

No Partner/S-Corp Shareholder SALT Deduction Limit on Entity Income Taxes

November 11, 2020

The Internal Revenue Service has announced that it will be issuing proposed regulations clarifying that certain state or local income taxes imposed on and paid by a partnership and/or an S corporation will not be subject to the \$10,000 limit on state and local taxes. Specifically, in [Notice 2020-75](#), the IRS announced that it intends to issue proposed regulation to clarify that state and local income taxes imposed on and paid by a partnership or an S corporation are allowed as a deduction by the partnership or S corporation in computing non-separately stated taxable income or loss for the taxable year of payment.

The Tax Cuts and Jobs Act (Public Law 115-97, 131 Stat. 2054 (December 22, 2017)) added IRC § 164(b)(6), which limits an individual's deduction under IRC § 164(a) (the SALT deduction limitation) for taxable years beginning after 2017 and before 2026 to \$10,000 (\$5,000 in the case of a married individual filing a separate return) for the aggregate amount of the following state and local taxes paid during the calendar year:

- real property taxes;
- personal property taxes;
- income, war profits, and excess profits taxes; and
- general sales taxes.

Notice 2020-75 and the forthcoming proposed regulations are consistent with Congressional intent set forth in Congress's Conference Report to the Tax Cuts and Jobs Act. In enacting IRC § 164(b)(6), Congress provided in the Conference Report that "taxes 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." H.R. Rep. No. 115-466, at 260 n. 172 (2017).

Clarification is needed because, as a way to possibly avoid the SALT deduction limitation, certain U.S. jurisdictions have enacted, or are contemplating the enactment of, tax laws that impose either a mandatory or elective entity-level income tax on partnerships and S corporations that do business in the jurisdiction, or have income derived from or connected with sources within the jurisdiction. (Generally, partnerships and S corporations are not subject to state and local income tax; rather, the partners and S corporation shareholders are subject to tax.) In certain instances, the jurisdiction's tax law provides a corresponding or offsetting, owner-level tax benefit, such as a full or partial credit, deduction, or exclusion. For example, if a partnership with two

equal partners pays a state income tax of \$30,000, the jurisdiction might allow each partner to claim a \$15,000 credit against his or her personal income tax liability owed that jurisdiction. In this example, the question is whether the \$15,000 income tax credit that each partner receives is subject to the SALT deduction limitation.

The forthcoming proposed regulations will provide clarity by introducing the concept of “Specified Income Tax Payments,” and providing that Specified Income Tax Payments are deductible by partnerships and S corporations in computing their non-separately stated income or loss. Any Specified Income Tax Payment made by a partnership or an S corporation during a taxable year does not constitute an item of deduction that a partner or an S corporation shareholder takes into account separately in determining the partner’s or S corporation shareholder’s own federal income tax liability for the taxable year. Instead, Specified Income Tax Payments will be reflected in a partner’s or an S corporation shareholder’s distributive or pro-rata share of non-separately stated income or loss reported on a Schedule K-1 (or similar form). The effect of the non-separately stated treatment is that the Specified Income Tax Payment is not treated as flowing through to, and paid by, the partner or shareholder even though such partner or shareholder may receive, on their personal tax return, a full or partial credit, deduction, or exclusion for their “share” of the tax . If the partner or shareholder is not treated as paying the tax, the SALT deduction limitation does not apply.

The term “Specified Income Tax Payment” means any amount paid by a partnership or an S corporation to a state, a political subdivision of a state, or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or the S corporation. For this purpose, a Specified Income Tax Payment includes any amount paid by a partnership or an S corporation to a Domestic Jurisdiction pursuant to a direct imposition of income tax by the Domestic Jurisdiction on the partnership or S corporation. It is irrelevant (1) whether the imposition of and liability for the income tax is the result of an election by the entity or (2) whether the partners or shareholders receive a partial or full deduction, exclusion, credit, or other tax benefit that (a) is based on their share of the amount paid by the partnership or S corporation to satisfy its income tax liability under the Domestic Jurisdiction’s tax law and (b) which reduces the partners’ or shareholders’ own individual income tax liabilities under the Domestic Jurisdiction’s tax law.

The proposed regulations will apply to Specified Income Tax Payments made on or after November 9, 2020. The proposed regulations will also permit taxpayers to apply the rules described in Notice 2020-75 to Specified Income Tax Payments made in a taxable year of the partnership or S corporation ending after December 31, 2017, and made before November 9, 2020, provided that the Specified Income Tax Payment is made to satisfy the liability for income tax imposed on the partnership or S corporation pursuant to a law enacted before to November 9, 2020. Until the proposed regulations are issued, taxpayers may rely on the provisions of Notice 2020-75 with respect to Specified Income Tax Payments.

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