Have you noticed your taxes have gone up because you can't deduct ALL of the state taxes you pay? Like many tax advantages – there's a work around for that and we wanted to make sure you know about it!

Three Strategies for Business Owners to Overcome the $10,000 SALT Cap

The state and local taxes (SALT) cap has proven to be one of the most politically charged pieces of the Tax Cuts and Jobs Act (TCJA) of 2017. The SALT deduction allows taxpayers who itemize on their federal tax returns to deduct certain taxes paid to state and local governments. **TCJA capped the total taxes that can be deducted at $10,000 per year**, making this benefit suddenly not an option to nearly 11 million Americans.

But if you own a business known as "pass-throughs" you may have some unique options to deduct the state taxes you pay. Pass-through businesses include sole proprietorships, partnership, or S corporations, which are not subject to corporate income tax because the company's income is reported on your individual tax return as the owner. If you own your company and report your business income on your individual income tax return, **a Certified Tax Planner can walk you through the strategies available to regain that SALT deduction**.

Read on for an overview of three possible ways to overcome the SALT cap.

THE "SALT CAP" PROBLEM

The recent $10,000 SALT cap limited many taxpayers' ability to fully deduct their personal and local taxes, including real estate and property taxes, on their federal tax returns. For states that do not collect income tax, the SALT cap applies to sales tax, although the cap does not apply to rental real estate or investment property.

Taxpayers with high property taxes have gotten most of the attention, but **the cap also has a significant impact on the owners of pass-through entities**, which can range from mom-and-pop stores to privately-held manufacturers to larger partnerships for medical offices, law firms, and hedge funds. Since pass-through businesses report their tax obligations on their personal income tax returns, residents of high-tax states like California, Connecticut, Illinois, New Jersey, New York, Pennsylvania and Texas are hit the hardest by the SALT limitation.

STRATEGIES FOR PASS-THROUGH BUSINESSES

Before assuming you will not qualify for a SALT deduction, keep in mind that **Certified Tax Planners have parsed the recent federal and state rules** to find ways for you to receive a full deduction. Below are three strategies that business owners may be able to leverage:

Strategy #1: Charitable Contributions

Starting in 2018, the states of Connecticut, New York, New Jersey and Oregon passed laws that said individual taxpayers could make donations to state or local charitable trusts, municipal funds, or school districts in exchange for a state tax credit. The idea behind these laws was that these taxpayers would receive a credit and could also deduct the "contributions" on their federal tax returns as charitable deductions. Unfortunately, the IRS largely closed up this loophole in 2019 with a new ruling. However, before this ruling, the IRS had signaled that it was on board with the strategy **if carried out by pass-throughs**, and the agency made this distinction official in August 2020.

The clarification provided by the IRS states that "*business taxpayers who make business-related payments to charities or government entities for which the taxpayers receive state or local credits can generally deduct the payments as business expenses*." This created a safe harbor for pass-through entities to say that the portion of their SALT payment that equaled the state tax credit received could be treated as **an ordinary and necessary business expense** instead of a charitable contribution.

The catch is that the safe harbor does not apply to pass-throughs if their SALT liability is reduced by the credit. Still, this helpful clarification from the IRS led to a new idea: since the SALT cap does not apply to business taxes, business owners can deduct their SALT payments in full as a business expense on their federal returns.

Strategy #2: Entity-Level Taxes

Since TCJA took effect, a number of states have passed new measures that offset the tax impact on pass-through businesses. In May 2018, Connecticut established a mandatory 6.99% levy for pass-through businesses in exchange for what is now **an 87.5% credit on their state taxes**. In January 2020, New Jersey passed a law known as the "Business Alternative Income Tax" (BAIT), under which pass-through owners can opt to "reclassify" their state income tax payments as **an "elective entity-level tax"** ranging from 5.675% to 10.875%. Other states, including Louisiana, Maryland, Massachusetts, Oklahoma, Rhode Island, Texas and Wisconsin have enacted similar laws. About six other states have similar bills pending.

Still, there is a potential thorn in this workaround. The 2020 IRS ruling mentioned above was silent on the question of business owners paying state taxes at the entity level to generate a business deduction on a federal personal return. Fortunately, a recently released notice states that the IRS will allow pass-through entities to fully deduct entity-level income tax payments as long as certain requirements are met.

Strategy #3: C Corporations

Since the SALT cap applies only to individual taxpayers and not separately taxed entities like C corporations, this provides another potential workaround. The IRS permits an S corporation to revoke its S election and become a C corporation for tax treatment. A limited liability company (LLC) can also simply elect to be taxed as a C corporation. How can business owners determine if it is worthwhile to convert? This is where **the advice of a Certified Tax Planner** comes in handy. Businesses will want to determine if their full SALT deduction is outweighed by the loss of the 20% qualified business income deduction that applies to pass-throughs (but not to C corporations).

To think through how these tax strategies might play out in real life, consider the examples below.

EXAMPLE: MAKING A CHARITABLE CONTRIBUTION

Let's say you are married filing jointly and have an adjusted gross income of $170,000 per year from a business that you own as an LLC. Your property tax is $15,000, and your state income tax bill is $10,000. Before TCJA, you would have been able to deduct $25,000 (your property tax amount + your state income tax amount) from the total taxable income on your federal return. After the introduction of the SALT cap, you would only be able to deduct $10,000. Since $15,000 of your state and local taxes is non-deductible, your additional tax bill due to the SALT cap is $3,300 (assuming here that you itemize deductions and are in the 22% tax bracket).

Now let's say you employ the strategy of donating $15,000 through your pass-through business to a state charity. Because **the IRS considers a business taxpayer's contributions to be a trade or business expense deduction** (rather than a charitable contribution) you preserve the ability to deduct that $15,000. Since the business income you will now report is $15,000 less, you have successfully eliminated that $3,300 tax liability.

Keep in mind that other line items on individual tax returns are also impacted by the SALT cap. Fewer itemized deductions means higher taxable income. By using the pass-through deduction workaround, both taxable income and adjusted gross income (AGI) are lowered. Having a lower AGI can also make you eligible for **other benefits that would normally be unavailable like taxable social security benefits, deductible medical expenses, and tax credits**.

EXAMPLE: FILING AS A C CORPORATION

In our second example, let's say you're married filing jointly and earn an adjusted gross income of $750,000 a year from a business that you own as an LLC. You have property taxes of $15,000 and a state income tax bill of $100,000. Before TCJA, you could deduct $115,000 ($15,000 + $100,000) from the total taxable income on your federal return. Now, with the $10,000 SALT cap, you can deduct only $10,000, leaving $105,000 in non-deductible state and local taxes.

Now let's say that instead of filing taxes as an LLC, you elect to be taxed as a C corporation. With a C corporation, you will pay yourself a salary—let's say that is $250,000 per year. Since you are no longer viewed as a pass-through business, you will enjoy the benefit of **avoiding personal tax on any business earnings, the ability to deduct all of the state taxes paid, and a 21% corporate tax rate**. After your salary is paid, this leaves $500,000 in taxable income in the C corporation. Your federal tax liability is $105,000.

Now let's say your state tax is $44,200. Let's also say that you retain $100,000 to reinvest into the business, and you distribute the remaining cash of $270,800 as a dividend which is taxed at a 15% qualified dividends tax rate. By shifting the income to a C corporation, you have preserved the ability to deduct the $44,200 in state taxes, reduced your effective tax rate to just 18%, and saved over $34,000 in federal tax!

SUMMARY

With the SALT cap in place until 2026, business owners of pass-throughs can look to these three workarounds to potentially receive their full SALT deduction. Understanding the pros, cons, and requirements of each strategy is critical, which is why business owners should **seek the counsel of a Certified Tax Planner**. A little time spent in consultation could result in thousands of "extra" dollars in deductions and provide a welcome boost to your bottom line.

To learn more about navigating the SALT cap, reach out to a Certified Tax Planner today!