# State and Local Tax Deduction and 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 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 liability.

## 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 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 the members 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 corresponding or offsetting state income tax benefit.
  - The tax benefit is typically structured as a full or partial credit, deduction, or exclusion for the individual's share of the state tax paid by the pass-through entity.

#### SALT Cap Workaround

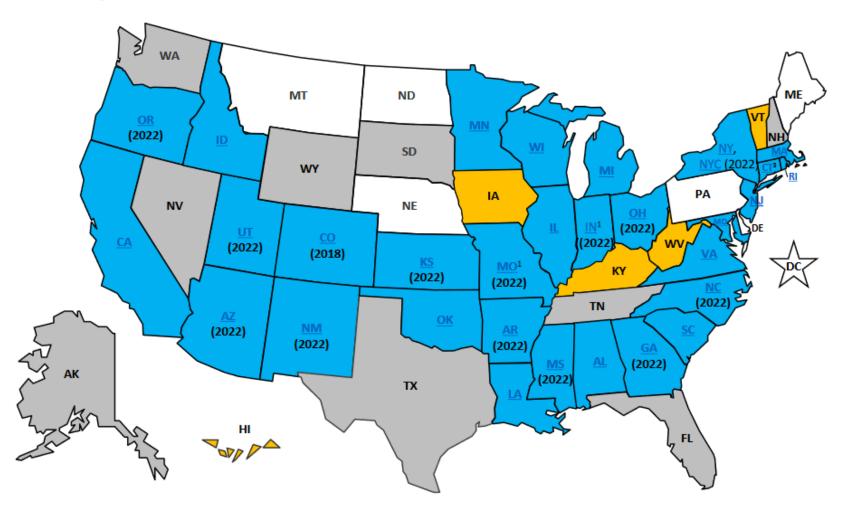
- In Nov. 2020, the Treasury Dept. and I.R.S. issued a notice "blessing" these SALT cap workarounds, stating that taxes paid at the entity-level are not subject to the SALT deduction cap, which only applies to partners and shareholders who itemize deductions. Notice 2020-75.
- The amount of tax deducted at the entity level is not counted in the \$10,000 cap on SALT paid by the individual taxpayer, so individuals may still deduct up to \$10,000 in other SALT paid, such as property taxes.

#### SALT Cap Workaround in Other States

- Since 2018, 30 states (and NYC) have enacted SALT cap workarounds.
  - In 2022, 11 new states (and NYC) enacted a workaround.
- Connecticut was the first state to adopt a workaround and is the only state to make the pass-through entity tax mandatory.
- Most states provide a credit that is a percentage of the tax paid by the entity.
- The first proposal introduced in Vermont is: <u>H.527 of 2022</u>.

#### States with Enacted or Proposed Pass-Through Entity (PTE) Level Tax

As of March 17, 2023



Source: Association of International Certified Professional Accountants https://us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/56175896-pte-map.pdf

30 states (& 1 locality) that enacted a PTE tax since TCJA SALT deduction limitation, effective for 2021 (or earlier) unless noted:

AL,  $AR^1$ ,  $AZ^1$ , CA,  $CO^2$ ,  $CT^3$ ,  $GA^1$ , ID, IL,  $IN^1$ ,  $KS^1$ , LA, MA, MI, MD, MN,  $MO^1$ ,  $MS^1$ ,  $NC^1$ , NJ,  $NM^1$ , NY,  $OH^1$ , OK,  $OR^1$ , RI, SC,  $UT^1$ , VA, WI, and  $NYC^1$ 

- <sup>1</sup> Effective in 2022 or later on map (2022) or (2023)
- <sup>2</sup> Retroactive to 2018
- 3 Mandatory
- 5 states with proposed PTE tax bills: HI – <u>HB1362</u>, <u>SB 1437</u>, in committee IA - <u>HF 352</u>, (<u>HSB 69</u>) in committee KY – <u>HB 360</u> passed legislature, awaiting governor signature

VT – <u>HB61/SB45</u> passed Senate, in House WV - <u>SB 151</u> passed legislature, awaiting governor signature

- 9 states with no owner-level personal income tax on PTE income:
  AK, FL, NH, NV, SD, TN, TX, WA, WY
- 7 states with an owner-level personal income tax on PTE income that have not yet proposed or enacted PTE taxes:
  DC, DE, ME, MT, NE, ND, and PA

