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Indiana Law Journal

Volume 98 | Issue 2 Article 8

2023

State Workarounds to the IRC's SALT Cap: The Past, the Present, and Building for the Future

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Stephenson McEwan, Richard (2023) "State Workarounds to the IRC's SALT Cap: The Past, the Present, and Building for the Future," *Indiana Law Journal*: Vol. 98: Iss. 2, Article 8.
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State Workarounds to the IRC's SALT Cap: The Past, the Present, and Building for the Future

RICHARD STEPHENSON MCEWAN*

Recently, Congress has debated measures to provide some relief to taxpayers negatively impacted by the Internal Revenue Code's State and Local Tax (SALT) deductibility limit. Although Congress has not yet budged on whether to adjust this cap, many states have taken it upon themselves to find creative workarounds to provide relief for their constituent taxpayers. In the face of an uncertain future for the current SALT cap, crucial questions exist for these state workarounds and those still to come. This Note carefully lays out the individual income tax issue posed by the SALT cap, before analyzing the core elements of each state workaround passed through March 2022. This Note then takes on each of these key elements and posits a best path forward, with an eye toward cohesively providing the most flexibility for pass-through entity owners, ultimately concluding that state workarounds present benefits for taxpayers that should propel their adoption despite any federal SALT cap uncertainty or existence.

* Third-year law student at the Indiana University Maurer School of Law. I would like to thank Elaina Wilson, as well as the rest of the *Indiana Law Journal* Volume 97 notes and comments team, for their guidance as I worked on this Note. I also want to thank Rebecca Wiebke, Hadley Smithhisler, Madeline Ash, Bryant Barger, Nainika Ravi, and Sophie Stevanovich on the *Indiana Law Journal* Volume 98 staff for their vital contributions in preparing this piece for publishing. Finally, I want to thank my family, whose unconditional love always propels me forward: Paul and Elizabeth, William and Taylor (and family), Robert, and Kathleen. I dedicate this piece to my late uncle, Robert Richard Stephenson II—a loving uncle, a prolific attorney and humorist, and a renowned basketball player.

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INTRODUCTION

In 2017, Congress and then-President Trump enacted the Tax Cuts and Jobs Act (TCJA), aimed at spurring economic growth by lowering both individual and corporate income-tax rates for tax years 2018 through 2025.[1] Overhauling the federal Internal Revenue Code (IRC, or "Code"), TCJA added a contentious limitation to the deductibility of individuals' state and local income taxes (SALT), limiting these deductions to $10,000 per year for almost all individual taxpayers (or $5000 in the case of a married-filing-separate taxpayer)[2]—this limitation subsequently became known as the "SALT cap." In the intervening years, taxpayers in higher income tax states have pressed (unsuccessfully) for repeal of the SALT cap because the limitation raises these taxpayers' effective tax rates each year.[3] In the fall of 2021,

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1. *What Are the Economic Effects of the Tax Cuts and Jobs Act?*, TAX POL'Y CTR., https://www.taxpolicycenter.org/briefing-book/what-are-economic-effects-tax-cuts-and-jobs-act [https://perma.cc/E67H-RCPV] (May 2020).

2. 26 U.S.C. § 164(b)(6); Joseph Mandarino, *Partial Repeal Could Resolve Biden's SALT Cap Dilemma*, LAW360 (Apr. 9, 2021, 6:04 PM), https://www.law360.com/articles/1373385/partial-repeal-could-resolve-biden-s-salt-cap-dilemma [https://perma.cc/MXQ5-6YF7].

3. *See, e.g.*, Sarah Ewall-Wice, *Some Democrats Want to Repeal the SALT Tax Deduction Cap, Which They Say Hurts Middle-Class Taxpayers in High-Cost Areas. Others Say That's a Tax Cut for the Rich.*, CBS NEWS (Nov. 3, 2021, 7:33 AM), https://www.cbsnews.com/news/salt-tax-deduction-democrats-repeal/ [https://perma.cc/QX2D-2ATL]. "Effective tax rate" essentially refers to the tax rate actually paid on a taxpayer's income. *E.g.*, Julia Kagan, *Effective Tax Rate Definition*, INVESTOPEDIA, https://www.investopedia.com/terms/e/effectivetaxrate.asp#:~:text=The%20term%20effecti

however, Congress and President Biden pushed Biden's hallmark legislation, the "Build Back Better" bill, all the way through the House of Representatives, where its fate rested in the hands of Senate democrats to carry it through to law with whatever changes that might have come.[4] In addition to providing for President Biden's social safety net and climate frameworks, Build Back Better would also have provided partial relief to aggrieved taxpayers by raising the SALT cap from $10,000 to $80,000.[5] Although Build Back Better ultimately never passed, President Biden succeeded in passing the similar Inflation Reduction Act in August 2022, albeit without any SALT relief measure included.[6]

Regardless of the success (or lack thereof) of federal SALT cap relief measures to date, any potential changes to the IRC's SALT cap in the future would not occur in a vacuum. While the federal government has wrestled, and continues to wrestle, with providing taxpayers relief, several states have also sought and achieved SALT cap relief mechanisms through entity level taxes for pass-through entity (PTE) owner-taxpayers ("workarounds"),[7] which allow PTEs to pay (and subsequently deduct) SALT liabilities on behalf of the PTE's owners.[8] In view of these state income-tax regimes, the prospect of eventual federal SALT cap change (or even ultimate removal) poses crucial questions, both for states that have already enacted PTE-level tax mechanisms and those that weigh enacting similar regimes in the coming years as the popularity of PTE-level tax schemes spreads across the country.[9] What does the potential change mean for existing state workarounds to the current SALT cap problem? Should states continue enacting SALT cap workaround measures anyway, and why? If so, what should states do moving forward to create more cohesion across state lines for multistate PTEs?

Below, Part I of this Note examines the unique issue presented by the 2017 TCJA SALT cap for individual taxpayers,[10] Part II explores the past and present treatment

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ve%20tax%20rate,as%20stock%20dividends%2C%20are%20taxed [https://perma.cc/3VVD-AHKQ] (Mar. 24, 2021).

4. Jacob Pramuk, *The House Passed Biden's Massive Social Safety Net and Climate Bill. Here's What Happens Next*, CNBC, https://www.cnbc.com/2021/11/19/house-passes-build-back-better-act-what-happens-next-in-the-senate.html [https://perma.cc/AN5J-2AYS] (Nov. 19, 2021, 6:56 PM).

5. *Id.*

6. *See, e.g.*, Jim Tankersley, *Biden Signs Expansive Health, Climate and Tax Law*, N.Y. TIMES (Aug. 16, 2022), https://www.nytimes.com/2022/08/16/business/biden-climate-tax-inflation-reduction.html [https://perma.cc/FA9Y-9UZS]; Peter Warren, *"Inflation Reduction Act" Holds the SALT*, EMPIRE CTR. (Aug. 11, 2022), https://www.empirecenter.org/publications/inflation-reduction-act-holds-the-salt/ [https://perma.cc/9H92-CLC5].

7. *See infra* Table 1.

8. *See infra* Parts III–V.

9. *See, e.g.*, Sam McQuillan, *SALT Workarounds Spread to More States as Democrats Seek Repeal*, BLOOMBERG TAX (Apr. 27, 2021, 4:46 AM), https://news.bloombergtax.com/daily-tax-report/salt-workarounds-spread-to-more-states-as-democrats-seek-repeal [https://perma.cc/7JKZ-P8YC] (highlighting state SALT provision changes taking place in early 2021).

10. *See infra* Part I.

of SALT deductibility for individuals,[11] and Part III briefly details how businesses pay taxes under the Code.[12] Part III then turns to canvassing the key characteristics of each state workaround provision enacted through March 2022.[13] Part IV ultimately concludes that because state workarounds provide unique advantages from both taxpayer and tax-revenue perspectives that cannot be ignored, states should maintain and continue to enact elective PTE-level tax schemes.[14] In doing so, states can bolster the benefits that workaround provisions offer to states and taxpayers alike by prioritizing the following, as described in Part V[15]:

1. creating the PTE-level tax as an elective feature for both the entity and the individual owners exercising the election;[16]
2. standardizing the eligible PTEs that may elect the PTE-level tax;[17]
3. simplifying the mechanism for passing the tax benefit through to the PTEs' owners;[18]
4. decoupling the workarounds' existence and provisions from the federal SALT cap;[19] and
5. expressly including credit and recognition provisions for PTE tax payments made to other states.[20]

I. INDIVIDUAL INCOME TAX FRAMEWORK

Understanding the exact issue posed by the TCJA SALT cap requires a baseline understanding of the individual tax framework. In a nutshell, tax liabilities are calculated using the following formula: gross income[21] minus above-the-line deductions[22] (resulting in adjusted gross income[23]), minus below-the-line deductions[24] (whether the taxpayer uses their itemized deductions or standard deduction, plus any below-the-line-but-not-itemized deductions[25]), resulting in the taxpayer's taxable income, or tax base. After determining the taxpayer's taxable income, the taxpayer then applies the tax rate tables depending on their taxable income amount and filing status.[26] The result is the taxpayer's tax liability for the year, which may be reduced dollar-for-dollar by any tax credits, if applicable.[27]

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11. *See infra* Part II.
12. *See infra* Section III.A.
13. *See infra* Section III.B.
14. *See infra* Part IV.
15. *See infra* Part V.
16. *See infra* Section V.A.
17. *See infra* Section V.B.
18. *See infra* Section V.C.
19. *See infra* Section V.D.
20. *See infra* Section V.E.
21. *See* INTERNAL REVENUE SERV., 1040 (AND 1040–SR): INSTRUCTIONS 24 (2021), https://www.irs.gov/pub/irs-pdf/i1040gi.pdf [https://perma.cc/LM7Y-EX5X].
22. *See id.* at 30.
23. *See id.*
24. *See id.* at 30–32.
25. *See id.* at 32.
26. *See id.* at 13–15, 32.
27. *See id.* at 37–39, 57–58.

A. Gross Income

Under the IRC, gross income purports to capture all income attributable to a taxpayer within the tax year. Looking at the limited items that the Code *excludes* from gross income shows how expansive the definition of gross income truly is. In the Code, "excluded" logically means that the taxpayer's total gross income amount for the year will not include that item of income[28] (this concept is categorically different than "deductions"[29] and "credits"[30]). For federal income tax purposes, some of the most commonly excluded items are certain death benefits,[31] gifts and inheritances,[32] compensation for injuries or sickness (including compensatory damages),[33] qualified scholarships,[34] some gains on the sales of principal residences,[35] and certain fringe benefits from employers,[36] among others.

Apart from excluded items, then, gross income includes "all income from whatever source derived."[37] I.R.C. § 61 then specifically names a nonexhaustive list of included gross-income items, many of which likely would directly concern pass-through business owners, as many PTEs are treated as partnerships under the federal tax code.[38] "Compensation for services, including fees, commissions, fringe benefits, and similar items;"[39] "[g]ross income derived from business;"[40] "[g]ains derived from dealings in property;"[41] "[i]nterest" earnings;[42] "[r]ents";[43] "[r]oyalties;"[44] "[d]ividends;"[45] "[i]ncome from discharge[s] of indebtedness;"[46] and "[d]istributive share[s] of partnership gross income" are all included here.[47] The sum of the taxpayer's included items becomes their gross income, from which above-the-line deductions are then subtracted.

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28. *See, e.g.*, I.R.C. § 101(a)(1).
29. *See infra* Section I.B.
30. *See infra* Section I.F.
31. I.R.C. § 101.
32. *Id.* § 102.
33. *Id.* § 104.
34. *Id.* § 117.
35. *Id.* § 121.
36. *Id.* § 132.
37. *Id.* § 61.
38. *See infra* Section III.A.
39. § 61(a)(1).
40. *Id.* § 61(a)(2).
41. *Id.* § 61(a)(3).
42. *Id.* § 61(a)(4).
43. *Id.* § 61(a)(5).
44. *Id.* § 61(a)(6).
45. *Id.* § 61(a)(7).
46. *Id.* § 61(a)(11).
47. *Id.* § 61(a)(12).

B. Above-the-Line Deductions

Very generally, deductions under the IRC are expenses or losses that taxpayers incur that reduce the taxpayer's taxable income—and thus tax liability.[48] The tax benefit to a taxpayer claiming and recognizing a deduction is equal to the taxpayer's marginal income-tax rate (the taxpayer's highest bracket) multiplied by the amount of the deduction recognized.[49] Specifically, "above-the-line" deductions—expenses or losses that are deductible *for* adjusted gross income—are deducted from the total gross income for the year in arriving at the taxpayer's adjusted gross income.[50] Above-the-line deductions, in a certain sense, stand for common expenses that taxpayers often incur throughout the year, which taxpayers should always be able to receive a tax benefit from without risking that the expense may not provide a benefit if the expense's deductibility was left to be determined by the taxpayer's amount of itemized deductions.[51]

In the IRC, above-the-line deductions are defined by inclusion, as the Code delineates the possible deductions permitted in reaching the adjusted gross income figure in I.R.C. § 62: deductions attributable to a trade or business that the taxpayer carries on;[52] deductions allowed from losses on the sale or exchange of properties;[53] deductions allowed by § 212 relating to expenses for the production of income and those attributable to properties held for the production of rents and royalties;[54] deductions for moving expenses allowed under § 217;[55] deductions for interest payments on education loans under § 221;[56] and deductions for health savings account contributions under § 223.[57]

C. Adjusted Gross Income

After deducting a taxpayer's above-the-line deductions from the taxpayer's total gross income, the intermediate difference is called "adjusted gross income."[58]

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48. *Tax Deduction*, TAX FOUND., https://taxfoundation.org/tax-basics/tax-deduction/ [https://perma.cc/YV3P-AMKK].

49. *Tax Credits vs. Tax Deductions*, NERDWALLET (Apr. 5, 2022), https://www.nerdwallet.com/article/taxes/tax-credit-vs-tax-deduction [https://perma.cc/R2H4-K3D4]. Compare this concept with excluded income. *See supra* Section II.A. For an example of this tax benefit calculation, see the tax credit example *infra* Section II.F.

50. *See* I.R.C. § 62. Adjusted gross income is discussed *infra* Section II.C.

51. *See infra* Section I.D. In short, above-the-line deductions are usually frequent and important expenses, which the Code seeks to compensate taxpayers for.

52. § 62(a)(1).

53. *Id.* § 62(a)(3).

54. *Id.* § 62(a)(4).

55. *Id.* § 62(a)(15).

56. *Id.* § 62(a)(17).

57. *Id.* § 62(a)(19).

58. *See id.* § 62. For the sake of remembering the difference between above-the-line and below-the-line deductions, think of "adjusted gross income" as the "line." Above-the-line deductions are deducted before (or "above") arriving at adjusted gross income, and below-the-line deductions are deducted after (or "below") adjusted gross income is determined.

Functionally, the adjusted gross income amount is not terribly important for the sake of determining a taxpayer's tax liability because the taxpayer is still entitled to additional deductions "below the line,"[59] but the adjusted gross income amount is sometimes used as a threshold amount to determine the deductibility of certain itemized items. For example, individual taxpayers can claim an itemized deduction (below the line) for authorized medical and dental expenses paid throughout the year that have not been compensated by insurance or otherwise—but only to the extent that the total amount of the medical and dental expenses is greater than 7.5% of the taxpayer's adjusted gross income.[60]

D. Below-the-Line Deductions

As mentioned, and particularly important in the SALT-deductibility realm, taxpayers claim and subtract "below-the-line" deductions from their adjusted gross income to arrive at their taxable income for the year, which finally will be used to calculate the taxpayer's liability.[61] Under the IRC, there are three basic types of below-the-line deductions: (1) the standard deduction,[62] (2) itemized deductions,[63] and (3) neither standard nor itemized ("Neither") deductions.[64]

Although the Neither deductions are very few, they are conceptually the simplest to understand and apply—a taxpayer may claim these deductions regardless of whether the taxpayer uses the standard deduction or instead elects to itemize.[65] One of these Neither deductions, § 63(b)(3), is particularly important for PTE owners as it allows individuals to deduct twenty percent of their qualified business income for the tax year,[66] defined as "the net amount of qualified items of income, gain, deduction, and loss with respect to" a taxpayer's "qualified trade or business."[67]

Aside from the Neither deductions, taxpayers are entitled to claim either the standard deduction or the taxpayer's itemized deductions (if the taxpayer so elects).[68] The standard deduction conceptually stands for the automatic tax benefit that all taxpayers are entitled to receive, regardless of the amount of their itemized deductions (explained below)—the standard deduction essentially creates a predetermined number of pretax dollars that will be removed from the taxpayer's adjusted gross income. In the absence of a taxpayer's election to itemize, the standard deduction is used by default in calculating the taxpayer's taxable income, to which the applicable tax rate is then applied.[69]

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59. *See infra* Section I.D.
60. I.R.C. § 213(a).
61. *See id.* § 63.
62. *Id.* § 63(b)(1), (c).
63. *Id.* § 63(a), (e).
64. *Id.* § 63(b)(2)–(4).
65. *Id.* § 63(a), (b)(2)–(4). Mathematically, this effectively means that the taxpayer may subtract from their adjusted gross income the Neither below-the-line deductions as well as the standard or itemized deductions.
66. *See id.* § 199A(a).
67. *Id.* § 199A(c)(1).
68. *See id.* § 63(b), (e).
69. *See* § 63(a), (b). A taxpayer's applicable tax rate is located in § 1.

Because the standard deduction is not based on any real expenses or losses incurred by taxpayers through the year, the amount of the (basic) standard deduction is a fixed amount determined by Congress, albeit indexed to match the inflation rate to provide a steadily proportional benefit to taxpayers each year.[70] The total amount of the standard deduction, though, is defined as the sum of the basic standard deduction and the additional standard deduction.[71] The basic standard deduction amount is given in I.R.C. § 63(c)(2): for single taxpayers, the pre-TCJA[72] amounts were $6000 for joint and surviving spouse filers, $4400 for heads of household, and $3000 for any other type of filer (single or married filing separately).[73] Likewise, the pre-TCJA additional standard deduction amount is also provided in I.R.C. § 63(f): taxpayers aged sixty-five and older are entitled to an additional standard deduction of $600,[74] as are blind taxpayers.[75]

Itemized deductions, then, will only be used if the taxpayer elects to use their total itemized deductions in lieu of their allotted standard deduction based on their age, ability, and filing status.[76] Since the standard deduction is given automatically, the expenses and losses giving rise to itemized deductions only provide a benefit to the extent that the taxpayer's total itemized deductions exceed what would be their standard deduction amount. Following this logic, essentially, any provision that would limit a taxpayer's ability to deduct payments only deductible as an itemized deduction increases the risk that the taxpayer's expense will not result in a tax benefit at the end of the year.[77]

Itemized deductions are defined by exclusion in the Code, including deductions for interest,[78] taxes under § 164,[79] "casualty or theft losses,"[80] charitable contributions,[81] and medical expenses.[82] Although currently disallowed by TCJA, any other deductions aside from those listed in § 67(b) of the Code are "miscellaneous," and these deductions may only be "allowed . . . to the extent that" they "exceed two percent of" the taxpayer's adjusted gross income.[83] Because the list of freely deductible (not subject to any adjusted-gross-income-based limitations, like miscellaneous itemized deductions are) itemized deductions is so exclusive, any action undermining these deductions may lead to harm for certain classes of

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70. *See id.* § 63(c)(4); Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.
71. § 63(c)(1)(A)–(B).
72. See *infra* Part II for the current, post-TCJA amounts.
73. § 63(c)(2).
74. *Id.* § 63(f)(1).
75. *Id.* § 63(f)(2).
76. *See id.* § 63(e).
77. *See infra* Part II. In short, itemized deductions are already "difficult" to use because taxpayers only use them when they have excessive itemized expenses for the year. Tax provisions that make it even more difficult to use itemized deductions, then, expand the pool of taxpayers who will not benefit from paying expenses that could lead to tax benefits (in the form of itemized deductions).
78. *Id.* § 67(b)(1).
79. *Id.* § 67(b)(2).
80. *Id.* § 67(b)(3).
81. *Id.* § 67(b)(4).
82. *Id.* § 67(b)(5).
83. *Id.* § 67(a).

taxpayers. The itemized deduction for taxes contained in § 67(b)(2) sets the stage for the TCJA SALT cap issue, which is covered in-depth below in Part II of this Note.

E. Taxable Income

Taxable income, finally, is the amount of gross income remaining after taking into account all the includable income items, minus above-the-line deductions, either the standard or total itemized deductions, and Neither deductions. Taxable income is succinctly defined in I.R.C. § 63: "Except as provided in subsection (b), for purposes of this subtitle, the term 'taxable income' means gross income minus the deductions allowed by this chapter . . . ."[84] After determining the final taxable income for the year, the taxpayer then applies the tax rate table calculation based on their filing status to determine their tax liability.[85]

F. Tax Credits

After a taxpayer determines their tax liability using the tax rate tables in I.R.C. § 1, the last way for the taxpayer to reduce their tax liability is through using tax credits. Tax credits directly reduce a taxpayer's tax liability for a given year, dollar for dollar.[86] Generally, there are two types of tax credits: refundable and nonrefundable.[87] Each of these labels simply refers to whether any excess amount of the credit (over and above the taxpayer's liability) is paid back to the taxpayer. Predictably, refundable tax credits could potentially result in a refund if the credit outweighs the tax liability, and nonrefundable tax credits may only be exercised to the extent of the tax liability.[88]

While tax credits appear to offer the same benefit as deductions, there are important differences in the implications for the taxpayer's final tax liability. Deductions decrease the taxpayer's taxable income and thus lower the base to which the tax rate will be applied, thereby lowering the taxpayer's tax liability. Thus, the tax benefit to the taxpayer is equal to the taxpayer's marginal tax rate (the taxpayer's highest bracket) multiplied by the amount of the deduction recognized.[89]

To illustrate the deduction benefit, imagine a fictional taxpayer, Paul, with an average and marginal tax rate of 10%. This year, Paul has gross income of $1000 and has authorized deductible expenses of $200. Using a simplified version of the income-tax calculation laid out above, Paul would have $1000 of gross income and deduct the $200 of expenses, resulting in a total taxable income of $800. Applying the 10% tax rate, Paul faces an income-tax liability of $80. To see the effect of the deduction more clearly, compare Paul's income-tax liability with what it would have been without the deduction—$1000 of gross income multiplied by Paul's tax rate of 10% would result in a tax liability of $100. The effect of the $200 deduction is $20 for Paul's end-of-year tax liability ($100 without the deduction and only $80 with

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84. *Id.* § 63(a).
85. *Id.* § 1.
86. *Tax Credits vs. Tax Deductions*, *supra* note 49.
87. *Id.*
88. *Id.*
89. *See supra* Section I.B.

the deduction). More simply, the benefit of the deduction can be found by multiplying the marginal tax rate (10%) by the amount of the deduction ($200).

Tax credits, on the other hand, are not subtracted until the tax liability has already been calculated on the taxpayer's taxable income; thus, the tax benefit of a credit is equivalent to the amount of the credit (ignoring the refundability issue).

Once again, to illustrate the tax-credit benefit, imagine another fictional taxpayer, Elizabeth, also with an average and marginal tax rate of 10%. This year, Elizabeth also has gross income of $1000, but Elizabeth instead has an authorized refundable tax credit of $75. Using the same simplified version of the income-tax calculation, Elizabeth would have $1000 of gross income without any deductions, resulting in a total taxable income of $1000. Applying the 10% tax rate, Elizabeth faces an income-tax liability of $100. Using the tax credit dollar for dollar against the tax liability, however, Elizabeth's tax liability decreases to $25. To see the effect of the credit, compare Elizabeth's income-tax liability with what it would have been without the credit—$1000 of gross income multiplied by Elizabeth's tax rate of 10% would result in a tax liability of $100, but after subtracting the $75 credit, Elizabeth's liability is only $25. Much clearer than for deductions, the benefit of the tax credit can simply be found by looking at the amount of the credit ($75 in this example).

Because of the inherent benefit that tax credits provide over and above that of deductions, Congress has approved far fewer credits than deductions, and it typically uses credits to benefit specific causes and taxpayers, including but not limited to: lower-income taxpayers who are supporting qualifying children,[90] first-time home purchasers,[91] taxpayers owning health insurance,[92] elderly and disabled taxpayers,[93] taxpayers who are adopting or have adopted children,[94] taxpayers paying home mortgage interest,[95] and taxpayers pursuing higher education.[96]

II. SALT DEDUCTIBILITY—PAST AND PRESENT

As mentioned, the itemized deduction for state and local taxes paid[97] sets the scene for the individual tax predicament faced by so many taxpayers following the Trump-era TCJA of 2017. Properly understanding the TCJA and its subsequent implications and issues, though, necessitates a pre-TCJA SALT deductibility conceptual background.

Prior to TCJA's passage, the normative tax treatment for individual taxpayers' SALT payments was generally unlimited deductibility[98] (and presently, this treatment is slated to return if the TCJA provisions retire undisturbed following the 2025 tax year).[99] This baseline treatment is still shown in the Code:

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90. I.R.C. § 24, 32.
91. *Id.* § 36.
92. *Id.* § 36B.
93. *Id.* § 22.
94. *Id.* § 23.
95. *Id.* § 25.
96. *Id.* § 25A.
97. *Id.* § 67(b)(2). See *supra* Section I.D for an in-depth coverage of itemized deductions.
98. I.R.C. § 164(a).
99. *Id.* § 164(b)(6).

> (a) Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued: (1) state and local, and foreign, real property taxes[,] (2) state and local personal property taxes[,] (3) State and local, and foreign, income, war profits, and excess profits taxes[,] (4) the GST [general sales taxes] tax imposed on income distributions. In addition, there shall be allowed as a deduction State and local, and foreign, taxes not described in the preceding sentence which are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for production of income).[100]

Specifically, the SALT payments described above in I.R.C. § 164(a) are deductible below the line if the taxpayer elects to itemize for the given tax year.[101]

From a policy perspective, generally allowing taxpayers to deduct all SALT payments provides a substantial favor to taxpayers by allowing them to reap a federal tax benefit from taxes paid to the other levels of government that in many cases may significantly increase the taxpayers' effective tax rate.[102] Especially because the choice to allow a deduction for a personal expense (such as personal taxes paid) already serves as an exception to the general rule that personal expenses do not give rise to deductions, the TCJA limitation indicates a pointed, conscious decision from Congress that makes a significant difference for taxpayers in some areas.[103]

Turning to the TCJA itself, when President Trump took office in 2017, Republican lawmakers moved to pass a sweeping array of tax cuts, which collectively became the Tax Cuts and Jobs Act.[104] TCJA make changes to the individual tax Code for tax years 2018 through 2025, primarily cutting the highest individual tax bracket rates and shifting the income-tax bracket thresholds while cutting the corporate tax rate from 35% to 21%.[105] Specifically, TCJA made fundamental changes to below-the-line deductions, namely the standard deduction and itemized deductions.

Relating to the standard deduction, TCJA drastically increased the standard deduction amounts,[106] perhaps to afford some relief for taxpayers who may otherwise be adversely affected by the itemized deduction rollbacks. I.R.C. § 63(c)(7) increased

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100. *Id.* § 164(a).

101. *Id.* § 67(b)(2).

102. Not to be confused with a taxpayer's marginal tax rate, "effective tax rate" simply refers to the average tax rate paid on a taxpayer's income (calculated by dividing total taxes paid by gross income). Beverly Bird, *What Is an Effective Tax Rate?*, THE BALANCE, https://www.thebalance.com/how-to-calculate-your-effective-tax-rate-4685263 [https://perma.cc/UX73-HBHB] (Oct. 31, 2022).

103. *See* Alan Rappeport & Patrick McGeehan, *Tax Deduction that Benefits the Rich Divides Democrats Before Vote*, N.Y. TIMES (Nov. 18, 2021), https://www.nytimes.com/2021/11/18/us/politics/salt-tax-deduction-democrats.html [https://perma.cc/5BQK-UPUA].

104. *How Did the Tax Cuts and Jobs Act Change Personal Taxes?*, TAX POL'Y CTR., https://www.taxpolicycenter.org/briefing-book/how-did-tax-cuts-and-jobs-act-change-personal-taxes [https://perma.cc/LLR8-TZK6].

105. *Id.*

106. § 63(c)(7).

the basic standard deduction from $4400 for head-of-household filers to $18,000 and from $3000 for single filers up to $12,000 (from $6000 for married-filing-jointly (MFJ) up to $24,000),[107] additionally adjusting each of these amounts to match the rise of inflation each year.[108]

Most notably, though, regarding itemized deductions, TCJA overhauled the deductibility of individuals' SALT payments, capping the deduction at $10,000 (and only $5000 for MFJ) for tax years 2018–2025.[109] Because SALT deductions are itemized, the effect of the change has resulted in an increased number of taxpayers utilizing the standard deduction.[110] Essentially, far fewer taxpayers receive a benefit from paying their SALT now, resulting in an effectively higher federal tax bill at the end of the year.

From an economic justification perspective, the $10,000 SALT cap functions as a way for the federal government to recoup some of the losses they would otherwise have suffered because of the decreased tax rates across the individual tax brackets and the corporate-rate tax cut.[111] Further, from a partisan policy perspective, the taxpayers who suffer the most under the SALT cap are typically higher-earning taxpayers who pay large amounts of state income tax (more likely to itemize)[112] because the SALT cap is a hard limit of $10,000, instead of a ratable percentage limit of SALT payments. From the perspective of a Republican government, these taxpayers typically live in higher-tax states, which typically vote Democrat.[113] This partisan line of thinking has contributed to the SALT cap's divisiveness among high state income tax and low state income tax taxpayers, but taxpayers in states with high and low state income taxes are vulnerable under the SALT cap—albeit at differing frequencies.

In states with high income tax rates, taxpayers run into the issue of the SALT cap more frequently. The income taxes in these states, like in New Jersey, New York, and California,[114] typically push taxpayers (particularly high-earning ones) over the $10,000 cap, meaning that these taxpayers may not receive a federal income-tax benefit from their SALT payments, creating a sort of reciprocal or double taxation on a portion of their income. The same issue also exists in states with lower income tax rates, but the problem occurs less frequently. States with lower tax rates, by definition, take less of their taxpayers' income at the end of the year, so taxpayers are less likely to pay taxes to the government exceeding the deductible $10,000 SALT cap.

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107. *Id.* § 63(c)(7)(A).

108. *Id.* § 63(c)(7)(B).

109. *Id.* § 164(b)(6).

110. *See* Scott Eastman, *How Many Taxpayers Itemize Under Current Law?*, TAX FOUND. (Sept. 12, 2019), https://taxfoundation.org/standard-deduction-itemized-deductions-current-law-2019/ [https://perma.cc/Y7PY-99W7].

111. *See* Rappeport & McGeehan, *supra* note 103.

112. *See* Garrett Watson, *Who Benefits from the State and Local Tax Deduction?*, TAX FOUND. (Jan. 25, 2021), https://taxfoundation.org/salt-deduction-salt-cap-repeal/ [https://perma.cc/SRN9-H3R5] (contextualizing which states' individuals typically use the itemized SALT deduction the most).

113. *Id.*

114. *Id.*

Against this backdrop of growing frustration among taxpayers facing effective tax rates creeping skyward, many states began pressuring Congress to raise or repeal the SALT cap,[115] meanwhile brainstorming solutions of their own to grant their resident taxpayers some relief.[116]

III. THE STATES' SOLUTION: ENTITY TAXATION

Before introducing the bona fide solution that the states have developed to work around the federal SALT cap, observers should be familiar with some basic business entity taxation principles under the Code. Entity taxation, after all, is the means through which the SALT cap circumvention end is achieved. After laying out the baseline IRC entity taxation principles, this Part introduces and analyzes the state workarounds' development and current provisions, focusing on a handful of core themes connecting (and distinguishing) each of them.

A. A Primer on Entity Taxation

Making any sense of the state workarounds to the Code's SALT cap requires background knowledge of the Code's treatment of some common business formations, such as C-Corporations (the traditional corporation, or C-Corps), S-Corporations (small business corporations,[117] or S-Corps), partnerships, limited liability companies (LLCs), and sole proprietorships.

Beginning with the traditional corporation, C-Corp taxation seems to inspire the PTE-level tax that many states have adopted as the structural model for their workarounds.[118] Under the Code, C-Corps are treated as entities separate from their shareholders that are taxed yearly[119] before distributing any capital back to the shareholders. Most businesses are not organized as C-Corps, however, as the C-Corp method of taxation effectively creates another layer of taxation that adds complexity to the tax-filing process at year end[120]—this idea of a separate business-entity taxpayer is important to keep in mind, though, for the discussion below in Section III.B.

As mentioned, most businesses are organized as some form of a PTE, due to the size and simplicity desires of small-business owners.[121] The most important PTE

115. *See* Andrew Osterland, *State and Local Tax Breaks Could Be Revived, but not Without a Fight*, CNBC (Jan. 20, 2021, 11:19 AM), https://www.cnbc.com/2021/01/20/state-and-local-tax-breaks-could-be-revived-but-not-without-a-fight.html [https://perma.cc/9QHN-CUXJ].

116. *See infra* Section III.B.

117. I.R.C. § 1361(a)(1).

118. *See infra* Section III.B.

119. I.R.C. § 11(a).

120. *See* KYLE POMERLEAU, AN OVERVIEW OF PASS-THROUGH BUSINESSES IN THE UNITED STATES 5–7 (2015), https://files.taxfoundation.org/legacy/docs/TaxFoundation_SR227.pdf [https://perma.cc/4LBL-WD2X].

121. *See id.* at 7–8.

forms for the purposes of this Note are S-Corps, partnerships, LLCs, and sole proprietorships.[122]

S-Corps, or small business corporations, are special types of C-Corps that meet certain requirements[123] and thus may elect out of the C-Corp entity-level tax requirement, holding the shareholders (owners) individually liable for paying taxes on the results of the business.[124] Partnerships (sometimes indicated by "GP," "LP," or "LLP") are much less formal (in terms of formation) and are simply a relationship between at least two individuals to perform a trade or business, with each person contributing money, property, labor, or skill in exchange for sharing in their business's results.[125] Much like S-Corps, partnerships do not pay an entity-level tax, only the individual partners (owners) do.[126] Similarly, LLCs are state statute-created formations that offer greater flexibility than partnerships—LLCs can elect to pay taxes like a C-Corp, but the default treatment is the same as for partnerships.[127] One important note regarding LLCs, though, is that single-member (having only one owner) LLCs' default treatment is that of a "disregarded entity,"[128] which some states treat separately in crafting their state SALT cap workarounds.[129]

Moving to the development and analysis of the state workarounds, the most important takeaway from this Section is that PTEs, by definition, are entities that do not pay an entity-level tax prior to allocating income or distributing money to owners—whether an S-Corp, partnership, LLC (that has not elected to be treated as a C-Corp), or sole proprietorship (a disregarded entity).

B. The States' Solution

Responding to taxpayers' concerns in the wake of the TCJA SALT cap, a handful of states, beginning with Connecticut in 2018, began to enact PTE-level mechanisms (even without confirmation that such a scheme would hold up in the eyes of the Internal Revenue Service (IRS)) to help their taxpayers trim their total tax liabilities and avoid too much "repeat" taxation by the state and federal levels.[130] Even without federal confirmation of the viability of the PTE-level tax regimes, the PTE-level tax quickly caught on over the following years, and the "workarounds" became a popular

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122. *See infra* Table 1; *see also* I.R.C. § 1(h)(10).

123. S-Corps must be domestic corporations, have no more than 100 shareholders, have only individual "person[s]" as shareholders, have no nonresident aliens as shareholders, and have only one class of stock. I.R.C. § 1361(b)(1)(A)–(D).

124. *Id.* § 1363(a).

125. *Tax Information for Partnerships*, INTERNAL REVENUE SERV., https://www.irs.gov/businesses/partnerships [https://perma.cc/Y33M-48QK] (Dec. 7, 2021).

126. I.R.C. § 701.

127. *Limited Liability Company (LLC)*, INTERNAL REVENUE SERV., https://www.irs.gov/businesses/small-businesses-self-employed/limited-liability-company-llc [https://perma.cc/V9H4-K34M] (Feb. 24, 2022).

128. *Id.*

129. *See infra* Table 1.

130. *See* Bruce P. Ely & Kelvin M. Lawrence, *A More Viable SALT Cap Workaround? Pass-Through Entity-Level Taxes*, BRADLEY (July 11, 2019), https://www.bradley.com/insights/publications/2019/07/a-more-viable-salt-cap-workaround-pass-through-entity-level-taxes [https://perma.cc/XN64-KG5T].

choice for state legislators looking to provide demonstrable bottom-line results to their state constituencies.[131]

As the PTE-level taxes caught on across higher and lower income tax states alike, a common mechanism for the PTE taxes began to take shape. The PTE-tax structure and operation, which subsequently enacting states have continued to follow, uses the following common features: the enacting state allows PTEs—such as S-Corporations, partnerships, and often LLCs—to elect to be taxed at the entity level. Doing so then allows the *entity* to deduct the state and local tax payments, which are then allocated to the individual owners using either a pro rata tax credit or by excluding the owners' distributive share from gross income (for *state* income-tax purposes), bypassing the SALT cap.[132] In concert with the Code provisions for individuals, PTE taxes are an acceptable alternative to the cap because the SALT cap only applies to individuals, and the state PTE taxes are paid at the entity level instead of on the income-tax returns of the individual PTE owners, rendering the $10,000 cap inapplicable.[133]

Finally, in November 2020, the IRS seemingly blessed PTE-tax state workarounds to the federal SALT deduction cap. Issuing IRS Notice 2020-75, the IRS stated that "specified income tax payments" (those made by a PTE to a state, political subdivision of a state, or domestic jurisdiction) are (1) deductible by the PTEs in determining their net taxable income for the year, (2) reflected in a pro rata share of the owners' non-separately-stated income, and (3) not taken into account for the purposes of the SALT deduction limitation in I.R.C. § 164(b)(6).[134]

Through March 2022, the following states have all enacted a PTE-level tax scheme: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Georgia, Idaho, Illinois, Louisiana, Maryland, Massachusetts, Minnesota, Michigan, New Jersey, New York, North Carolina, Oklahoma, Oregon, Rhode Island, South Carolina, and Wisconsin.[135] So far, twenty-two states have joined in, with more likely to follow in the upcoming years.[136]

In Table 1 below, the currently enacted state workarounds appear in alphabetical order, and each is broken down based on its stance on five distinctive PTE-level tax features: (1) elective capabilities, (2) eligible entities, (3) mechanics for the passed-through tax benefits, (4) coupling with the federal SALT cap, and (5) nonresident state workaround payment recognition.[137] "Elective capabilities" refers to whether the state's PTE scheme is elective or mandatory, and for cases with special election

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131. *Id.*

132. *A Closer Look at SALT Cap Workarounds*, CBIZ, https://www.cbiz.com/insights/articles/article-details/a-closer-look-at-salt-cap-workarounds [https://perma.cc/YW7J-J4Y9].

133. *See* Jim Pierzchalski, *Pass-Through Entity Tax Treatment Legislation Sweeping Across States*, FORVIS (Oct. 8, 2021), https://www.forvis.com/article/2021/10/pass-through-entity-tax-treatment-legislation-sweeping-across-states [https://perma.cc/L9P8-QARJ].

134. I.R.S. Notice 2020-75, 2020-49 I.R.B. 1453.

135. *See infra* Table 1.

136. *See* McQuillan, *supra* note 9; Chelsea Vargason, *What To Know About the SALT Cap Workaround*, PERKINS & CO (Mar. 29, 2022), https://perkinsaccounting.com/blog/salt-cap-workaround/ [https://perma.cc/F5VB-HELE].

137. *See infra* Table 1.

rules for owners opting in or out of the PTE's election, these details are noted parenthetically. "Eligible entities" refers to the types of PTEs that the state allows to make the PTE tax election. "Mechanics for the passed-through tax benefits" refers to the method that the state uses to pass the benefit through to the PTE owners. "Coupling with the federal SALT cap" refers to whether the state has tied the existence of its PTE tax regime to the federal SALT cap. Finally, "nonresident state workaround payment recognition" refers to whether the state has expressly included a recognition or tax credit provision for PTE taxes paid to other states.

Table 1: State-by-State SALT Workarounds

State	**Elective?**	**Eligibility (Who can elect?)**	**Mechanics (How do they work?)**	**Tied to federal SALT cap?**	***Expressly* recognize other state workaround payments?**
Alabama[138]	Yes	S-Corps & IRC Subchapter K entities[139]	Pro rata tax credit passes through to owners	No	No
Arizona[140] (effective 2022)	Yes (owners can individually opt out of election)	S-Corps & IRC Subchapter K entities, excluding owners who are not individuals, estates, or trusts	Pro rata tax credit passes through to owners	Yes[141]	Yes, for "substantially similar" tax payments to other states
Arkansas[142] (effective 2022)	Yes	S-Corps, GPs, LPs, LLPs & LLCs	Owners exclude income from the electing entity	No	Excludes income related to tax payments under a "substantially similar" other-state regime

138. ALA. CODE § 40-NEW (2021).

139. *Electing Pass Through Entities*, ALA. DEP'T REVENUE, https://revenue.alabama.gov/individual-corporate/electing-pass-through-entities/ [https://perma.cc/D9E4-LY4P] (June 30, 2022).

140. ARIZ. REV. STAT. ANN. §§ 43-1014, 43-1071, 43-1075 (2021).

141. Isabelle Sarraf, *Arizona Governor Signs SALT Cap Business Tax Workaround*, BLOOMBERG TAX (July 12, 2021, 1:19 PM), https://news.bloombergtax.com/daily-tax-report/arizona-governor-signs-salt-cap-business-tax-workaround [https://perma.cc/G337-5BJY].

142. ARK. CODE ANN. §§ 26-51-404(b)(35), 26-65-102, 26-65-103 (2021).

California[143]	Yes, but irrevocable (owners can individually opt in or out without affecting the election)	S-Corps & partnerships, excluding publicly traded partnerships	Pro rata tax credit passes through to owners	Yes[144]	No
Colorado[145]	Yes (election binding on all owners)	S-Corps & partnerships required to file a return in Colorado	No tax credit passes through to owners, but only the entity faces a tax liability	Yes	Entity receives tax credit for payments made to other states
Connecticut[146]	No	S-Corps, LLCs, LLPs & LPs	Pro rata tax credit passes through to owners (at 87.5% of the pro-rata amount)	No	Yes, for "substantially similar" tax payments to other states
Georgia[147] (effective 2022)	Yes, but irrevocable	S-Corps & partnerships (wholly controlled by owners eligible to hold shares in an S-Corp)	Owners exclude income from the electing entity	No	No
Idaho[148]	Yes	S-Corps & partnerships (under Idaho Code), including LLCs	Pro rata tax credit passes through to owners	No	Yes, for "substantially similar" tax payments to other states
Illinois[149] (effective 2022)	Yes, but irrevocable	S-Corps & partnerships, excluding	Pro rata tax credit passes through to	Yes	Yes for "substantially similar" tax

143. CAL. REV. & TAX. CODE §§ 19900, 19902 (West 2021).

144. *California AB 150 Provides SALT Cap Workaround and Increases Funding for Business Tax Credits*, GPW CERTIFIED PUB. ACCTS. (July 19, 2021), https://gpwcpas.com/california-ab-150-provides-salt-cap-workaround-and-increases-funding-for-business-tax-credits/ [https://perma.cc/BQ6W-CEMW].

145. COLO. REV. STAT. §§ 39-22-343 to -346 (2021).

146. CONN. GEN. STAT. §§ 12-284b, 12-699(g) (2019).

147. GA. CODE ANN. §§ 48-7-21, -23 (2021).

148. IDAHO CODE § 63-3026B (2021).

149. 35 ILL. COMP. STAT. 5/201(p) (2021).

		publicly traded partnerships	owners		payments to other states
Louisiana[150]	Yes, until terminated by Secretary of Revenue	S-Corps & IRC Subchapter K entities	Owners exclude income from the electing entity	No	No
Maryland[151]	Yes	S-Corps, partnerships, LLCs & business or statutory trusts	Pro rata tax credit passes through to owners	No	Yes, for any pro rata net income-tax payment to another state
Massachusetts[152]	Yes, but irrevocable	S-Corps, partnerships & LLCs (treated as partnerships or S-Corps) (binding on all owners)	Pro rata tax credit passes through to owners (at ninety percent of the pro rata amount)	Yes[153]	No
Michigan[154]	Yes, but irrevocable for two years	S-corps & IRC Subchapter K entities, excluding disregarded entities and publicly traded partnerships	Pro rata tax credit passes through to owners	Yes	Yes for "similar" provisions in other states
Minnesota[155]	Yes, but irrevocable (election binding on all owners)	S-Corps, partnerships & LLCs, excluding entities with a partnership, non-disregarded entity LLC, or corporation as an owner	Pro rata tax credit passes through to owners	Yes	Yes, for any pro rata net income-tax payment to another state

150. LA. STAT. ANN. §§ 47:297.14, 47:287.732.2 (2019).
151. MD. CODE ANN. TAX-GEN. § 10-102.1 (West 2021).
152. MASS. GEN. LAWS ch. 63D, §§ 1–2, 6 (2021).
153. Christopher McLoon, Melissa Sampson McMorrow, Michael Mooney & Erin Whitney, *Overriding the Governor, Massachusetts Legislature Gives Pass-Through Entity Owners a Workaround to Federal SALT Deduction Cap*, JD SUPRA (Oct. 26, 2021), https://www.jdsupra.com/legalnews/overriding-the-governor-massachusetts-4151301/ [https://perma.cc/5L7Y-3UCY].
154. MICH. COMP. LAWS §§ 206.254–.255 (2021).
155. MINN. STAT. §§ 289A.08(7a), 290.06 (2021).

New Jersey[156]	Yes (but all partners must elect)	S-Corps, partnerships & LLCs	Pro rata tax credit passes through to owners	No	Yes, for "substantially similar" tax payments to other states
New York[157]	Yes, but irrevocable	New York S-Corps & IRC Subchapter K entities, excluding publicly traded partnerships	Pro rata tax credit passes through to owners	No	Yes for "substantially similar" tax payments to other states
North Carolina[158] (effective 2022)	Yes, but irrevocable	S-Corps & partnerships, excluding those publicly traded and those with corporate shareholders	Pro rata tax credit passes through to owners	No	Expressly provided only for electing S-Corps
Oklahoma[159]	Yes	Oklahoma S-Corps & partnerships	Owners exclude income from the electing entity	No	No
Oregon[160] (effective 2022)	Yes (but all partners must elect)	S-Corps, partnerships & (non-disregarded) LLCs (must be owned by individuals or PTEs owned by individuals)	Pro rata tax credit passes through to owners	Yes	No
Rhode Island[161]	Yes	S-Corps & IRC Subchapter K entities (GPs, LPs, LLPs, trusts, LLCs, or unincorporated sole proprietorships)	Pro rata tax credit passes through to owners	No	Yes, for "similar" provisions in other states

156. N.J. REV. STAT. §§ 54A:4-1, 12-1 to 12-6 (2020).
157. N.Y. TAX LAW §§ 860–866, 620(b) (2021).
158. N.C. GEN. STAT. § 105-154.1 (2021).
159. OKLA. STAT. tit. 68, §§ 2355.1P-4, 2358(a) (2019).
160. OR. REV. STAT. § 314.NEW (2021).
161. 44 R.I. GEN. LAWS § 44-11-2.3 (2020).

South Carolina[162]	Yes	S-Corps, partnerships & LLCs (including those disregarded), & sole proprietorships	Pro rata tax credit passes through to owners	No	No
Wisconsin[163]	Yes	S-Corps & IRC Subchapter K partnerships	Exclude income from the electing entity	No	Yes, for any pro rata net income-tax payment to another state

The following simplified example illustrates the value to individual taxpayers electing to pay a PTE-level tax under a typical state workaround scheme.[164] Bin-of-Mints is an imaginary partnership equally owned by two individuals, Kate and Taylor, who each have other sources of income and other SALT liabilities of at least $10,000 before considering their Bin-of-Mints income (rendering additional SALT payments nondeductible under the SALT cap).[165] Kate is a resident of Scarlet state, which has *no* PTE-tax workaround, and Taylor is a resident of Green state, which *has* enacted a PTE-tax workaround (assume that Green does not require every partner to elect the PTE tax).[166] Both Scarlet and Green states have a 10% income tax.[167] Both Kate and Taylor face a marginal federal income-tax rate of 25%.

This year, Bin-of-Mints earned $4 million of taxable income. In Kate's scenario, she is allocated $2 million, which will be taxed on her individual income-tax return. Kate faces a $200,000 tax liability from the state of Scarlet, none of which will be deductible for federal income-tax purposes. Thus, Kate will face a $500,000 federal tax liability and a $200,000 Scarlet state income-tax liability, leaving Kate with a $1.3 million after-tax return on her partnership activities ($2 million minus $700,000 total in taxes).[168]

Now compare Kate's situation to Taylor's. Taylor can elect to have the partnership pay her Green state income-tax liability at the entity level. Bin-of-Mints pays Taylor's $200,000 Green state income tax and nets this amount against Taylor's allocation,[169] so Taylor's individual income-tax return instead reflects $1.8 million from Bin-of-Mints. On this amount, Taylor would then face a $450,000 federal

162. S.C. CODE ANN. § 12-6-545 (2021).
163. WIS. STAT. §§ 71.01, .21 (2018).
164. *See* Mandarino, *supra* note 2.
165. *See id.*
166. *See id.*
167. *See id.*
168. *See id.*
169. *See id.*; I.R.S. Notice 2020-75, *supra* note 134. For simplicity, this example uses the "income exclusion" mechanics, but Green state could alternatively have elected to pass a credit through to Taylor. If that were the case, Taylor would still be individually taxed on her partnership income (a "second" time) allocation from Bin-of-Mints, but it would be completely washed out by the corresponding credit from Bin-of-Mints, and the end result would be the same to Taylor.

income-tax liability, leaving Taylor with a $1.35 million after-tax return on her partnership activities.[170] On these facts, Taylor walks away with $50,000 more in tax savings (compared to Kate), all because Green uses a PTE-level workaround.[171]

IV. PRESERVING STATE WORKAROUNDS

Presently, the federal SALT cap is scheduled to retire after the 2025 tax year, and individual SALT payments are slated to return to unlimited deductibility.[172] But for the reasons set forth below, states should continue working to enact these PTE-level workarounds, even if the SALT cap retires in 2026 or is renewed with or without alterations.

Expanding state workarounds offers promising cost savings for the federal government, state governments, and taxpayers alike. At the federal government level, many commentators have acknowledged how expensive the SALT repeal proposition is from a tax-revenue perspective, with estimates placing the tax-revenue hit around $100 billion (using 2022 estimates) if fully repealed.[173] Against the backdrop of increased social spending, many foresee a more permanent future for the SALT cap, as the federal government would prefer to maintain as much of its current funding as possible.[174] Complementarily, government revenues would essentially remain the same, albeit tax collection would likely become less risky for states. From the federal government's perspective, tax revenues remained relatively unchanged by the passage of state workarounds, as indicated by the IRS's acquiescence to the state workaround provisions in November 2020.[175] Similarly, numerous observers have noted the state workarounds' relative revenue neutrality.[176] Essentially, from a state's perspective, the same amount of PTE income is taxed each year; the only change is structural—the point at which the tax is collected. Moreover, using a PTE-level workaround, the state would then impose its tax liability before the allocation and any subsequent distribution of that income to the owners, on a source more likely to be able to pay the tax liability. Under these considerations, the principal negative ramification of *not* enacting a PTE-level workaround is the increased federal tax bills that a state's resident small-business owners face.[177]

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170. *See* Mandarino, *supra* note 2.

171. *See id.*

172. I.R.C. § 164(b)(6).

173. STEVE WAMHOFF, CARL DAVIS & MATTHEW GARDNER, OPTIONS TO REDUCE THE REVENUE LOSS FROM ADJUSTING THE SALT CAP 1 (2021), https://itep.sfo2.digitaloceanspaces.com/Options-to-Reduce-the-Revenue-Loss-from-Adjusting-the-SALT-Cap.pdf [https://perma.cc/LQ7R-5FM6].

174. *See, e.g.*, *Recapping Workarounds to the State and Local Tax Deduction Cap*, FORBES (Sept. 9, 2021, 12:26 PM), https://www.forbes.com/sites/taxnotes/2021/09/09/recapping-workarounds-to-the-state-and-local-tax-deduction-cap [https://perma.cc/EL65-DDRF] (interviewing Nikki E. Dobay).

175. *See* I.R.S. Notice 2020-75, *supra* note 134.

176. *S-Corp Joins SALT Parity Panel Discussion*, S-CORP (Dec. 13, 2021), https://s-corp.org/2021/12/s-corp-joins-salt-parity-panel-discussion/ [https://perma.cc/9UWF-JRRU] (noting Alysse McLoughlin's comments from a panel discussion).

177. *Id.*

Furthermore, from an individual tax perspective, as demonstrated above in the example featuring Kate and Taylor,[178] state workarounds offer vital relief for small-business owners under the current SALT deductibility circumstances. Even if the SALT cap is raised, PTE tax workarounds provide an important safety net for individuals still falling above the no-deductibility line. Besides the immediate savings against a SALT cap, though, states should continue adopting PTE-level workarounds because the workarounds provide increased flexibility for start-up business owners, which states could then use to gain competitive advantage in the marketplace for attracting new businesses to register in their state. Criteria for determining a business ownership structure upon formation chiefly include management flexibility, income-tax considerations, and formalities and expenses, among others.[179] Following these criteria, states enacting an elective PTE-level tax scheme grant both start-up and existing business owners even more options than currently exist[180] in nonenacting states. From the perspective of PTE owners, while wading through PTE-tax principles as complex as those covered in this Note can be cumbersome, the benefits of creating such a workaround scheme far outweigh the marginal additional complexity.[181]

V. BOLSTERING STATE WORKAROUNDS IN THE FUTURE

Part V analyzes the findings laid out in Table 1, covering the five distinct dynamics used to analyze the twenty-two state workarounds enacted across the country. Tracing Table 1, this Part comprehensively walks through (A) election concerns, (B) eligibility concerns, (C) mechanics for passing through tax benefits to owners, (D) decoupling from the federal SALT cap, and (E) cross-state recognition concerns. This Part concludes by ultimately weighing the ramifications of selected current provisions and recommending the most appropriate way forward for state workarounds in the future, with an eye toward the likely concerns of PTEs and their owner-taxpayers.

A. Election Concerns

On the elective front, in terms of whether PTEs will be obligated to participate in the PTE-level workaround scheme, states should create the PTE tax as an elective feature. From the PTE owner-taxpayer perspective, creating a mandatory tax on the PTEs destroys one of the fundamental benefits that many owners seek when they decide to create a PTE instead of a C-Corp.[182] To date, only Connecticut, as the first state to pass such a state workaround, has opted to make its new tax provision a

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178. *See supra* text accompanying notes 164–171.

179. *See, e.g.*, Bethany K. Laurence, *Choosing the Best Ownership Structure for Your Business*, NOLO, https://www.nolo.com/legal-encyclopedia/business-ownership-structure-choose-best-29618.html [https://perma.cc/Q58T-QSYX]; *Key Issues in Selecting Formation State*, WOLTERS KLUWER (Nov. 21, 2019), https://www.wolterskluwer.com/en/expert-insights/key-issues-in-selecting-formation-state [https://perma.cc/M47R-9QAY].

180. *See supra* Section III.A.

181. *See* S-CORP, *supra* note 176 (interviewing Brian Reardon).

182. *See supra* Section III.A; *supra* text accompanying note 179.

mandatory scheme.[183] The rest of the twenty-one states that followed Connecticut have changed direction, all opting for the elective route.[184]

Also, in the electability arena, regarding how the enacting states so far have treated the election as binding on all the owners of the PTE, future workarounds should allow owners to individually opt in or out of the PTE tax election, regardless of the owners' decision as a collective. Allowing the owners to elect in or out of the PTE-level tax scheme, the stance taken by each of Colorado, Minnesota, New Jersey, and Oregon,[185] holds true to the policy justification for creating such a regime: allowing taxpayers to evade the harsh individual tax implications from the federal SALT cap as best as the individual owners can.[186]

Lastly, still on the issue of electability and how states (aside from Connecticut) treat the PTE-level tax election as revocable, states should likewise allow PTEs at least a limited revocability window. Legislatures in California, Georgia, Illinois, Louisiana (although revocability is ultimately left up to the Secretary of Revenue), Massachusetts, Michigan (where the election is binding for two years), Minnesota, New York, and North Carolina have all opted not to allow PTEs to revoke their tax election throughout the tax year.[187] As mentioned, however, this decision does not run alongside the policy underscoring state workarounds' creation in the first place, which is to allow taxpayers to evade the SALT cap repercussions as best as they can. In keeping with the underlying policy, enacting states should shift to allowing PTEs a limited opportunity to change their elective tax status as their respective tax situations may fluctuate throughout the year.[188]

B. Eligibility Concerns

On the issue of eligibility, the twenty-two states that have SALT cap workarounds in place vary significantly in their definitions of which PTEs are permitted to make the PTE-tax election. For instance, Colorado approaches the issue by defining the eligible entities using the Colorado Code; Alabama borrows definitions from the IRC, North Carolina uses general definitions and subsequently excludes certain ownership interests from eligibility; and South Carolina goes out of its way to name certain ownership interests that are nonetheless included in the eligible pool of PTEs.[189]

Moving forward, as more states move to adopt workarounds, these states can convey the widest benefit to their resident PTE owners by defining the eligible entities broadly and by standardizing the language used to define such entities. For example, states might use the IRC distinctions (something taxpayers in every state are subjected to) as a guide, as Illinois, Louisiana, Michigan, New York, Rhode Island, and Wisconsin have.[190] Additionally, like South Carolina and Rhode

183. *See supra* Table 1.
184. *See supra* Table 1.
185. *See supra* Table 1.
186. *See supra* text accompanying notes 7–8.
187. *See supra* Table 1.
188. *See supra* text accompanying notes 178–181.
189. *See supra* Table 1.
190. *See supra* Table 1.

Island,[191] states can further spread the benefit by bringing sole proprietorships and disregarded entities into the eligible pool to give even more (and typically even smaller[192]) business owners an opportunity to participate in the federal tax savings and added formational flexibility.

C. Mechanics for Passing Through Tax Benefits to Owners

When deciding how to pass through the tax benefits derived from the PTE paying the tax on behalf of its owners, states have clustered around two general approaches. The first, and more popular, approach is to pass a pro rata (according to agreed-upon profit-sharing ratios among the PTE's owners) tax credit through to the owners to recognize on their individual income-tax returns.[193] This is the approach used in Alabama, Arizona, California, Idaho, Illinois, Maryland, Minnesota, New Jersey, New York, North Carolina, Oregon, Rhode Island, and South Carolina.[194] Connecticut and Massachusetts also follow the tax credit method, albeit altering the percentage of the pro rata tax credit that the owner may recognize.[195]

The second, and perhaps simpler, approach that states use is to exclude the already-taxed, passed-through income from taxation on the owners' individual state returns, as is the case for electing owners in Alaska, Georgia, Louisiana, Michigan, Oklahoma, and Wisconsin.[196] In such a tax regime, rather than needing to reflect a credit on their individual returns, electing owners are only taxed (by the state) on their gross income arising from non-PTE sources.

As state workarounds proliferate and spread to more states, the income-exclusion mechanics are slightly simpler, easier to use, and more predictable for taxpayers. However, the particulars of the pass-through mechanics, in the end, do not make an all-important difference to the taxpayer or to the state. The most important detail to pin down is whether the benefit will be recognized at all,[197] and both the credit and income-exclusion methods accomplish this goal for owner-taxpayers.

D. Decoupling from the Federal SALT Cap

Although a relatively minor issue to fix, clearly, so long as state workarounds tie the workarounds' existence to the existence of some form of a SALT cap in the Code, state workarounds will, after 2025, cease to provide benefits beyond the presently effective SALT cap sunset.[198] Thankfully, the states that have indeed coupled their state workaround to the Code's SALT cap (Arizona, California, Colorado, Illinois, Massachusetts, Michigan, Minnesota, and Oregon[199]) have left some breathing room, requiring the mere existence of a cap, rather than any particular set amount (meaning

191. *See supra* Table 1.
192. *See* POMERLEAU, *supra* note 120.
193. *See supra* Table 1.
194. *See supra* Table 1.
195. *See supra* Table 1.
196. *See supra* Table 1.
197. *See infra* Section V.E.
198. *But see supra* Part IV.
199. *See supra* Table 1.

that only complete repeal would retire the state workaround). If future states desire to retain some connection to the SALT cap, these states' leads serve as flexible models to follow.

E. Cross-State Recognition Concerns

Recognizing PTE tax payments made pursuant to nonresident states' workaround mechanisms occupies perhaps the most crucial area for growth and cohesion among the present state workarounds and those to come. The easier that states can make it for multistate PTE owners to receive credit for (i.e., recognize) workaround payments under other state regimes,[200] the more trust will be garnered from PTE owner-taxpayers, allowing the benefits for state income taxpayers to be spread wider.

Presently, the expressed standards for which other state workarounds will be recognized by enacting states vary, and each state seems to have its own idea of how high that standard must be (how similar must another state's workaround scheme be to their own). One popular choice has been to use "substantially similar," which appears in the workaround provisions in Alaska (albeit an income-exclusion mechanism, whereas the others in this list are pass-through-credit mechanisms), Arizona, Connecticut, Idaho, Illinois, New Jersey, and New York.[201] Meanwhile, some states have opted for a seemingly lower standard for payments to other states, as Michigan and Rhode Island simply recognize payments made under "similar" laws in other states.[202] Even lower still, some states opted for general recognition without adding any extra similarity standard, such as the workarounds enacted in Colorado, Maryland, Minnesota, North Carolina (which appears to apply only to S-Corps), and Wisconsin.[203] Finally, some states have decided not to expressly include any new recognition standard, such as the workaround provisions in Alabama, California, Georgia, Louisiana, Massachusetts, Oklahoma, Oregon, and South Carolina.[204]

Moving forward, with a nod toward cohesion, each state should expressly include a recognition provision as part of its PTE tax statutes for the sake of streamlining PTE-tax elections and state income-tax payments. Ideally, the similarity standard will be lower, perhaps something like "similar," as used in Michigan and Rhode Island.[205] As more states enact workarounds and the workaround schemes become more mainstream, a more reasonable cross-state standard for recognition, especially when paired with states expressly providing for interstate recognition, will make PTE elections for owner-taxpayers all the more attractive, as any uncertainty as to recognition is slowly removed.

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200. *See supra* Table 1.
201. *See supra* Table 1.
202. *See supra* Table 1.
203. *See supra* Table 1.
204. *See supra* Table 1.
205. *See supra* Table 1.

CONCLUSION

Regardless of the unsettled future for the IRC's SALT cap, the current state workarounds to the unique individual tax issue posed by the cap provide profound structural advantages to state governments, and vital tax savings and business-formative flexibility for individual PTE owner-taxpayers. In moving to expand the utility of state workarounds to more states moving forward, states should enhance and ensure the benefits that workaround provisions offer to both states and taxpayers alike by focusing on (1) creating the PTE-level tax as an elective feature for both the entity and the individual owners exercising the election, (2) standardizing the eligible PTEs that may elect the PTE-level tax, (3) simplifying the mechanism for passing the tax benefit through to the PTEs' owners, (4) decoupling the workarounds' existence and provisions from the federal SALT cap, and (5) expressly including credit and recognition provisions for PTE tax payments made to other states.