



IRS to Issue Favorable Regulations on SALT Deduction Limitation Workarounds by Partnerships and S Corporation

November 13, 2020

The Internal Revenue Service (IRS) recently announced in [Notice 2020-75](#) that it will issue proposed regulations on the federal income tax deduction by a partnership or S corporation for its payment of State and local income taxes at the entity level.

This guidance is significant and favorable for so-called “workaround” arrangements under state laws which provide for a partnership or S corporation to pay State and local income tax on partnership and S corporation income. Such arrangements are intended to avoid application of the \$10,000 limitation on deduction of State and local taxes (“SALT deduction limitation”) for individuals who are partners of a partnership or shareholders of an S corporation. The SALT deduction limitation was enacted by the Tax Cuts and Jobs Act (“TCJA”).

The SALT deduction limitation limits a federal income tax deduction of State and local income taxes to \$10,000 (\$5,000 for a married individual filing a separate return) for individual taxpayers. The SALT deduction limitation applies to taxable years beginning after December 31, 2017, and before January 1, 2026.

Oklahoma is one of the States that has enacted a change in its State income tax law intended to be used to avoid, or workaround, the SALT deduction limitation for State and local taxes on partnership and S corporation income realized by individual taxpayers.

The Pass-Through Entity Tax Equity Act of 2019 enacted by Oklahoma provides for tax years beginning on or after January 1, 2019, entities taxed as partnerships or S corporations for federal income tax purposes may make an annual election to pay Oklahoma income tax at the entity level. State income tax paid at the entity level will not flow through to be deducted at the individual partner or shareholder level. Oklahoma income or losses that the electing pass-through entity included in computing its tax will not be allocated to a partner, member or shareholder of the electing entity.

IRS Notice 2020-75 indicates the IRS will not challenge State tax laws providing for payment of State income tax on partnership or S corporation income at the entity level and will allow deduction of such State taxes by the entity, rather than individual owners, for federal income tax purposes.

IRS Notice 2020-75 states that the proposed regulations will be issued 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. The regulations are to be based on an interpretation made by the IRS in a prior revenue ruling, Rev. Rul. 58-25, 1958-1 C. B. 95. The IRS ruled that a city tax imposed upon and paid by a partnership on net profits of the partnership’s business was deductible in computing taxable income of the partnership, and the distributive shares of the partnership’s non-separately stated income or loss, which reflected a deduction for the tax paid by the partnership, could be taken into account by the partners for federal income tax purposes. The reasoning of that interpretation will apparently be followed in the IRS proposed regulations with

respect to State and local income tax paid by a partnership or S corporation and the effect of that on the SALT deduction limitation.

Notice 2020-75 gives a new defined term “Specified Income Tax Payment” to be used for purposes of the new regulations. It generally means any amount paid by a partnership or an S corporation to a State or local jurisdiction (e.g. a city) to satisfy liability for income taxes imposed on the partnership or the S corporation.

If a partnership or an S corporation makes a Specified Income Tax Payment during a taxable year, the partnership or S corporation will be allowed a deduction for the Specified Income Tax Payment in computing its taxable income for the taxable year in which the payment is made.

Any Specified Income Tax Payment made by a partnership or an S corporation during a taxable year will not constitute an item of deduction that a partner or an S corporation shareholder will be required to take into account separately in determining the partner’s or S corporation shareholder’s own federal income tax liability for the taxable year. Instead, Specified Income Tax Payments will be reflected in a partner’s or an S corporation shareholder’s distributive or pro-rata share of non-separately stated income or loss reported on a Schedule K-1 (or similar form). As a result, a Specified Income Tax Payment made by a partnership or an S corporation will not be taken into account in applying the SALT deduction limitation to any individual who is a partner in the partnership or a shareholder of the S corporation.

The proposed regulations will apply to Specified Income Tax Payments made on or after November 9, 2020. The proposed regulations will permit taxpayers described in Notice 2020-75 to apply the rules described in it to Specified Income Tax Payments made in a taxable year of the partnership or S corporation ending after December 31, 2017, and made before November 9, 2020, provided that the Specified Income Tax Payment is made to satisfy the liability for income tax imposed on the partnership or S corporation pursuant to a law enacted prior to November 9, 2020. Prior to the issuance of the proposed regulations, taxpayers may rely on the provisions of Notice 2020-75 with respect to Specified Income Tax Payments described in it.

If you would like to discuss this new IRS guidance, the federal income tax \$10,000 SALT deduction limitation or other tax law matters, please contact your GableGotwals attorney, or a member of our [Tax Law Practice Group](#) which includes:

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