State and Local Tax Deduction Cap

Abby Shepard, Legislative Counsel
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Legal Background – General Rule

- For purposes of the federal personal income tax, income starts with gross income, which is "all income from whatever source derived." I.R.C. § 61. Taxable income is gross income minus either the standard deduction or itemized deductions. I.R.C. § 63.
- One itemized deduction is for certain taxes paid, including:
  - State, local, and foreign real property taxes.
  - State and local personal property taxes.
  - State, local, and foreign income, war profits, and excess profits taxes.
  - General sales taxes (in lieu of state and local income taxes). I.R.C. § 164.
- This is colloquially referred to as the SALT (state and local tax) deduction.

Legal Background – TCJA Changes

- The federal Tax Cuts and Jobs Act of 2017 (TCJA) created special rules for itemized deduction for taxes paid in tax years 2018-2025. I.R.C. § 164(b)(6).
  - Disallowed foreign taxes from the deduction.
  - Capped at $10,000 the aggregate amount of taxes deducted for any tax year ($5,000 for married individuals filing separately). Applies to:
    - State and local real property and personal property taxes.
    - State and local income taxes.
    - General sales taxes (in lieu of state and local income taxes).
- The federal 2021 Build Back Better bill proposed capping the deduction at $80,000 of taxes paid ($40,000 for married individuals filing separately).
  - Build Back Better bill passed U.S. House but did not pass U.S. Senate.

Legal Background – Vermont Impact

- Vermont's taxable income definition was amended in 2018 in response to the TCJA, in order to decouple from federal itemized deductions. Act 11 of 2018, Sec. H.1.
  - This means that the SALT deduction (including its cap) does not apply to Vermont taxable income and does not directly impact Vermont tax revenues.
- However, the federal cap still impacts Vermont taxpayers who itemize federally and pay more than $10,000 in taxes, thus increasing their tax burden.

SALT Cap Workaround

- States have crafted laws that impose either a mandatory or elective entity-level income tax on pass-throughs that do business or have income derived from or connected with sources in the state.
- "Pass-through entity" means a partnership, S corporation, limited liability company, etc.
  - A pass-through is generally not taxed at the entity level. The individual members, owners, partners, or shareholders pay income tax on the income received from the pass-through when they file their own personal income tax returns.
  - A pass-through is not a C corporation, which is a separate legal entity that is taxed at the entity level. C corporation shareholders also pay personal income tax on dividends received.

SALT Cap Workaround

- The state then provides a corresponding or offsetting income tax benefit to the individual taxpayer, such as a full or partial credit, deduction, or exclusion for the tax paid by the pass-through.
- In Nov. 2020, the Treasury Dept. and I.R.S. issued a notice “blessing” these SALT cap workarounds, stating that taxes paid at the entity-level are not subject to the SALT deduction cap, which only applies to partners and shareholders who itemize deductions. Notice 2020-75.

SALT Cap Workaround

- The state tax paid by the pass-through can be deducted from the pass-through's income at the federal level because the SALT deduction cap does not apply to businesses; only individuals. This reduced federal tax is then passed onto the pass-through members, so they pay less federal income tax.
- The pass-through also passes on the state tax to its individual members. The individual members can then claim a state income tax credit for the tax paid.

SALT Cap Workaround – Other States

- Since 2018, over 20 states have enacted SALT cap workarounds, and there are handful of states with pending legislation.
- Connecticut was the first state to adopt a workaround and is the only state to make the pass-through entity tax mandatory.
- The first proposal introduced in Vermont is: H.527 of 2022.