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NEWS ALERT

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IRS Provides Certainty Regarding Deductibility of Connecticut Pass-Through Entity Tax Payments

By Marc T. Finer | November 19, 2020

One of the most controversial individual income tax changes enacted under the Tax Cuts and Jobs Act ("TCJA") is the $10,000 cap on the deduction for state and local income and property taxes ("SALT") for federal income tax purposes. Because this SALT deduction limitation does not apply to entities, Connecticut, as well as a number of other states, enacted a pass-through entity tax ("PET") on partnerships (including limited liability companies taxed as partnerships) and S corporations. The PET imposes the SALT taxes at the entity level. The consequences of this are that the taxes become a fully deductible business expense for federal income tax purposes and reduce the taxable income passed through to the partners and shareholders. However, until recently, the "million dollar question" was whether the IRS would respect these entity-level taxes and the corresponding business deduction.

On November 9, 2020, the IRS announced in Notice 2020-75 that the Treasury Department intends to issue proposed regulations to clarify that state and local taxes imposed and paid at the pass-through entity level are fully deductible (i.e., not subject to the SALT deduction limitation) in computing the entity's federal taxable income or loss for the tax year of the payment. Specifically, the Notice states that partnerships and S corporations are permitted to deduct "specified income tax payments" paid by the entity to a state, a political subdivision of a state (e.g., a county or municipality), or the District of Columbia to satisfy its liability for income taxes imposed by the jurisdiction. The practical effect of the clarification is that these taxes are not passed through to the partners and shareholders as a separately stated expense, which then would be subject to the $10,000 SALT deduction limitation. Importantly, the Notice does not differentiate between pass-through entity tax regimes that are mandatory versus elective and ignores the individual tax credit mechanism these regimes may include for the entity owner to avoid double taxation on the same income.

The Notice states that the proposed regulations will apply to specified income tax payments made on or after November 9, 2020. The Notice also states that the proposed regulations will allow taxpayers to apply the rules of the Notice to a specified income tax payment paid in tax years ending after December 31, 2017, and before November 9, 2020, if 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 November 9, 2020.

The issuance of Notice 2020-75 is welcome news to tax practitioners and individual owners of pass-through entities who remained in limbo about whether they could fully deduct SALT expenses under the Connecticut pass-through entity tax for federal income tax purposes. Importantly, in Notice 2020-75, the IRS finally makes it clear that the Connecticut PET is a legitimate deductible entity-level business expense for federal income tax purposes. The Notice likely will cause more states to enact some form of pass-through entity tax now that the IRS has blessed the tax as a workaround to side-step the $10,000 SALT deduction limitation enacted under the TCJA. This is because states hit hard by COVID-19 are facing significant financial pressures and will be looking for ways to increase revenue while avoiding tax increases on wealthy residents who might then flee to low or no tax states as a result. The IRS has now declared that it will not challenge the pass-through entity tax as a strategy to accomplish this goal.

If you have any questions regarding Notice 2020-75, the PET regime, how the PET might impact your business, and/or any potential tax planning opportunities that are available under the PET regime, please contact Marc T. Finer, Tax Partner, at 860-240-6096 or mfiner@murthalaw.com.