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New Jersey Enacts Legislation Providing Business Owners With Workaround for Federal “SALT” Cap

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On January 13, 2020, New Jersey Governor Phil Murphy signed into law the “Pass-Through Business Alternative Income Tax Act,” joining five other states that have already enacted similar legislation. The new law allows pass-through businesses to elect to be taxed at the entity level for New Jersey income tax purposes, providing the business owners with a corresponding state income tax credit.

Following the December 2017 enactment of the Tax Cuts and Jobs Act, individual taxpayer’s annual deductions have been capped at \$10,000 for state and local taxes (SALT). For high income tax and property tax states such as New Jersey, this has severely impacted both higher and middle-income taxpayers, leaving many states in search of a viable workaround.

The IRS and Treasury Department recently enacted final regulations which specifically disallow the deductibility of donations which result in state tax credits, but these regulations only reference pass-through entity taxation in passing. To date, the IRS has not addressed the use of a pass-through level tax, which was enacted in some states in 2018 and is similar to the unincorporated business taxes in existence in New York City and the District of Columbia for decades. In fact, Section 1.164-7 of the Treasury regulations specifically supports the payment of taxes by the business and the exclusion of such taxes from the owner’s income.

For those taxpayers who own an interest in a New Jersey pass-through business, such as an S corporation, partnership and limited liability company with more than one member, the new law gives the company the option of electing to be taxed at the entity level, and provides the owners with a corresponding state income tax credit. If the election is made, the business would then pay a tax equal to the aggregate of each owners’ share of distributive proceeds multiplied by the following:

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- Up to \$250,000 – 5.525%
- Between \$250,001 and \$1 million – 6.37%
- Between \$1,000,001 and \$5 million – 8.97%
- Over \$5 million – 10.75%

Thus, if a partnership had 2 partners and \$1,500,000 in distributive proceeds, if each partner was allocated \$750,000, they would each be taxed at a rate of 6.37%. However, if the proceeds were allocated \$200,000 to Partner A and \$1,300,000 to Partner B, they would be taxed at rates of 5.525% and 8.97%, respectively. Each of the owners would then be given a state tax credit equal to the amount of New Jersey taxes paid by the business on that owner's behalf.

For federal purposes, however, the amount of taxable income flowing through to the business owners is now equal to the owner's share of distributive proceeds minus that owner's share of New Jersey taxes paid by the business. Unlike individuals, federal law does not place limitations on a business's ability to deduct operating expenses such as state taxes.

Effectively, for federal purposes, utilizing the new law shifts state income taxes on pass-through business profits from Schedule A to an "above-the-line" deduction, not only minimizing the impact of the \$10,000 SALT limitation, but also allowing state income taxes to be deducted for those taxpayers choosing to utilize the increased standard deduction rather than itemizing.

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