Featured Articles

Connecticut Finds a SALT Workaround That Would Actually Work

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Connecticut's newest proposed workaround to the cap on state and local tax deductions still hasn't received much media attention, but that could change soon because those who have read it say it would work.

In case you missed it, Gov. Dan Malloy (D) earlier this month added a third proposal to the national mix of potential methods for working around the $10,000 SALT deduction limit in the federal Tax Cuts and Jobs Act.

Developed by the Department of Revenue Services, the proposal calls for an entity-level tax on the net income of passthrough businesses and an offsetting individual income tax credit for the entity's members. Taking advantage of the fact that the new SALT cap does not apply to businesses, the proposal would effectively shift back to Connecticut residents a projected $600 million in otherwise lost SALT deductions.

"It works, and we can't see any way that there's any credible argument the federal government could make — IRS or otherwise — to disallow this," said Revenue Commissioner Kevin Sullivan.

Now that the proposal has circulated, people are coming out in support of it, including Brian Reardon of Reardon Consulting LLC, who lobbies Congress and Treasury on behalf of the S Corporation Association.

"For most states, this approach would make the state more attractive to businesses," Reardon said, adding that the trade association will be seeking similar changes in other states. "The law is clear that taxes paid by the entity are deductible, so I don't know how or why the IRS would challenge this."

Entity-level taxes on passthroughs have existed in some jurisdictions for years. "Why not have more of them if done properly?" asked Stephen Kranz of McDermott Will & Emery, who agreed that the proposal provides another tool for states attempting to address the new SALT deduction limits.

Examples of entity-level taxes based on net income include the unincorporated business taxes (UBT) imposed by New York City and the District of Columbia, the personal property replacement tax in Illinois — a tax based on income and imposed on passthroughs — and the excise and franchise tax in Tennessee. Ohio imposes its commercial activities tax on passthroughs, as does Texas with its margin tax and Los Angeles with its business tax, but those are taxes on gross receipts rather than net income.

Brad Wilhelmson of KPMG LLP said that even in Connecticut the idea isn't new, because through the early 1980s the state had a tax on unincorporated businesses. He said some of the logistics of Connecticut's latest proposal are similar to rules already in place in other states that tax passthrough entities or require withholding. "But the aspect of the refundable tax credit for individual owners, or the carryforward tax credit for corporate owners, is not a common aspect among the current taxes in other states," Wilhelmson said.

"The real thing that makes this a little different is the credit that the individual or corporation gets on their return for the amount of taxes paid at the passthrough entity level," Wilhelmson said. "In most other states, you get the deduction for it, but you don't get a separate credit for it. There may be subtractions of income or other tiering mechanisms to prevent doubling of the tax at tiers, but that's done through the tax base and not as an after-tax computation tax credit."

Across the board, leading SALT practitioners and think-tank advisers said the Connecticut proposal would be a viable workaround to the SALT cap — whether observers believed the approach makes for good state tax policy was another matter. Several people recommended modifications to Connecticut's first legislative language, while others discussed the broader issues inherent when any state considers adopting such a proposal.

"There are some technical details that still need to be thought through, some of which could lead to constitutional issues if they aren't handled right," said Shirley Sicilian, also of KPMG.

The Specifics

S.B. 11, which contains the governor's proposal, was introduced by four members of Connecticut's Democratic leadership and is pending in the legislature's Joint Finance and Revenue committee. While the proposed entity-level tax on passthroughs and its corresponding

individual income tax credit represent only one piece of the state's response to the changes in the federal tax law, the administration is explicitly framing the proposal as a workaround to the cap on SALT deductions.

Lost SALT deductions will cost Connecticut residents more than $10.3 billion. Forty-one percent of Connecticut residents claim the deduction at an average amount of $18,940, which the governor's office said puts the state behind only New York's average claim of $21,038. And according to Sullivan, most of the taxpayers affected — 66 percent — have annual incomes in the $250,000–$500,000 range and do not represent the state's wealthiest top 1 percent.

"The governor wanted to look at what we might do as a state, and we have come up with two solutions," Sullivan said.

The plan calls for Connecticut to impose a 6.99 percent income tax on the net receipts of partnerships, S corporations, and limited liability companies that are partnerships for federal purposes. Sullivan said that because state and local taxes paid or accrued in carrying on a trade or business are still deductible at the federal level, passthroughs could claim the amount as an expense for federal deduction purposes. That expense would arguably lower the passthrough's distribution to members who work in the entity, while the new state individual income tax credit would offset 100 percent of the tax the members paid on the passthrough income. In this way the passthrough is held harmless for the additional tax, the individual is held harmless for the SALT deduction cap, and Connecticut gets the benefit of the deduction continuing at the business level.

"I call it the virtuous tax circle — no losers, all gainers, and a bit of payback for what I think was the utter disregard of the Congress for the impact of this on states like Connecticut," Sullivan said.

As a workaround to the SALT deduction limits, the proposal for an entity-level tax and offsetting individual income tax credit is unique to Connecticut. Like other states, Connecticut has proposed its own version of the charitable donation workaround to the SALT cap. A third major workaround, proposed by New York Gov. Andrew Cuomo (D), would involve converting income taxes to payroll taxes.

Reaction

"I like the fact that states like Connecticut and New York are looking for creative ways to help taxpayers in their states," said Timothy Noonan of Hodgson Russ LLP, a frequent writer on New York state and local tax law.

Noonan said that when Treasury Secretary Steven Mnuchin in January called some of the floated SALT cap workarounds ridiculous, he seemed to be objecting to things like the charitable deduction workaround, where a taxpayer would be able to reclassify a state tax payment as a charitable deduction by directing it to a state-created charitable fund.

"The Connecticut change is different," Noonan said. "It's not a reclassification of tax dollars. Instead, the tax is being shifted, in substance and in form, to another taxpayer. It's not at all unusual for a state or locality to impose a tax on flow-through entities. I agree with Commissioner Sullivan that it 'works.' I don't think the IRS could disallow the entity the deduction just because it was designed as a workaround."

Reardon agreed. "It makes sense for states like Connecticut to shift the incidence of the tax — who's writing the check — to the entity, making those taxes deductible to the shareholders," Reardon said. "As their commissioner says, it's a win-win." Reardon said the S Corporation Association is requesting minor changes to Connecticut's legislative language, including recommending that the entity-level tax be an election rather than mandatory.

Alan Goldenberg of Friedman LLP, who represents clients before both the IRS and state tax authorities, said the Connecticut proposal "seems to be the most reasonable 'workaround' with respect to the SALT deduction." Besides serving as a workaround, entity-level taxes can ease compliance from a state perspective, Goldenberg said; because tax is collected at the entity level, often there is no need for multiple entities in a tiered partnership organization to file returns.

"This cuts down on compliance processing and ensures states receive their revenues up front," Goldenberg said. "Even states without entity-level taxes often permit the filing of composite returns whereby a partnership pays the taxes of its nonresident partners."

Michael Mazerov of the Center on Budget and Policy Priorities is also a fan. "Governor Malloy's proposal to shift the liability for passthrough business taxes from the owners to the entities themselves is a very promising strategy for preserving the deductibility of these taxes," he said. "It has the added benefit of increasing the chance that the taxes due from out-of-state owners will be paid in full, which states often find difficult to ensure."

Jared Walczak of the Tax Foundation started out sounding like he'd wind up in the camp supporting Connecticut's proposal. "Compared to other states' efforts at SALT deduction cap avoidance, Connecticut may have a decent argument for the legality of its proposal," Walczak said. But then he said that even if the proposal is legally viable, it diverges sharply from the principles of sound tax policy.

"This labyrinthine scheme may not run contrary to federal law, but administration could be a nightmare, especially when businesses have owners in multiple states," Walczak said. "It's also peculiar that Connecticut would go out of its way to provide a tax benefit to passthrough business owners that isn't available to wage earners. The desire to find workarounds to the new federal law seems to be outstripping any sort of concern for whether the workarounds achieve a legitimate state policy goal."

Mark Richards of Ice Miller LLP in Indianapolis said threats by states to circumvent the SALT deduction limitations reflect bad state tax policy generally, and Connecticut's newest proposal is no exception.

"This proposed law is effectively *publicized* as intended solely for federal income tax avoidance," Richards said, adding that any state legislation designed to create a workaround to federal law will generate complexity and uncertainty.

Meg Wiehe of the Institute on Taxation and Economic Policy had yet another take, saying that states may have good reasons to start taxing passthrough businesses at the entity level, "but that has nothing to do with the new federal tax law."

"The Connecticut proposal would allow the owners of passthrough businesses, and no one else, to avoid the cap on state and local tax deductions in the new federal law," Wiehe said. "Singling these people out for more tax savings does not make sense because they just received a particularly lavish tax break under the new federal law in the form of the 20 percent deduction for passthrough income."

Wiehe said the proposal should be modified to claw back some of the federal tax savings provided to high-income taxpayers with passthrough income. "For example, the tax imposed at the entity level could be greater than the personal income tax credit received by the owners, who would effectively pay the state a portion of the federal tax break they have received," she said.

Mazerov agreed, and then went one step farther, saying that all states should consider imposing some type of permanent entity-level tax on passthroughs in addition to income taxes on the owners. "Many of these businesses are a lot larger than many taxable C corporations while providing limited liability for all their owners, just like C corporations do," Mazerov said. "It's hard to justify passthrough treatment in these circumstances."

Noonan said Connecticut's proposal is a viable way for states to address the potential harm created by the loss of the SALT deduction. "The fact that Connecticut has chosen to do so to curb some of the negative effects from federal tax reform doesn't trouble me as a policy matter."

"That said, there's one aspect in particular that I think needs to be seriously considered before this becomes law, and that relates to the harm that this could cause for multistate taxpayers, particularly nonresident owners," Noonan said.

He was referring to what Steven Wlodychak of EY calls the "*Wynne II*" problem.

Wynne II

In *Comptroller of the Treasury of Maryland v. Wynne* (2015), the U.S. Supreme Court found Maryland's failure to provide a full credit for individual income taxes paid to other states to be unconstitutional under the dormant commerce clause. The case involved Maryland's denial of a county income tax credit for income a couple received from an investment in an out-of-state S corporation.

"States that are interested in imposing an entity-level tax need to carefully structure the regime, making sure to give credit to similar entity-level taxes imposed by other states, to avoid a constitutional challenge," Kranz said. "Connecticut has appropriately provided for such a credit," he added.

It's true that under the legislative language, Connecticut would provide a credit to an individual for taxes paid to another state with a similar tax or regime. "But it doesn't give details. It delegates to the commissioner to determine how that credit is formulated," said Wilhelmson. One question this raises is which specific taxes imposed by other states would be allowed as part of that credit, and which wouldn't. "It's going to be a little more interpretative whether another partnership tax, such as a gross receipts tax, would fall under that provision or not," he said.

Wlodychak acknowledged that the drafters of the Connecticut proposal would credit tax paid under a similar regime, but asked: "What's the nonresident's resident state going to do with this? That's the '*Wynne II*' problem."

"Unless Connecticut gets every other state to go along with its proposal, there's a very serious problem. Is Gov. Cuomo going to go along with credits for contributions to Connecticut charities and payments of Connecticut UBT? I am a supreme skeptic," Wlodychak added.

Noonan elaborated. He said that under current law, the Connecticut tax paid by nonresidents on income from passthrough entities is usually creditable in the nonresident's home state. By shifting the tax burden to the entity, these nonresidents would still bear the economic burden of the tax, but because the individuals didn't pay the tax, their home states might not allow them a resident credit. To illustrate, Noonan provided the following example:

> I'm a nonresident partner in a partnership that does business in Connecticut. Right now, let's say I pay $500 in tax to Connecticut each year. But it's a net zero for me, because New York gives me a full credit. Under the new regime, I don't pay $500 to Connecticut, my firm does. And then my firm can deduct it, which is nice. I still bear the economic burden of the after-tax $500 payment though, since my income will get reduced by that amount (after taking into account the benefit of the deduction my firm got). But is New York going to give me a credit for that $500? I don't think so, since I didn't pay it. And yes, this problem has arisen with other state/city entity-level taxes.

"For this to really to work, this problem needs to be addressed," Noonan said.

Wilhelmson agreed that one of the things that can happen under the mechanics of the tax is that a nonresident could ultimately — across their federal and state income taxes — owe more after the tax is in place. He said that for individuals in states with a personal income tax, the advantage of the federal deductibility of the Connecticut entity-level tax may be outweighed by the fact it might not end up in the credit for taxes paid computation. Wilhelmson said it depends on the benefit of federal deductibility versus the additional tax a nonresident would pay in their state of residency if the Connecticut tax is not included in their credit for taxes paid computation; it would vary by state if the Connecticut tax is included in a nonresident's credit for taxes paid computation.

Is it Connecticut's job to get every other state on board? "From a legalistic point of view, no, they're not compelled by the Constitution to get every other state on board," said Sicilian. "But as a practical matter, given the impacts the Connecticut proposal could have on nonresident investors and Connecticut partnerships, it would be good if other states were on board."

Unpredictable Outcomes

The IRS's new centralized partnership audit regime has already led to discussion about whether more states would move to taxing partnerships at the entity level.

When the Multistate Tax Commission formed a work group to consider state responses to the IRS partnership audit regime, some states asked the group to consider state entity-level taxation issues in connection with the project. MTC staff provided a very preliminary overview of the issue early on — but since then, the group has focused primarily on developing a model state statute

for reporting federal partnership audit adjustments. MTC General Counsel Helen Hecht told the work group that entity-level state tax assessment would inevitably shift taxes between residency and source states to some extent, and in sometimes unpredictable ways.

"I would say that our analysis of the entity-level tax issues has, so far, been in the context of the partnership-pays election for federal partnership level audits, but the basic analysis is the same," Hecht now says. "The difference between partner-level and partnership-level tax, for individuals, is the difference between our hybrid residency-source-based system for taxing individuals, and our pure-source-based system for taxing entities. The bottom line is that, assuming state tax rates differ, imposing tax at the partnership level, rather than the partner level, may change to total tax paid and may shift the tax from one state to another state."

Hecht said the states most affected are those with higher individual tax rates and with higher levels of residents with substantial partnership income. "In those states, because partners currently pay tax on 100 percent of their income and take a credit for taxes paid to other states on a source basis, that state picks up tax on any untaxed or lower-taxed income," she said. "But if tax is imposed at the entity level on a pure-source basis, the residency states would not pick up tax on any untaxed income, or income taxed at a lesser rate."

Hecht added that there is one exception. "In a number of states, purely passive investment income from partnerships is taxed solely on a residency basis." She said that if all states did that, then that income could be taxed at the partnership level by apportioning based on residency rather than source, without affecting the overall amount of tax paid or the states to which it is paid. "But that doesn't solve the issue for other types of income [that] would be apportioned at the entity level based on the typical entity factors," she said.

The handful of states that would be more affected are not typically MTC compact members, and some do not participate in the MTC's uniformity process. "So, it's not clear to me whether the committee will be interested in doing more with the issue once we've wrapped up the audit issues, but it's possible," Hecht said.

In the end, Noonan said he does not believe Connecticut's entity-level tax proposal combined with the offsetting individual income tax credit will jump-start state movement to tax passthroughs, as the method has its share of complications. "It's not as easy as just flipping a switch," he said.

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