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Louisiana's Attempts to Mitigate the Limitation Of the SALT Deduction

by Kathryn Pittman and Jordyn Farizo

Kathryn Pittman

Jordyn Farizo

Kathryn Pittman is an associate director and Jordyn Farizo is a manager at Postlethwaite & Netterville in Baton Rouge.

In this inaugural installment of Tackling SALT, the authors examine Louisiana's approaches to mitigate the effect of the Tax Cuts and Jobs Act's limitation on the deduction available to individual taxpayers for state and local taxes.

The Tax Cuts and Jobs Act limited the deduction available to individual taxpayers for state and local taxes (SALT deduction). In response, some states have proposed or enacted policies that attempt to mitigate the effect of this limitation. This article examines Louisiana's approaches to mitigation, including Louisiana Act 442, signed into law June 22, which allows income from passthrough entities to be taxed at the entity, rather than the individual, level. When entities make this election, passthrough income is excluded from the shareholder's state tax base. This, in turn, limits the amount of individuals' passthrough income subject to state and local tax, thereby bypassing the limitation on the SALT deduction with respect to that income.

While this law has wide-reaching intentions and implications, several questions remain. Is Act 442 actually an effective way to mitigate the effect of the limitation on the SALT deduction? Is this mechanism different from composite filings that many states, including Louisiana, have adopted to ease the state and local tax burden for passthrough entities and their owners? Is the IRS likely to issue new regulations in response to these state laws, in similar fashion to its recently enacted guidance on the deduction for charitable contributions made through state tax credit exchange programs? This article will describe the context for the limitation on the SALT deduction, previous attempts at reducing the effect of the limitation, the mechanism of Act 442, and will attempt to provide guidance on the multitude of questions that still remain.

A Hope for Simpler Times: The TCJA and the SALT Deduction

In December 2017 Congress passed, and President Trump signed, the TCJA, the most wide-reaching tax legislation since the Tax Reform Act of 1986. One of the stated and overarching goals of this legislation was to simplify the administration of the tax code. Another prominent goal was to lower the overall tax burden of both individuals and corporations in the United States. To achieve the goals of simplification and a lower tax burden, the TCJA embraced two common tenets of tax reform — lowering the tax rate but broadening the tax base. The TCJA lowered the income tax rates for individuals, but also limited the

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deductions that many individuals had previously used.[1]

One of the more impactful itemized deduction limitations enacted by the TCJA involved the limitation of the SALT deduction for individual taxpayers. Before the TCJA, relevant law provided for a deduction of state and local taxes paid or accrued for both individuals and corporations.[2] The deduction was not subject to a stand-alone limitation, though an overall limitation on itemized deductions applied to taxpayers with adjusted gross income exceeding defined thresholds.[3] After the TCJA, however, the aggregate amount of state and local taxes available for deduction was limited to $10,000 for a married couple filing a joint return.[4]

Importantly, however, the limitation on the SALT deduction does not apply to state and local taxes paid or accrued in connection with conducting a trade or business.[5] Thus, the limitation on the SALT deduction does not apply to corporate taxpayers, which continue to be allowed a full deduction at the federal level for the state and local taxes they pay or accrue during the tax year.

An Already Existing Louisiana Loophole: Charitable Contributions and SALT Credits

In response to the TCJA's limitations on the SALT deduction, some states, particularly those with high state and local tax rates, attempted to mitigate the effect of the limitation on their residents. One way that some states mitigated this effect was by using already existing programs (or creating new programs) that provided for state tax credits in exchange for charitable contributions. For example, some states, including Louisiana, have, over the years, established programs that provided taxpayers with credits or rebates to offset their state income tax liability in exchange for contributions made to specified charitable organizations.[6]

One Louisiana program, which has been in effect in a variety of forms for several years, provides taxpayers with a nonrefundable income tax credit for donations made during the school year to a school tuition organization.[7] Taxpayers receive a charitable deduction for federal purposes and receive a credit for state income taxes in the amount of contribution. While this program existed before the enactment of the limitation on the SALT deduction, the program increased in importance once the SALT deduction was limited. The post-credit reduction to a taxpayer's state income tax effectively reduced the taxpayer's exposure to the limitation on the SALT deduction. At the same time, the taxpayer was able to increase his or her federal charitable itemized deduction, which was not limited in the same manner as the SALT deduction.

In essence, these programs exchanged a limited SALT deduction for an unlimited charitable deduction. The IRS realized that this loophole, despite existing in Louisiana and other states before the TCJA, sidestepped the intent of the limitation on the SALT deduction. Thus, on June 13, 2019, the IRS issued final regulations and other guidance that thwarted the charitable contribution workaround attempted by the states.[8] Taxpayers are now required to reduce the amount of their total charitable contribution deduction by any amount of SALT credit procured through a state exchange program.[9] A de minimis safe harbor exception exists, which allows a full deduction for charitable contributions made through a state credit exchange program if the SALT credit received amounts to less than 15 percent of the charitable contribution made.[10]

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[1] For tax years beginning after December 31, 2017, the tax brackets applicable to individual taxpayers are 10 percent, 12 percent, 22 percent, 24 percent, 32 percent, 35 percent, and 37 percent. IRC section 1(j)(2). Under pre-TCJA law, the marginal rates were 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, 35 percent, and 39.6 percent. IRC section 1(i).

[2] IRC section 164(a).

[3] IRC section 68.

[4] IRC section 164(b)(6)(B).

[5] IRC section 164(b)(6)(B). Note that there is some ability to deduct certain state and local taxes for business reported on a taxpayer's federal schedules C, E, or F. A discussion of those taxes and how they interplay with the general limitation for individuals is outside the scope of this article.

[6] *See, e.g.*, La. Rev. Stat. 47:6301.

[7] *See* La. Rev. Stat. 47:6301. School tuition organizations are generally exempt from federal taxation under IRC section 501(c)(3).

[8] *See* Treas. reg. section 1.170A-1; and T.D. 9864.

[9] *See* Treas. reg. section 1.170A-1(h)(3).

[10] IRS Notice 2019-12, 2019-27 IRB 57.

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Take Two: Louisiana Act 442

Since the IRS effectively closed this charitable deduction loophole, states have turned to other avenues to restore full deductibility of state and local taxes. One such attempt was recently made with Act 442, signed into law by Gov. John Bel Edwards (D) on June 22. The principal provisions of the bill are designed to allow certain passthrough entities the option to elect to file as a corporation for state tax purposes, to pay tax on its income at the entity level, and to exclude such income from the state tax base of its shareholders, partners, or members (the Election).[11] Importantly, the tax rates established for entities making the Election range from 2 to 6 percent, while the generally applicable corporate tax rates in Louisiana range from 4 to 8 percent.[12] Thus, the tax rates applicable to those entities making the Election are more similar to individual income tax rates in Louisiana rather than to the corporate income tax rates.

The new law enacted by Act 442 essentially converts what is generally an individual state income tax liability to an entity-level state tax liability that can be deducted by the passthrough entity without limitation before income is passed through to its owners or members. In doing so, the individual taxpayer's exposure to the limitation on the federal SALT deduction is reduced. Therefore, by transferring the incidence of tax from the individual to the entity, Act 442 partially restores the deductibility of the state tax assessed on the income of the passthrough entity.

Taxpayers and practitioners have been trying to mitigate the effects of the limitation on the SALT deduction since its inception under the TCJA. The question remains, however: Will this strategy actually work?

Does ACT 442 Work? An Open Question

As described above, Act 442 seeks to convert an individual-level tax obligation to an entity-level obligation that is not subject to federal limitation on the SALT deduction. The real question then is: Will the IRS respect this as an entity-level obligation? While there are several reasons to be optimistic the Election might work to mitigate the effect of the limitation on the individual SALT deduction, there are some factors that may weigh against this treatment.

First, by the very nature of the Election, the tax is purported to be paid by passthrough entities, reducing income passed through to the owners/members. As a result, it is an entity-level expense that arguably should be deducted by the electing passthrough entities.[13] However, in this case, the tax rates applied after the Election are not the general corporate rates in effect in Louisiana; rather, the tax rates used after the Election more closely resemble the income tax rates that apply to individuals in Louisiana. The similarity in tax rates may lend credence to the idea that the Election does not actually create an entity-level tax obligation.

Though the tax rates used after the Election may cast doubt about the effectiveness of the Election, it is possible that Act 442, as it applies to S corporations, may be more effective than as applied to other passthrough entities. While Louisiana conforms to the federal tax treatment of entities taxed as partnerships, Louisiana does not conform to the federal tax treatment of S corporations.[14] Instead, in Louisiana, S corporations, as corporations, are generally subject to corporate-level tax.[15] However, unlike general C corporations, S corporations are allowed an exclusion for amounts passed through and taxed at the individual owner level in Louisiana.[16] If S corporations make the Election, however, they are not allowed the exclusion and are taxed at the entity level.[17] Thus, for S corporations, since the default rule is taxation at the entity level rather than the individual level, it is possible that the IRS may view the Election

[11] La. Rev. Stat. 47:287.732.2.

[12] La. Rev. Stat. 47:287.12; 47:287.732.2(B).

[13] If this is an entity-level expense, it will be deducted before the income flows through to ultimate owners for federal tax purposes. As a result, making the Election to be taxed at the entity level may reduce flow-through income. This may, in turn, reduce the amount of the qualified business income deduction that the taxpayer could receive for federal purposes. Thus, passthrough entities should review their current tax situations and consult with their owners to determine the overall effect of making the Election.

[14] *See* La. Rev. Stat. 47:201; 47:287.732.

[15] La. Rev. Stat. 47:287.732(A).

[16] La. Rev. Stat. 47:287.732(B).

[17] La. Rev. Stat. 47:287.732.2(B)(1).

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more favorably with respect to S corporations rather than other passthrough entities.

Finally, Louisiana already allows for composite returns.[18] Under Louisiana's composite return rules, partnerships are generally required to file a composite return and make tax payments on behalf of all nonresident partners.[19] The tax paid on behalf of each nonresident partner is that partner's share of Louisiana income multiplied by the highest individual tax rate.[20] Even though this tax is paid by the partnership with the composite filing, it is deemed to be a payment on behalf of the individual owners rather than an entity-level obligation. For that reason, composite filing payments are not generally deducted by the entity at the federal level but are rather treated as distributions to partners for federal tax purposes. In many ways, especially for partnerships, the Election seems similar to the filing of composite tax returns and making payments on behalf of nonresidents. Thus, the IRS could view these similarities as reasons not to respect the Election for purpose of the limitation on the SALT deduction.

Conclusion

For the last two years, Louisiana has been on the forefront of attempts to reduce the impact of the TCJA's limit on the SALT deduction for individual taxpayers. Louisiana, which, before the TCJA, had already created a program under which charitable deductions generated state tax credits, saw the IRS issue guidance to ensure that such programs did not provide taxpayers with a way to avoid the limitation on the SALT deduction. Next, Louisiana became one of the first states, in addition to Connecticut and Wisconsin,[21] to create a passthrough entity election to convert individual-level taxes to entity-level taxes not subject to the limitation on the SALT deduction. While Louisiana hopes that it has finally established a way to limit the impact of the SALT deduction limitation on Louisiana taxpayers, the IRS has not issued any guidance on Louisiana's program, or any other similar state program, and whether such programs will truly accomplish their goals. Interestingly, however, the IRS's most recent priority guidance lists applying the SALT deduction cap to passthrough entities as one of its top 10 priorities on the implementation of the TCJA.[22]

Thus, the IRS may soon issue guidance that will alert taxpayers how the Election made under Act 442 will be treated. Until that time, taxpayers and passthrough entities should review their specific tax situations to determine if the Election is a worthwhile path for their businesses to pursue. ■

[18] La. Rev. Stat. 47:201.1(A)(1).

[19] La. Rev. Stat. 47:201.1(A)(1). Note that the composite return filing is not required for nonresident members who agree to file an individual return in Louisiana under a binding agreement filed with the Louisiana Department of Revenue.

[20] La. Rev. Stat. 47:201.1(D)(1).

[21] Conn. Gen. Stat. 12-699; and Wis. Stat. 71.21(6)(a).

[22] IRS Office of Tax Policy, "2018-2019 Priority Guidance Plan, 3rd Quarter Update" (June 17, 2019).

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