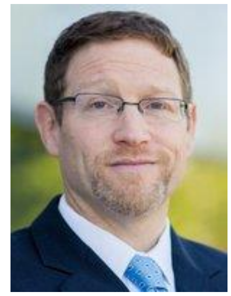
NJ Tax Talk: New Bypass For SALT Deduction Cap

By **Steven Saraisky and Reuben Muller**



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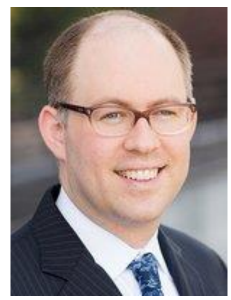

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New Jersey has enacted legislation that gives business owners of pass-through entities a way to bypass the $10,000 limit on state and local tax deductions.

The $10,000 state and local tax limitation was implemented under federal law in the Tax Cuts and Jobs Act.[1] The law has been controversial because of its disproportionate effect on high-tax jurisdictions like New York and New Jersey.

The Pass-Through Business Alternative Income Tax Act allows pass-through entities in New Jersey, which are S corporations and partnerships (including limited liability companies that are treated as partnerships for income tax purposes), to elect to pay state income taxes at the entity level (where deductions for such taxes are not limited) instead of at the personal income tax level. The individual taxpayer (who receives the flow-through income from the business) can then claim a gross income tax credit on his or her personal New Jersey income tax return.

In effect, this allows taxpayers who qualify to reduce their federal income by the full amount of state and local taxes paid by the pass-through entity since such amount is deducted from the taxpayers' taxable distributive share from the pass-through entity. This provides the same result as what was previously a full deduction against federal income tax for state and local taxes paid.

The legislation is effective for pass-through entities with taxable years beginning on or after Jan. 1. The law works by imposing an alternative income tax at graduated rates depending on the amount of the distributive proceeds of the pass-through entity to its owners. For instance, for 2020, if the distributive proceeds are greater than or equal to $5 million, the tax is $427,887.50 plus 10.9% of the excess over $5 milllion. The owner would receive a dollar for dollar credit on his or her gross income tax return.

For most, the effect of paying at a higher rate at the entity level will not make a material difference because of the offsetting credit. Nonetheless, this is something that should be considered. A second concern under the new law is that the liability for tax would now rest on the pass-through entity itself.

Under normal circumstances, one partner or shareholder would not be liable for the gross income tax liability of another partner or shareholder. Here, though, once elected, the tax liability needs to be paid by the entity (but the law also provides explicit relief to the entity for taxes of any nonconsenting owners).

It is also not uncommon for the amount of taxable distributive proceeds to exceed actual cash distributed by the entity. When the entity invests its profits back into its operations, the members or shareholders will be taxed on the phantom income. Without the election, the gross income tax liability was not a concern for the entity and the entity would not have to consider how it would be paid. With the election, the entity needs to pay the alternative income tax, which would be a new item to budget. If the entity doesn't pay the tax, the partner or shareholder is not entitled to his or her pro rata credit.

It is estimated that the new law will save New Jersey business owners $200 to $400 million annually on their federal tax bills. Sen. Troy Singleton, D-Delran, one of the sponsors of the bill, said in a statement, "This law will help to defray the out-of-pocket income tax hit for small business owners here in New Jersey and help alleviate the inequities created by the federal tax law."

The New Jersey Society of Certified Public Accountants assisted with the legislation. The executive director of the NJCPA, Ralph Albert Thomas, said in a statement:
We are grateful to the Governor, the Legislature and all those who supported the bill. Their dedication to assisting small businesses in New Jersey does not go unrecognized.

The new tax bill is not the first attempt to work around the $10,000 SALT deduction limit. An earlier approach in New York created a state-run charitable fund to which a taxpayer could contribute as a way of paying his or her taxes and receive tax credits in return. In New Jersey, Gov. Phil Murphy signed legislation in 2018 aimed at allowing taxpayers to convert local property tax payments into charitable contributions that could be deductible on federal tax returns.

However, the Internal Revenue Service issued regulations last year that prevent state-run charitable funds from being used in this way. At the present, there has been no federal response to the New Jersey legislation though it would not be surprising to see the U.S. Department of the Treasury issue temporary or proposed regulations to counter the new law as the law's purpose is to allow taxpayers a workaround to avoid the SALT limitation.

In addition, New Jersey, New York and Connecticut filed a lawsuit in the U.S. District Court for the Southern District of New York to challenge the IRS regulations, which is ongoing. These three states and Maryland also filed suit in the Southern District of New York to challenge the deduction cap itself. That case was dismissed by the U.S. District Judge J. Paul Oetken but is on appeal.

The new legislation may give New Jersey business owners a reason to structure a business as a pass-through entity. For example, an entrepreneur choosing between forming a startup business as a single-member LLC, which would be disregarded for federal and state income tax purposes (and not qualify as a pass-through entity), and an S corporation which could take advantage of the new law, would have an incentive to choose the S corporation structure. Owners of other businesses that are typically organized as pass-through entities, such as law firms, accounting firms and medical practices, would also stand to gain.

Wage earners with state income and property taxes in excess of $10,000, though, have nothing to gain from the new legislation and would justifiably be frustrated by the uneven concern that the legislature has extended to some but not all heavily taxed New Jersey residents.

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[1] Tax Cuts and Jobs Act.