

BFKN Alert: Illinois SALT Cap Workaround

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Background

Prior to the enactment of the Tax Cuts and Jobs Act, individual income taxpayers who elected to itemize deductions on their federal income tax returns could claim an unlimited deduction for certain state and local taxes paid. However, as a result of the Tax Cuts and Jobs Act, for tax years 2018 through 2025, individual taxpayers can deduct no more than \$10,000 of such state and local taxes paid on their federal income tax returns (the “SALT Cap”).

For many individuals, including owners of pass-through entities, the SALT Cap results in a substantial increase in their federal income tax liability. In response to the SALT Cap, many states, particularly those with high tax rates, have devised workarounds to reverse the financial impact of the SALT Cap to individual taxpayers.

While there are some differences in the mechanics of the workarounds, the statutes effectively shift the state income tax burden from the individual owners of a pass-through entity (where the individual’s deduction at the federal level for state and local taxes paid would be subject to the SALT Cap) to the pass-through entity itself (where the federal deduction is uncapped). The individual owners then receive a state tax credit for their respective portion of tax paid by the pass-through entity. The state tax rate imposed on the pass-through entity is generally the same rate applicable to the individual owners. In effect, this allows the owners to bypass the SALT Cap simply because the pass-through entity is not subject to it.

On November 9, 2020 the Internal Revenue Service issued Notice 2020-75, which clarifies that the SALT Cap does not apply to pass-through entities. The Internal Revenue Service agreed that pass-through entities may claim federal entity-level deductions for state income taxes paid under state laws that shift the income tax burden from the individual owners to the entity and confirmed that any resulting owner-level benefits would not be subject to the SALT Cap.

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Illinois SALT Cap Workaround

On August 27, 2021, Illinois Governor Pritzker signed Senate Bill 2531 into law. This law contains a SALT Cap workaround similar to those generally described above. Beginning with tax years ending on or after December 31, 2021 and beginning prior to January 1, 2026, a pass-through entity may elect to pay tax on its Illinois-source net income at a rate of 4.95%, the same rate applicable to individuals (the “**PTE Tax Election**”). An entity making the PTE Tax Election is hereinafter referred to as an “**Electing Entity**.”

For federal income tax purposes, an Electing Entity is able to take a deduction for Illinois state taxes paid when calculating its federal taxable income. As an Electing Entity is not subject to the SALT Cap, it will be able to deduct its Illinois state tax payments in full thereby reducing the federal income tax liability of the Electing Entity allocable to each owner. Each owner of an Electing Entity would then be entitled to a credit against such owner’s Illinois individual income tax equal to 4.95% of such owner’s distributive share of the Electing Entity’s Illinois taxable income (computed by taking its federal taxable income, plus the Illinois tax deducted by the Electing Entity on its federal income tax return). The credit should be a dollar-for-dollar reduction of the individual owner’s personal Illinois income taxes because both the Electing Entity and the individual owner are subject to the same tax rate of 4.95%.

The PTE Tax Election must be made on an annual basis and is irrevocable and binding on the owners. An Electing Entity will be required to make quarterly estimated tax payments, but would no longer have a withholding tax obligation with respect to nonresident owners. A nonresident owner of an Electing Entity will not be required to file an Illinois tax return if the only source of net income is from the Electing Entity and the nonresident owner’s credit from the PTE Tax Election equals or exceeds such nonresident owner’s Illinois income tax liability. Should the Electing Entity fail to pay the tax, the owners are liable for the unpaid amount, including penalties and interest.

The PTE Tax Election may not be advantageous to all pass-through entities and their owners based on specific facts and circumstances. Therefore, an analysis should be performed before a PTE Tax Election is made. Additional procedural information is anticipated to be released by the Illinois Department of Revenue soon.