit in Massachusetts. Mass. Gen. L. ch. 63D § 2.
[6] Calif. Rev. and Tax. Code § 17052.10; Mass. Gen. L. ch. 63D § 2; N.J. Rev. Stat. § 54A:12-5; and N.Y. Tax Law § 863.
[7] Calif. Rev. and Tax. Code § 17052.10(c). In California, any unused credit carries forward for up to five years. Id.
[8] Colo. Rev. Stat. § 39-22-345; Ga. Code §§ 48-7-21(b)(7)(C)(ii) and 48-7-23(b)(3); and S.C. Code § 12-6-545(G).

Which states have adopted the workaround?

States that have enacted a workaround include:

Alabama	Minnesota
Arkansas	Mississippi
Arizona	Missouri
California	Montana
Colorado	Nebraska
Connecticut	New Jersey
Georgia	New Mexico
Hawaii	New York
Idaho	North Carolina
Illinois	Ohio
Indiana	Oklahoma
Kansas	Oregon
Kentucky	Rhode Island
Louisiana	South Carolina
Maryland	Utah
Massachusetts	West Virginia
Michigan	Wisconsin

PTE taxes vary from state to state. As we've seen, some states use a credit (which may be full or partial and which may be refundable or not), while other states use income exclusion. There are difference beyond those. For example, states differ in how they treat tiered pass-through entities (i.e., where one pass-through entity is a member of another pass-through-entity) and whether they allow members to opt out when the entity elects to pay the PTE tax (so that the workaround applies to the members who don't opt out). They also differ with respect to estimated tax payments by the entity and the corresponding impact of those payments on its members.

What has the IRS said about the workaround?

The Internal Revenue Service (IRS) confirmed that this workaround works. In November 2020, the IRS issued a notice, generally concluding that a member isn't subject to the SALT deduction limitation with respect to any state and local income taxes that a pass-through entity pays.[9] In the notice, the IRS announced that it plans to issue regulations on this point.

How might people use the workaround?

For an individual who already is a member of a pass through entity or who can create or restructure a pass-through entity so that income flows through it, this workaround may offer a tax savings. For example, an individual who resides in a state that has enacted this workaround and receives income from a single-member limited liability company that is classified as a disregarded entity for federal tax purposes might consider admitting another member, perhaps gifting or selling a 1% membership interest to another person. After admitting the new member, the limited liability company would be classified as a partnership for federal tax purposes, effectively enabling the PTE tax to be fully deductible for federal income tax purposes. Of course, the individual should consider whether the potential tax savings outweigh the costs and potential downsides of having a multi-member limited liability company.

[9] Notice 2020-75.

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