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A house under construction in Greenwich, Conn., in 2010. Connecticut is at the center of debate over the tax law's limit on state and local tax deductions.

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IRS Pushback on SALT Workarounds Worries Connecticut Tax Pros

By Kelly Zegers

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- *Connecticut program at center of debate over SALT cap*
- *IRS already curbed other attempted state workaround*

Connecticut tax professionals are warning clients that the IRS may not let them keep benefits from a state program designed to ease the pain of the tax law's cap on state and local deductions.

The state's workaround is viable for now, but the IRS has already issued guidance killing another effort to circumvent the $10,000 cap, and officials have suggested they're not done. The result of regulations curbing the Connecticut plan would be simple: Taxpayers could end up paying more in federal taxes.

"The uncertainty is giving a lot of tax preparers and tax attorneys agita," Marc Finer, a Hartford-based tax attorney at Murtha Cullina LLP, who said he has warned clients that the IRS could issue guidance.

Connecticut's workaround applies to pass-through businesses, like LLCs and partnerships, where the tax burden usually falls on individuals. The state created a new tax on the entities, which is offset by a corresponding personal income tax credit. The amount of the tax is a deductible expense on their federal return.

Finer said he has advised clients that if an entity is subject to the pass-through entity tax, it should pay with the understanding that the IRS may ultimately decide the entity-level deduction isn't legitimate for federal income tax purposes.

Alan Lieberman, another Hartford attorney, said everyone is in "regulatory limbo." He has advised some clients to request an extension to file their 2018 returns, in the hopes that guidance from the IRS could come before the extension is up. Otherwise, taxpayers may have to file amended returns and pay the additional federal taxes owed.

"Even those folks whose returns are on extension ultimately will be forced to take a position if we don't have some resolution one way or another by October," said Lieberman, managing partner at Shipman & Goodwin LLP.

The IRS directed comment requests to the Treasury Department, which didn't respond.

Viable Workaround?

The IRS issued final rules (T.D. 9864) in June that killed one type of workaround attempted used by some states, including New York and Connecticut, which would have allowed state tax credits for donations made to newly created charitable funds aimed at a variety of state programs.

New York, New Jersey, and Connecticut sued over the IRS' action in July.

"I don't know of any municipality that actually went ahead and created a charitable organization," said Eric Gjede, vice president of government affairs for the Connecticut Business & Industry Association, which represents thousands of companies. "I think everyone kind of new almost immediately it wasn't going to fly."

But the pass-through entity tax approach is different. Bruce Ely, partner at Bradley Arant Boult Cummings LLP, said that Connecticut's approach is likely more viable because it is mandatory—meaning individual partners or shareholders have no control over whether or not they keep pass-through entity status.

“My thinking is, the service may try to attack these, but I think they’ve got tough sledding, especially with a state like Connecticut that imposes a mandatory entity-level tax,” Ely said. “That’s not something the individual taxpayer can game the system.”

There may be a good argument for elective taxes, too, he said. All partners are bound by the choice they make, he said.

So far four other states, most recently Rhode Island, have enacted an elective pass-through entity tax. Connecticut has the only mandatory tax at this point.

Other states might be taking a wait-and-see approach on whether they take a similar step, Ely said. Michigan is among those considering a pass-through workaround.

But the credit available through the pass-through workaround could face the same scrutiny as the charitable scheme, if Treasury considers it to be a “quid pro quo” transaction, said Michael Knight, a CPA in Fairfield, Conn.

The legal claims in the New York, New Jersey, and Connecticut lawsuit center on the tax code section that allows taxpayers to deduct charitable contributions. The states argue that the IRS rules treat a SALT credit as a “quid pro quo” when the taxpayer receives it in return for having made a charitable contribution, even though a credit shouldn’t be treated as a return benefit.

Sooner, Rather Than Later

Ultimately, tax practitioners want clarity as soon as possible.

The IRS’s third-quarter update to its priority guidance plan, released in June, says the IRS plans to address how to apply the state and local deduction cap under Section 164(b)(6) to pass-through entities.

IRS Chief Counsel Michael Desmond told Bloomberg Tax in June that the agency wasn’t finished examining state workaround programs without giving further details.

“The longer you don’t come out with something, the more people are going to assume it’s tacit concern,” Knight said.

Knight, at Knight Rolleri Sheppard CPAS LLP, agreed that tax practitioners should be more conservative for clients until there is guidance.

Ideally, any IRS guidance would be consistent with a footnote in a document from 2017 tax law’s conference committee that essentially states the SALT limit wasn’t intended to change in any way the deductibility for pass through business entities, Lieberman said.

“That would be the ideal scenario certainly for taxpayers here in Connecticut and other states where pass through entity taxes have been enacted,” he said.

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