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SALT Cap Workarounds
Accounting by Pass-Through Entities

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The CPEA is receiving inquiries from our members related to how pass-through entities (e.g., partnerships, S corporations, LLCs) should account for state and local income taxes (SALT) related to efforts by many states to enact legislative workarounds to the federal tax policy that limits SALT deductions on individual federal tax returns. This report provides the CPEA's position on the accounting by pass-through entities for these SALT cap workarounds.

Background

The legislation commonly referred to as the Tax Cuts and Jobs Act (TCJA), P.L. 115-97, imposed a $10,000 limitation on the deductibility of SALT payments made by individuals (except for state taxes paid in connection with a trade or business). This limitation, known informally as the "SALT cap," significantly limited the itemized deductions of many individual taxpayers, including owners of pass-through entities, which generally incur state income tax at the individual owner level. However, the SALT cap does not limit deductibility of state taxes imposed on business entities. In response, a number of states have enacted new entity-level taxes on pass-through entities designed to permit the entity to deduct state income taxes that the individual owners would have otherwise been unable to deduct under the SALT cap.

In Notice 2020-75, the IRS announced "that the Department of the Treasury (Treasury Department) and the IRS intend to issue proposed regulations to clarify that state and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment."

Accounting Treatment

Based on the guidance in FASB ASC 740 (see examples below), the accounting treatment for the taxes assessed on pass-through entities requires a determination about whether, based on the laws and regulations of each specific jurisdiction, the taxes paid by the entity are attributable to the owners or attributable to the entity. If attributable to the owners, the transaction would be accounted for as a transaction with an owner (i.e., accounted for as an equity transaction). If attributable to the entity, the transaction would be accounted for in accordance with the requirements in FASB *Accounting Standards Codification* (FASB ASC) 740, *Income Taxes*, similar to other income taxes.

As of the writing of this report, approximately 20 states have SALT cap workarounds in place. These workarounds vary by jurisdiction. Even in cases where states have similar workarounds, slight differences among them may be present. Given the number and varied features of the workarounds, assessing how they apply to an entity can be challenging, especially for entities with multistate presences.

While we believe many of the new pass-through entity taxes are structured to be attributable to the owner, management and practitioners need to assess the tax laws and regulations in a specific jurisdiction to draw appropriate conclusions.

Three illustrative examples exist in FASB ASC 740-10-55-226 thru 228 which provide a lens to review the specific tax laws and regulations in a jurisdiction to make an assessment of a SALT cap workaround. While every jurisdiction is unique and may have different structures, these illustrations are helpful in forming a conclusion. The examples are presented below.

Illustrative Examples of Attribution of Income Taxes to the Entity or Its Owners

Example 35 (FASB ASC 740-10- 55-226)

This example is what new Alabama PTE rules do

Entity A, a partnership with two partners—Partner 1 and Partner 2—has nexus in Jurisdiction J. Jurisdiction J assesses an income tax on Entity A and allows Partners 1 and 2 to file a tax return and use their pro rata share of Entity A's income tax payment as a credit (that is, payment against the tax liability of the owners).

Because the owners may file a tax return and utilize Entity A's payment as a payment against their personal income tax, the income tax would be attributed to the owners by Jurisdiction J's laws whether or not the owners file an income tax return. Because the income tax has been attributed to the owners, payments to Jurisdiction J for income taxes should be treated as a transaction with the owners.

The result would not change even if there were an agreement between Entity A and its two partners requiring Entity A to reimburse Partners 1 and 2 for any taxes the partners may owe to Jurisdiction J. This is because attribution is based on the laws and regulations of the taxing authority rather than on obligations imposed by agreements between an entity and its owners.

Example 36 (FASB ASC 740-10-55-227)

If the fact pattern in paragraph 740-10-55-226 (example 35) changed such that Jurisdiction J has no provision for the owners to file tax returns and the laws and regulations of Jurisdiction J do not indicate that the payments are made on behalf of Partners 1 and 2, income taxes are attributed to Entity A on the basis of Jurisdiction J's laws and are accounted for based on the guidance in FASB ASC 740.

Example 37 (FASB ASC 740-10-55-228)

Entity S, an S Corporation, files a tax return in Jurisdiction J. An analysis of the laws and regulations of Jurisdiction J indicates that Jurisdiction J can hold Entity S and its owners jointly and severally liable for payment of income taxes. The laws and regulations also indicate that, if payment is made by Entity S, the payments are made on behalf of the owners.

Because the laws and regulations attribute the income tax to the owners regardless of who pays the tax, any payments to Jurisdiction J for income taxes should be treated as a transaction with its owners.

Application of FASB ASC 740

If a determination is made that the payments should be accounted for in accordance with FASB ASC 740 (tax is attributable to the entity), the specific features of the SALT cap workaround will need to be considered in applying FASB ASC 740, such as whether the state taxes are mandatory or optional, and the enactment date of the workaround legislation. The specific features of a workaround will impact accounting determinations and judgments, such as deferred tax effects and the timing and measurement of the amounts in the financial statements.

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