

State and Local Tax Deduction Cap

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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.
- 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 – #1

- Initially, states attempted to circumvent the deduction cap by creating state tax credits for charitable contributions to certain public and charitable entities, including state governments. I.R.C. § 170(c).
- However, the I.R.S. has seen through and, to an extent, disallowed these structures.
 - If a taxpayer makes a payment to a section 170(c) entity, and the taxpayer receives or expects to receive a state or local tax credit in return for the payment, the tax credit constitutes a return benefit to the taxpayer, or *quid pro quo*, reducing the taxpayer's charitable contribution deduction. Treas. Reg. § 1.170A-1(h).

SALT Cap Workaround – #2

- Subsequently, 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.
- The state then provides a corresponding or offsetting tax benefit to the individual taxpayer, such as a full or partial credit, deduction, or exclusion.
- 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 – Other States

- Since 2018, 22 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](#).

H.527 of 2022

Sec. 9. Adds new subchapter 10C to income tax chapter in title 32.

- Creates a new entity-level tax on pass-through businesses' distributive proceeds derived from or connected with Vermont sources.
 - "Distributive proceeds" means net income, dividends, royalties, interest, rents, guaranteed payments, and gains.
- Applies to pass-through entities: partnership, an S corporation, or a limited liability company; not corporations, although corporations may be a member of a pass-through.
- At least one member of the pass-through must be liable for income tax in Vermont.
- Rate is second highest marginal individual income tax rate (7.6%) under 32 V.S.A. § 5822.

H.527 of 2022

Sec. 9. Adds a new subchapter 10C to 32 V.S.A. chapter 151.

- Tax is elective upon consent of either:
 - each member of electing entity who is a member at the time the election is filed; OR
 - any officer, manager, or member of the electing entity who is authorized, under law or the entity's organizational documents, to make the election and who represents having such authority under penalties of perjury.
- Election must be made annually on or before due date for filing tax return, but may be revoked before due date for filing tax return.
- Pass-through entity is required to report annually to each member the member's share of distributive proceeds for the taxable year.

H.527 of 2022

Sec. 9. Adds a new subchapter 10C to 32 V.S.A. chapter 151.

- Interaction with C corporation unitary combined filing groups
 - Pass-through electing to pay entity-level tax is included in group by default
 - Pass-through electing to pay entity-level tax is excluded from group if:
 - all members of pass-through are taxpayers otherwise liable for Vermont income tax; and
 - no business entity taxed as a C corporation under this chapter has direct, indirect, beneficial, or constructive ownership or control of the pass-through entity.
- Returns and payments are due on or before the 15th day of the third month following the close of each entity's taxable year as determined for federal income tax purposes.
- Estimated tax payments follow the same schedule as for individuals.

H.527 of 2022

Sec. 9. Adds a new subchapter 10C to 32 V.S.A. chapter 151.

- Creates a refundable income tax credit for individual members of pass-through entities that elect to pay entity-level tax.
 - Amount of credit equals member's pro rata share of tax paid by pass-through entity for tax year and is available to member during the same tax year.
- Creates a credit against corporate income tax for C corporation members of pass-through entities that elect to pay entity-level tax.
 - Corporate credit cannot reduce a C corporation member's tax liability below the minimum corporate tax amount. 32 V.S.A. § 5832(2).
 - Amount of credit equals corporate member's pro rata share of tax paid by pass-through entity for tax year and is available to corporate member during the same tax year.
 - Exempt corporations are refunded full amount of pro rata share of tax paid.

H.527 of 2022

Sec. 2. Amends 32 V.S.A. § 5825.

- Creates a credit against tax imposed by another state on a pass-through entity, as long as the other state has a substantially similar tax to Vermont's.
- Credit amount is taxpayer's share of tax owed by the pass-through.
- Credit amount is limited to what the tax would have been if the taxpayer paid tax as an individual and not at the entity level.