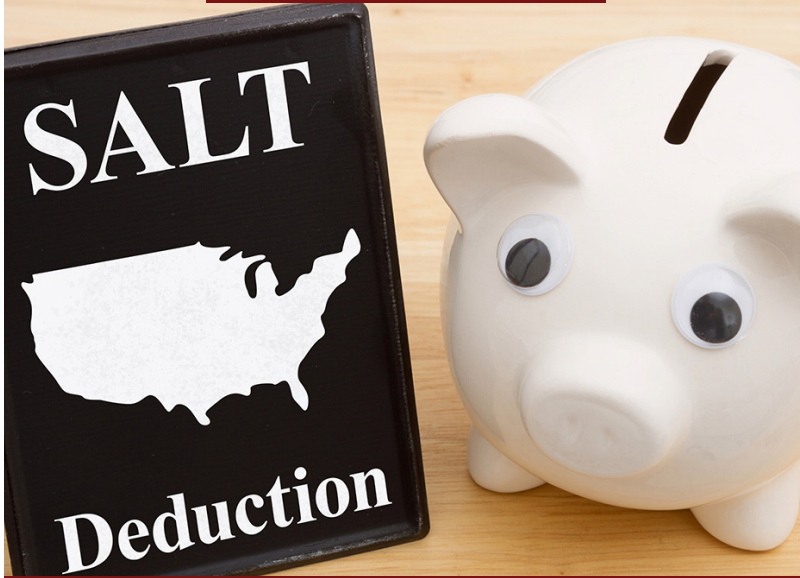




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In May of 2018, we alerted our readers to Internal Revenue Service (IRS) Notice 2018-54, which: (1) addressed certain state efforts attempting to circumvent the newly effective state and local tax [\(SALT\)](#) deductions cap, and (2) clearly stated the IRS's position then that "taxpayers should be mindful that federal law controls the proper characterization of payments for federal income tax purposes."¹ Although, Notice 2018-54 was expressly targeting states' plans to allow certain payments made in exchange for SALT credits (such as converting local property taxes into charitable contributions)—the tone led many to believe that the IRS would maintain that approach even for other types of workarounds.

IRS Projects Guidance Allowing Pass-Through Entity SALT Cap Workaround

By Mary Lundstedt, Esq.

Rather surprisingly, we can report now that on November 9, 2020, the IRS issued Notice 2020-75 stating that guidance is forthcoming to allow pass-through entity (PTE) SALT cap workarounds.² More specifically, the IRS stated that it intends to issue proposed regulations which will:

"clarify that State and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment."³

PTE SALT cap workarounds have been increasingly popular among the states—with Maryland joining the trend, effective July 1, 2020. In short, this type of workaround, the PTE is permitted (or in some states, mandated) to pay state income taxes at the entity level. Using Maryland's workaround here as an example, it means in practical terms that: (1) the PTE pays at a tax rate of 8.25% as to the PTE members' taxable income shares, and (2) the SALT cap is avoided because it only applies to individuals.

Per IRS Notice 2020-75, we know that the IRS intends to "provide certainty to individual owners of partnerships and S corporations in calculating their SALT deduction limitations" by permitting PTE SALT cap workarounds.⁴ The IRS stated that the proposed regulations would clarify that PTEs may deduct "Specified Income Tax Payments" when computing their non-separately stated income or loss. Note that "Specified Income Tax Payments" is defined in the new Notice as:

"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."⁵

The IRS explained that the proposed regulations would provide that a PTE that makes a Specified Income Tax Payment during a taxable year is then allowed a deduction for that payment in computing its taxable income for the taxable year in which it's made. Moreover, according to the IRS, the proposed regulations would require Specified Income Tax Payments to be reflected in a partner's or S corporation shareholder's distributive or pro-rata share of non-

separately stated income or loss on a form such as Schedule K-1.⁶ Finally, the IRS emphasized that the proposed regulations would provide that Specified Income Tax Payments will not be accounted for when applying the SALT deduction cap to any individual who is a partner or S corporation shareholder of the PTE making the payment.

The proposed regulations will be applicable to payments made on or after November 9, 2020. We will continue to monitor developments in this area of tax law, but for now it seems that the IRS has resolved an issue that has vexed small businesses since the beginning of 2018.

Footnotes

1. 2018-24 I.R.B. ____ (June 11, 2018). You can read our full alert, *IRS Responds to States' Attempts to Circumvent SALT Cap*, at: <https://www.districtofcolumbiataxattorney.com/articles/irs-responds-to-states-attempts-to-circumvent-salt-cap/>.
2. 2020-49 I.R.B. ____ (Nov. 30, 2020); IR-2020-252 (Nov. 9, 2020).
3. *Id.* at 1.
4. *Id.* at 5.
5. *Id.*
6. *Id.* at 6.

Additional Resources



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