Federal tax legislation in 2017 limited the deductibility of state and local taxes for individuals to $10,000 per year–but subsequent IRS guidance and changes in state laws have provide an opportunity for taxpayers to select an alternative tax regime for savings. In this week's Tax Credit Tuesday podcast, Michael Novogradac, CPA, Novogradac partner Tom Boman, CPA and Novogradac principal Reza Karim, CPA, discuss the options available to taxpayers. They present an overview of IRS Notice 2020-75, examine approaches by different states, show how those approaches work, explain how taxpayers qualify for options and look at other issues connected to state and local taxes.

Summaries of each topic:

1. Overview of IRS Notice 2020-75 (3:56-7:18)
2. Approaches by different states (7:19-14:06)
3. Examples of how different approaches work (14:07-19:26)
4. How to qualify for different options (19:27-26:21)
5. Additional issues (26:22-29:51)

Episode Transcript

[00:00:11] **Michael Novogradac, CPA:** Hello, I'm Michael Novogradac. And this is Tax Credit Tuesday. This is the Tuesday, November 30th, 2021 podcast. This week's podcast addresses a state and local tax planning opportunity that is available to many business owners. The planning opportunity relates to the limitation on the deductibility by individuals of state and local taxes.

More specifically, the Republican tax bill enacted in December 2017 limits the deductibility of state and local taxes by individuals to $10,000 a year. This limitation has its greatest effect on most individuals by limiting the ability to deduct state and local income taxes. Now I emphasize limitation by individuals because the limitation on the deduction of state and local income taxes does not apply to corporations and partnerships. Rather, corporations and partnerships are generally allowed to deduct their state and local income taxes as a business expense and are therefore not subject to the $10,000 limitation that individual face.

Well, fast-forward to last November. The Internal Revenue Service formally acknowledged this difference when it issued IRS Notice 2020-75. The IRS notice clarified that state and local income taxes paid by a partnership or an S corporation are allowed as a deduction, generally when computing non-separately stated taxable income or loss. Now, as a response to the IRS guidance and even in advance of the IRS guidance, a number of states modified their state tax rules. Now we'll note that the Build Back Better Act that was passed by the House would increase the state and local tax deduction limit well beyond $10,000. However, we do expect to see changes in that increase in the limit in the Senate should the Senate end up passing the bill. So we're not sure how that $10,000 limit may be increased in the year ahead. And I would also note that bill does propose sunsetting the limitation at some time out in the future.

Now, this week's podcast will help listeners learn more about this potential tax savings opportunity. We're going to start off with some background as to how states are responding to IRS Notice 2020-75. Responses do vary by state and we'll look at two of the primary ways states address this planning opportunity. We'll then discuss which taxpayers and entities are qualified for this potential tax-saving strategy, then we'll discuss some specific actions we want to take when electing this alternative taxation regime.

Joining me in this week's podcast are two of Novogradac's state tax planning experts. My partner Tom Boman from our St. Louis office and Novogradac principle Reza Karim from our New York City office.

Tom and Reza are returning guests on Tax Credit Tuesday and they both help clients with their state-tax-saving strategies, including how to expand their state tax deduction by applying these pass-through entity rules in certain states.

Now, let me give you a caveat. I want to note that today's discussion is simplified. It may not sound so simple when you're listening to it, but it is a simplified overview of what is a complex and nuanced issue or issues. There's more to this tax funding strategy than we can fit into a single podcast. Moreover, each and every taxpayer is unique. And as such, please make sure that you consult with an experienced state tax advisor about your particular tax situation and goals.

We have a lot of important ground to cover today. So if you're ready, let's get started.

So Tom and Reza, thank you for joining us again on task, right, Tuesday.

[00:03:52] **Reza Karim, CPA:** Thank you for having us again.

[00:03:54] **Tom Boman, CPA:** We look forward to discussing this topic.

Overview of Notice 2020-75

[00:03:56] **Michael Novogradac, CPA:** Now it's a very timely topic as we approach year-end. I gave a general overview of the current deduction limitation for individuals of state and local taxes in my introduction. I did note that IRS released guidance through Notice 2020-75 with respect to this tax planning strategy. And in that notice, also note to our listeners that the notice was basically saying that the IRS intended to issue regulations and then talked about in the notice what areas they were intending to issue regulations for guidance on this tax planning strategy.

But the fact that it was released in 2020, this guidance means there was a three-year gap between enactment of this limitation on the deduction and the issue of this IRS guidance that covers the tax treatment of income tax payments made by partnerships and S corporations. So Tom, why do you think it took so long to get the guidance? And then if you could also share why this guidance was so significant?

[00:04:58] **Tom Boman, CPA:** Well, Mike, I've been practicing as a tax consultant for 40 years and I can make the case that a three-year interval by the IRS to act on something is actually not that long. So I think that given the fact that the IRS generally operates at a glacial pace, it wasn't too surprising that it took three years.

I think they were finally prompted to act because of all the uncertainty that the law created because there was language in the House committee report that accompanied the bill that indicated that pass-through entity taxes should still be deductible. But the question was whether that was actually the case or not.

And there've been intervening steps by various states that enact some kind of an alternative rule other than what has finally been adopted. Most of those related to some type of a charitable donation to this state and the IRS actually came out with guidance rather quickly saying that was not really workable.

So I think you can attribute the IRS delay in guidance because of their normal hesitation to work quickly on almost anything just because they're so big busy and they're in there, they are understaffed. So, I wasn't too surprised it took them three years to come out with some guidance. Also, I would just note that it wasn't as if they didn't have other 2017 tax act guidance to come out. So they had a lot of guidance to the issuing along with their regular workload.

[00:06:23] **Michael Novogradac, CPA:** That's very much the case.

[00:06:24] **Tom Boman, CPA:** Yes, I would agree with that. You also asked on what's the significance of this as well. If you can–particularly with taxpayers and high-income-tax states, where the tax rate might be, exceed 10% and if they have a significant amount of and they might previously have been deducting state taxes on their federal return of six figures and then all of a sudden, it's clawed back under the new rule, starting in 2018 to only $10,000, that's a significant drop in their itemized deductions on their federal tax return–then this is having an increase in their federal tax liability. So this was a very significant change for individual taxpayers to limit their state tax deduction to $10,000. So that's why having some provision where you can still get the benefit of state taxes above $10,000 is a real significant benefit to individuals.

States and Regulations

[00:07:19] **Michael Novogradac, CPA:** Right and that's the beauty of this notice is that it does validate some of the structures that were being adopted by the states. And certainly led to more states adopting such rules. Maybe we could talk about that because, you know, prior to 2017 and this limitation on the state local tax deduction of $10,000, there weren't very many states that had a tax, an entity-level tax on partnerships or S corporations. They did exist, but it was rare. Now, as we look forward from today, maybe you could discuss, Tom, how many states have actually enacted some changes to their laws, as well as how many are considering a rule change. Maybe you can bucket the states and the different things in terms of how they're addressing this opportunity.

[00:08:07] **Tom Boman, CPA:** Yeah. So there's 21 states that have passed a law. I'll list each of them in case our listeners want to know whether they're in a state that has passed the rule. They include Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Georgia, Idaho, and Illinois. Louisiana, Maryland, Massachusetts, Minnesota, New Jersey and New York. North Carolina, Oklahoma, Oregon, and finally Rhode Island, South Carolina and Wisconsin. All 21 of those states have passed a rule that is trying to take advantage of Notice 2020-75.

And then if you look at other states, there's three states that are considering currently adopting a rule of this nature. They include Michigan, Ohio and Pennsylvania. There's nine states that don't have an income tax or have a tax where this is just doesn't really apply. And they include Alaska, Florida, New Hampshire, which has an interest on dividends tax, Nevada, South Dakota, Tennessee, Texas, Washington and Wyoming, and the other states, which are17 plus district of Columbia have not passed the rule and are not considering it to our knowledge.

[00:09:23] **Michael Novogradac, CPA:** Great, thank you for that list and that list will be included in our podcast notes and note that list is always changing. So if you're listening to this podcast, much later than November 30th, know that the list is evolving.

So Reza, the IRS guidance that was provided in Notice 2020-75 did note in the intro that the states were considering changing their laws or had changed their laws, so that partnerships or S-corporation taxable income would be taxed at the entity level and then in turn by virtue of having a tax apply at the entity level, they would allow members of the partnership or owners of the S corporation a corresponding or offsetting owner-level state tax benefit, because you certainly wouldn't want to have that income taxed for state tax purposes at the S-corporation or partnership level, then also have a tax again at the individual level without having some pass-through benefit.

So maybe you could discuss what the two approaches are that states use as they adopt this strategy to ensure that the individual business owner doesn't end up paying two levels of state taxes.

Different Approaches by States

[00:10:37] **Reza Karim, CPA:** Thank you, Mike. So, there are ifs and buts in all the states, but there are generally two themes that we see.

One is the exclusion approach. So I can name Louisiana and Colorado, whereby they will tax the income from the passthrough at the entity level and by doing so, the federal taxable income will be lowered by the taxes as imposed and the individual owner will then not have to include that on their state-level taxes.

The other approach is a credit method. So under the credit method, the state will allow the entity to take the deduction and the individual owner will still have to report that on their state tax return, but in return, they'll get a credit on their state tax return to pay for the taxes. So bottom line is there's not going to be a double taxation at the state level. It's just two approach they're taking.

[00:11:34] **Michael Novogradac, CPA:** That makes sense. Either you exclude the income that was taxed at the entity level for state tax purposes at the individual level, or you include the income on your return, but you get a state tax credit for the taxes paid by the entity.

So which of these two approaches do you find most prevalent?

[00:11:51] **Reza Karim, CPA:** Mostly, the credit approach. That's what's we're seeing, Louisiana, Colorado as I mentioned, those are the states that are going on the exclusion route, but most of the other states that we frequently work on are on the credit approach.

[00:12:06] **Michael Novogradac, CPA:** That's probably not too much of a surprise because that's probably from a state tax administration perspective, probably the easiest to adopt and maybe it doesn't affect the overall calculation of state taxes as dramatically, potentially as the exclusion approach, but both have pros and cons.

[00:12:25] **Reza Karim, CPA:** I think one advantage is, as I think about it now, is if an entity has multi-state activity, the states are giving credit to each other for the state-entity-level taxes. So if you follow the states around the credit approach, it's much easier for the state tax credit for taxes paid in the other state, issues. So those are, those becomes much easier.

[00:12:46] **Michael Novogradac, CPA:** One thing we won't be able to cover any real detail in this podcast the situation where you have investments and partnerships with multiple activities in multiple states. There's a lot of complexity to this rule for some taxpayers that we don't have time to cover in this podcast, which is why I give the disclaimer at the beginning and why you'll be getting Reza's and Tom's email addresses, toward the end. But let's talk a little bit more about the significance of the tax savings. So there are several variables involved in assessing what the net tax savings to an individual would be to. That's if they elected this strategy. And when I say net tax savings, I mean how much in federal income taxes that a taxpayer would say save by using this strategy whereby they, in essence, get a state tax deduction at the entity level, as opposed to being limited by $10,000 at the individual level. So there's a state tax savings or federal tax savings, I should say, from this structure.

But then there is the potential for a taxpayer to pay slightly more in state taxes, depending upon how the credit flows through and the rest. So, Tom, maybe you could give an example as to the magnitude of the potential savings under this rule such that listeners could decide to themselves if this really worth them thinking about and implementing.

Examples of How State-Level Solutions Work

[00:14:07] **Tom Boman, CPA:** Yeah. So let's assume an individual had a million dollars of income that was eligible for this program and if they lived in a state with a 10% tax rate, what would happen without this work around? Well, first of all, they would report a million dollars of income on their federal return and pay tax. But if they're at their effective tax rate on that income, that could be anywhere from, a low of 15% to a high of 37% of federal taxes. And then on their state return, they would also report the million dollars and pay, assuming a 10% state rate, $100,000 of taxes.

But, well, the question is what is the benefit of the tax state tax payment on your federal return? Prior to 2018, they could deduct all of the $100,000 of state taxes. That's 10% of a $1 million state tax liability would be $100,000 prior to 2018. You got a full deduction for the hundred thousand.

You know, as high as a 37% tax rate that saves you $37,000 of federal taxes, and once the cap was added in 2018 through 2025, we lost the deduction. It's up to $10,000 and from a practical perspective, you lost it entirely because you probably already have a $10,000 of personal property tax, real estate tax that you're already deducting.

So you effectively can potentially lose 100% of your state income tax deduction. That's a significant cost for many taxpayers, but particularly high-income taxpayers, but even moderate taxpayers often pay more than $10,000 of total taxes when you combine real estate taxes, property, personal, property tax and income tax.

So any additional tax they can deduct is a real benefit. So under this rule, what would happen is instead of paying $100,000 of tax at the individual level, they would own an interest in a pass-through entity that would report the $1 million of income and that entity would pay tax, let's assume at the same rate of 10% or $100,000. And that would change the income on the pass-through return from $1 million to $900,000. And that is the amount of income that would actually be reported on the individual's federal income tax return.

So by doing that, they're effectively getting a deduction for the entire $100,000 of state taxes on their federal return as a sanctioned by Notice 2020-75. So that's theoretically, on a credit state where they have the second alternate. They would report the same $1 million of income on their state return and then report a tax of $100,000, but then get credit for the $100,000 that was paid by the pass-through entity.

So the net additional tax, in a perfect world, is zero. That may not always work out perfectly, but that is in a perfect world, they wouldn't pay any additional state tax. And so, that's effectively how it works. So ultimately, it's a federal savings strategy and the net tax saved would be effectively the marginal rate for the individual, which is maybe a low of 15% to a high of 37%.

[00:17:17] **Reza Karim, CPA:** So, Tom, in your example, if we take $1 million taxpayer with the $100,000 deduction and 30% rate, the savings is $30,000, whereas if he could not take this deduction under the pass-through taxes, he would have been able to take only $3,000. So it's almost like in this situation, 10 times more in terms of tax savings.

[00:17:40] **Tom Boman, CPA:** It's a significantly better result. So it is real opportunity for individuals to reduce their federal tax burden that otherwise would not be available for them.

[00:17:54] **Michael Novogradac, CPA:** And I just wanted to comment, that was a great example, Tom that clarified the potential benefits. And I would just add for our listeners that was a very simplified example that no company actually faces and there's a lot more interactions that you need to be contemplating.

And I'm sure as a listener, you're probably thinking of some of the other interactions that are relevant, but we, once again, we can't go into all the various interactions, just why this really has to be customized to the individual taxpayer. But you certainly understand the through that example, that there are some significant savings that are possible.

And if it puts something in place, there could be multiyear savings depending upon of course, what the Build Back Better Plan, ultimately, if enacted, how it would affect the deductibility of state local taxes. But it is likely to be a multiyear strategy for most taxpayers.

[00:18:49] **Tom Boman, CPA:** Let me suggest one complicating factor that would let people pause to get some advice from a professional in this matter. Let's say for this million-dollar example, the entity files in multiple states and apportions its million dollars of income among multiple states. And some of those states may have a pass-through work-around bill enacted and others may not. And the question is, do you make the election in multiple states or not? And how does that affect your resident state? That's where it can become very complicated where you really need to seek some advice.

Qualifying for Options

[00:19:27] **Michael Novogradac, CPA:** So thank you for the example. Now, many of our listeners I'm sure are thinking, OK, that sounds interesting. Those tax savings sound notable, particularly when I think about it across multiple years. So how do I qualify? Is this something that I elect? Is it something that I'm automatically eligible for? What, if I'm operating through a business that I own 100% of either directly or through a disregarded entity and I'm showing my income on a Schedule C? So Tom, maybe you can unpack the application of this to partnerships S corporations or businesses being operated in a manner that except getting reported on the Schedule C of 1040.

[00:20:05] **Tom Boman, CPA:** So of the 21 states that have enacted the rule, all of them require the use of a pass-through entity, which is defined to include an S corporation or a partnership, including an LLC operating as a partnership and bypass your entity. That vernacular means that the entity normally doesn't pay tax at the entity level, but passes the income and losses through to the owners who report that activity on their own returns, whether it be a corporate shareholder partner or an individual shareholder or partner. So none of the states allow you to use this rule if you own your business through a disregarded entity or directly through individual ownership. And the planning idea there would be to transfer that business to a pass-through entity.

For example, with the disregarded LLC, you could elect to be an S corporation if you wanted to or bring in another member as a second member to change that from a disregarded entity to a partnership for tax purposes. That may be unavailable with some professional services entities where state law may limit the type of partners you can have if they're not actually practicing in the professional services that the entity does, but in that case, you might have to default to it to an S corporation that's 100% owned by the individual. But none of the states allow you to do this unless you are a pass-through entity. And I would emphasize that if you currently have an entity that doesn't qualify and then try to convert it to a pass-through entity, the issue there would be that you can only do it prospectively. You can't capture activity that occurred during the year that was generated prior to the time the entity changed the structure from a nothing or a disregarded entity to a S-Corp or a partnership.

[00:21:56] **Michael Novogradac, CPA:** No, thank you for that. That was really helpful. And it's nice to know that if you're operating as a schedule C, there is some potential. You obviously you have to weigh the benefits of the tax savings with the challenges and the costs of operating through a regarded entity, if you will, a partnership or an S-corporation.

[00:22:17] **Tom Boman, CPA:** It might be a good time for Reza to outline some of the differences in the states about what type of pass-through entities are eligible. Do you want to talk about some states and how they might change different rules for what pass-through entities actually qualify?

[00:22:32] **Reza Karim, CPA:** Yeah, I actually, that's a very good point because again, the states have their own set of rules as to what kind of entities or what qualifies. I can give example of California. If you have a partnership who is a partner or a member in a partnership or S-corporation, then that partnership is not eligible to make this election. Similar rules are in New York as well. So you know, many entities, if they have a publicly traded partnership, as a partner, that makes that entity not eligible to make the election.

Another complication is consent. So some states would require all of the partners to consent. And in some other states an entity representative, partner from a partnership or authorized person can make the election and it's binding on all the members. So it becomes a really problematic and because you need to go and see which partners are going to be benefited from making the election or whether it can be detrimental to some, because some of the states, especially, states that are going on the exclusion method, the tax at the pass-through entity level is final.

And if that rate is higher than the individual rate, potentially that individual partner's going to be paying more taxes, essentially. So these are some complications around this election that we need to navigate through.

[00:23:59] **Michael Novogradac, CPA:** Thank you for that, Reza. So that was really helpful. I mean, as we're noting in the course of this podcast, the savings can be substantial, but there's also going to be complexities depending upon how you're operating your business, how many states your business is in, how many partners you have, states of residence and the rest. One of those questions that initially came to my mind when I was reading the notice that the IRS released, as well as seeing the states adopting their entity-level taxation, is what about investment or portfolio income at the pass-through level?

We've talked about that this a state tax deduction and we've talked about how kind of implicit in our discussion so far is you have this entity that's operating a business and it's generating business income that's being subject to tax at the entity level and the like, but what about the portion of pass-through-level income that's investment or portfolio income? Are the entity-level taxes paid on that also eligible for this benefit to pass through to the individual partners for federal income tax purposes?

[00:25:11] **Reza Karim, CPA:** I think there's a very interesting question, Mike, and the reason I say that is because, if you look at the state rules or the guidance they have provided so far, it only says income allocable to the partner, a source for the state. Only one state I can name so far that I have looked at, it's Rhode Island, which specifically mentioned that it's only in a business income allocable to the state so, I believe that we have to wait for further guidance from the authorities. Tom, do you have anything to add to that?

[00:25:44] **Tom Boman, CPA:** Yeah and they're related. There's two questions. One is what does the state rules provide? Do they expand the rule to include investment income rather than just business income? And then the question is– the IRS has a say on this as well– and it was it intended for this rule to apply to non-business income. Because it's very clear, it does apply to business income. So there's some concern that if states do allow it to apply to investment income, the IRS will preclude that benefit from occurring. And my guess is the only way we're going to find out about that is through additional guidance from the IRS, including regulations that they said they're going to issue that they haven't issued yet.

Additional Issues

[00:26:22] **Michael Novogradac, CPA:** Great. Thank you for that clarification that we don't know, there are issues there.

So as I said in the introduction and was said in the course of the podcast, this issue is pretty complex and we can't go into every detail and nuance and discuss every possible sort of situation. But with that in mind, are there maybe one or two additional issues Reza that you'd want to make sure that our listeners were aware of.

[00:26:51] **Reza Karim, CPA:** I think we have already discussed it.

[00:26:55] **Tom Boman, CPA:** I have a couple of thoughts. One is obviously you want to talk to your tax advisor and, and start the discussion with them because there may be some things you want to do by year end. There may be elections you have to make soon. If you're a cash-basis, pass-through entity and you're trying to get a deduction in 2021 for the taxes, you arguably have to prepay them by 12-31-21 in order to do that.

Otherwise, if you, make the election in 2021, but don't pay any taxes in 2021, then theoretically it's a 2022 deduction and you kind of won't get the benefit that you're trying to do. And then obviously I would certainly consider or suggest what people think about ways to deal with disregarded entities and schedule C activity in order to try to convert that to a different type of a structure that's a pass-through structure in order to take advantage of these rules, if it's income and it's particularly if it's a business income.

[00:27:51] **Reza Karim, CPA:** I think another thing that our clients should look at is selecting the candidate entities. As I mentioned before, you know, each state defines as to which would be a qualified entity, so we have to look at which state to make the election for, as Tom also mentioned before.

And then if there's any partners in that entity which may disqualify the entity for that election in that particular state. So, I mean, from my perspective, I think identifying the right entity and in the right state and see if it's a cash basis, taxpayer record basis and take action by the year end.

[00:28:30] **Tom Boman, CPA:** I would also say that once you go through the analysis of whether this is maybe of a benefit, then the question is how do you elect and what do you need to do to keep electing going forward? There are dates that you're going to have to do things by including possibly making an election.

In California, starting in 2022, you have to make a 50% payment of your expected tax liability by June 15th, 2022, and every year thereafter with a second payment due later in the year. If you don't do that, then make that first payment. Then the law says you cannot take advantage of this, of this pass-through deduction.

[00:29:08] **Tom Boman, CPA:** So you have to understand all the nuances of every state law in order to make sure that you comply with every requirement that they impose. And then clearly if you're operating in multiple states, then you have to really think carefully about whether to make the election in more than one state, assuming more or more than one of those states allow for it.

[00:29:30] **Reza Karim, CPA:** Yeah, I think we are talking about many elections. I just want our listeners to know that in Connecticut, there is no election. It's mandatory for all the pass-through entities.

[00:29:39] **Tom Boman, CPA:** That's the only state that is mandatory. Every other state, you have locked in. Connecticut, you can't elect in and you can't elect out. It's automatic. You're in.

[00:29:51] **Michael Novogradac, CPA:** Great. Thank you. Both Tom and Reza. this has been really helpful. It's a little bit dense at times in terms of the topics that we cover, but I think we did a good job of covering the overall benefits of some of the issues that potential listeners should be considering. So if

I could ask each of you to share your email addresses, so listeners can reach out to you, if they want to engage you to assist them with their planning.

[00:30:13] **Tom Boman, CPA:** So mine is, Tom.Boman@Novoco.com.

[00:30:21] **Michael Novogradac, CPA:** And that is just so our listeners know it's Tom-dot versus Thom or some other version of Tom.

[00:30:31] **Reza Karim, CPA:** Mine is Reza.Karim@Novoco.com.

[00:30:45] **Michael Novogradac, CPA:** And I'll also include their contact information in today's show notes, which will be posted to www.Novoco.com/podcast. So thank you both and please be sure to stick around for our Off-Mike portion of podcast, where I get ask you for some words of advice outside of taxes, or at least outside of directly being related to taxes, get your words of wisdom on that area to our listeners.

Be sure to tune into next week's podcast. You can be sure you're notified at that episode and each week's episode by following or subscribing to the Tax sCredit Tuesday podcast. Simply go to www.Novoco.com/podcast to subscribe to and to stream the show on our website. You can also follow or subscribe to Tax Credit Tuesday on iTunes, Spotify, Google podcast, Stitcher and Radio Public.

Additional Resources

Email

[Tom Boman]

[Reza Karim]

States that have passed laws to account for state and local taxes

- Alabama
- Arizona
- Arkansas
- California
- Colorado
- Connecticut
- Georgia
- Idaho
- Illinois
- Louisiana
- Maryland
- Massachusetts
- Minnesota
- New Jersey
- New York
- North Carolina
- Oklahoma
- Oregon
- Rhode Island
- South Carolina
- Wisconsin

States considering laws to account for state and local taxes

- Michigan
- Ohio
- Pennsylvania