



# **Report on the Administrative and Revenue Impact of a Proposal to Allow Owners of Certain Entities to Avoid the Federal Limitation on State and Local Tax Deductions**

**Commonwealth of Massachusetts  
Department of Revenue**

**Geoffrey E. Snyder**  
Commissioner of Revenue

**March 1, 2021**

## Origin of the Study

Chapter 227 of the Acts of 2020 (the FY21 Budget) directed the Commissioner of Revenue (Commissioner) to analyze the administrative and revenue impact of implementing potential changes to the Massachusetts tax law that would allow owners of partnerships and S corporations to avoid the \$10,000 federal limitation on the state and local tax (SALT) deduction with respect to income earned by those entities.

The contemplated law change would impose a tax on partnership and S corporation income at the entity level. Individual partners and shareholders would continue to report their share of partnership or S corporation income on a pass-through basis, but each partner or shareholder would be eligible for a refundable credit equal to the tax paid by the partnership or S corporation on that partner or shareholder's distributive share income. The credit would prevent double taxation of partnership and S corporation income.

Partnerships and S corporations are pass-through entities (PTEs) for federal and Massachusetts income tax purposes. This means that their income and deductions are taken into account by the individual partners and shareholders. PTEs are permitted to deduct state income taxes imposed on them when determining distributive share income that flows through to the PTE owners for federal tax purposes. As a result, PTE owners' federal taxable income is generally reduced by their share of taxes paid by the PTE.

Starting with tax years beginning on or after January 1, 2018, the federal Tax Cuts and Jobs Act (TCJA) limited the amount of state and local taxes that an individual can deduct annually to a total of \$10,000.<sup>1</sup> The limitation applies to all of an individual's SALT liability, including the SALT liability that flows through to the individual from a PTE. However, the Internal Revenue Service (IRS) has indicated that the limitation does not apply to income taxes imposed at the PTE level.<sup>2</sup> As a result, individual PTE owners may reduce their federal taxable income by their entire share of state taxes paid by the PTE, even when such share would result in an individual's total SALT liability exceeding \$10,000. A PTE tax imposed at the entity level potentially allows PTE owners a federal tax benefit equivalent to the amount of federal tax incurred as a result of the disallowance of SALT expenses in excess of \$10,000. Under the contemplated entity-level PTE tax and accompanying credit, individual partners and shareholders would receive this federal tax benefit without increasing their Massachusetts tax.

This study addresses the administrative and revenue impact of a potential Massachusetts law change (i) imposing a mandatory or elective tax on partnerships and S corporations and (ii) allowing a credit for the tax to the partners and shareholders. As directed by the FY21 Budget, the analysis includes: (i) a review of the law in other states that have adopted similar taxes and credits in response to the federal SALT limitation; (ii) a distributional analysis of the effect of the contemplated tax and credit in Massachusetts; (iii) an assessment of administrative challenges that would likely follow from the implementation of the tax and credit; (iv) an estimate of the revenue impact, if any, of the tax and credit; and (v) a description of the legislation that would be necessary to adopt the tax and credit.

## Other States

The state or local imposition of entity-level taxes on PTEs is not a new phenomenon. The District of Columbia, New Hampshire, New York City, Tennessee, and Texas, for example, have imposed mandatory entity-level income or franchise taxes on PTEs for years. This section addresses only those states that have enacted PTE

---

<sup>1</sup> See P.L. 155-97, s. 11042. The limitation does not apply to corporations.

<sup>2</sup> Notice 2020-75, 2020-49 IRB 1. The IRS Notice did not distinguish between the deductibility of elective, as opposed to mandatory, state taxes imposed upon the PTE.

taxes and corresponding credits (or similar rules) intended to compensate partners and S corporation shareholders for SALT deductions disallowed under the federal \$10,000 limit.

States that have enacted PTE taxes in response to the federal SALT limitation generally take one of two different approaches. Connecticut, New Jersey and Rhode Island impose a tax on the PTE and allow individual partners or shareholders an income tax credit for their share of the tax paid by the entity. In contrast, Alabama, Louisiana, Oklahoma, and Wisconsin impose a tax on the PTE and allow partners or shareholders to deduct their share of PTE income taxed at the PTE level. It is the credit model that the FY21 Budget directed the Commissioner to analyze. Other differences among states include (i) whether the PTE tax is elective or mandatory, (ii) whether the PTE tax applies to partnerships, S corporations, or both, and (iii) whether partners or shareholders that are corporations are eligible for the corresponding credit or deduction. The following is a list of states that have enacted such legislation as of the date of this study, as well as a description of the tax treatment adopted.

**Alabama:** Alabama allows PTEs doing business in the state to elect to pay tax at the entity level for tax years beginning on or after January 1, 2021. Partnerships and S corporations are eligible to make the election. Individual and corporate partners and S corporation shareholders of an electing PTE are not required to pay Alabama income tax on their share of the PTE's income.<sup>3</sup>

**Connecticut:** Connecticut has adopted a mandatory PTE tax on all partnerships and S corporations doing business in the state, effective for tax years beginning on or after January 1, 2018. Individual and corporate partners and individual S corporation shareholders are allowed a credit for their share of PTE tax paid by the entity. The credit is equal to only 87.5% of the tax paid, so the Connecticut rules result in an increase in revenue. Credits in excess of a PTE member's overall Connecticut tax are refundable.<sup>4</sup>

**Louisiana:** Louisiana has enacted an elective PTE tax effective for tax years beginning on or after Jan. 1, 2019. The election is available to partnerships and S corporations. If an election is made, the PTE pays tax on its income at the entity level. Partners and S corporation shareholders include their share of the income reported by the PTE on a pass-through basis but receive a deduction for the amount of such income.<sup>5</sup>

**Maryland:** Maryland allows partnerships and S corporations to elect to pay an entity-level tax on their income effective for tax years beginning after December 31, 2019. Individual and corporate owners of an electing PTE may claim a credit for their share of tax paid by the entity. Any unused credit is refundable.<sup>6</sup>

**New Jersey:** New Jersey has adopted an elective tax on PTEs effective for tax years beginning on or after Jan. 1, 2020. Partnerships and S corporations are eligible to make the election. If an election is made, the PTE pays tax on its income and the partners and shareholders receive a credit for their share of the tax paid by the entity. Individual and corporate owners of an electing PTE may claim the credit. Unused credit is refundable for individual partners and shareholders but is subject to a twenty-year carry-forward for corporate partners.<sup>7</sup>

---

<sup>3</sup> Code of Ala. § 40-18-39.1.

<sup>4</sup> Conn. Gen. Stat. § 12-699.

<sup>5</sup> La. Rev. Stat. Ann. § 47:287.732.2.

<sup>6</sup> Md. Code Ann., Tax-Gen. § 10-102.1.

<sup>7</sup> N.J. Rev. Stat. §54A:12-3.

**Oklahoma:** Oklahoma allows partnerships and S corporations to elect to pay tax at the entity level starting with tax years beginning on or after January 1, 2019. The election requires PTEs to pay tax on their income at the entity level. Individual and corporate partners and S corporation shareholders may deduct their share of PTE income.<sup>8</sup>

**Rhode Island:** Rhode Island has enacted an elective PTE tax, effective for tax years beginning on or after January 1, 2019. All entities other than C corporations are eligible to make the election. If an election is made, the PTE pays tax on its income. Individual partners, shareholders, and other eligible individuals include their share of the PTE income on their returns, but receive a credit for their share of the tax paid by the PTE. The credit does not apply to PTE members that are C corporations, but C corporations are allowed a deduction for taxes paid by the PTE.<sup>9</sup>

**Wisconsin:** Wisconsin adopted an elective PTE tax on S corporations for tax years beginning on or after January 1, 2018. Subsequently the state extended the elective tax to partnerships. If an election is made, the PTE pays tax on its income. Corporate and individual partners and shareholders may exclude their share of the income reported by the PTE on their tax returns.<sup>10</sup>

Note that several other states are considering adopting a PTE tax and corresponding deduction or credit. States with proposals pending include New York, Michigan, Minnesota, and Arkansas.

#### Federal Revenue Impact/Distributional Analysis

The Department of Revenue (DOR) estimates that 55,500 filers would benefit from an enacted PTE tax coupled with a corresponding credit. This figure represents the number of Massachusetts personal income tax filers who, on their 2019 return, (i) reported income from a pass-through entity, (ii) itemized deductions on their federal return, and (iii) exceeded the \$10,000 cap on the federal SALT deduction. These filers reported an average of \$59,505 in state and local income taxes on their 2019 federal returns. Their average potential federal tax savings from the proposal would be \$20,158 (as shown in the table below) if all of the \$59,505 were attributable to flow-through income from PTEs. Note that DOR does not have data identifying what portion of state and local tax reported is attributable to PTEs.

Average SALT Taxes Reported and Allowed (2019 data)					Average Potential Federal Tax Saving		
<i>State / Local Income Tax</i>	<i>Real Estate Tax</i>	<i>Personal Property Tax</i>	<b>All SALT Taxes</b>	<b>Allowed Deduction</b>	<b>Potential Increase in Deduction*</b>	<i>Marginal Tax Rate</i>	<b>Average Potential Tax Saving</b>
<i>a</i>	<i>b</i>	<i>c</i>	<b>d=a+b+c</b>	<i>e</i>	<i>f</i>	<i>g</i>	<b>h=f*g</b>
\$59,505	\$14,972	\$357	<b>\$74,834</b>	\$10,000	\$57,528	35%	<b>\$20,158</b>

\*Potential Increase in deduction is the higher of the State/Local Income Tax amount (\$59,505 in 2019) (a) or filer's federal taxable income (with an average of \$57,528 in 2019).

<sup>8</sup> 68 Okl. St. § 2355.1P-4.

<sup>9</sup> R.I. Gen. Laws Section 44-11-2.3.

<sup>10</sup> Wis. Stat. Ann. § 71.365(4m).

Although the table shows data for all SALT categories, only income taxes paid by the PTE would be eligible for the credit. Thus, although the average reported state and local taxes were \$64,834 over the cap (\$74,834 minus \$10,000), the referenced filers would only be able to use credits to offset the \$59,505 state and local income tax total. In addition, the potential benefit to taxpayers is further limited by the amount of reported federal taxable income against which to claim additional deductions, which, for those taxpayers impacted by the federal SALT limitation, averaged \$57,528 in 2019. Those filers, however, would still be able to use the federal \$10,000 limitation amount against “Real Estate” or “Personal Property” taxes.

It is also likely that there are additional filers with pass-through income who used the standard deduction in 2019 who would be able to benefit from the proposed pass-through entity tax credit. DOR is not able to quantify these additional taxpayers based on the available data at this time.

In total, the 55,500 filers referenced in the table reported SALT taxes that exceeded their aggregate federal cap by \$3.2 billion. If this entire \$3.2 billion were deducted on federal returns as a result of an enacted potential PTE tax and corresponding credit, it would reduce the federal tax burden for these filers by \$1.12 billion.

### **Massachusetts Revenue Impact**

The DOR estimates that a PTE tax and corresponding refundable credit would be revenue neutral for Massachusetts, or slightly revenue positive. The PTE tax itself would generate new revenue, but the corresponding credit would create an offsetting revenue loss. There is a possibility of a slight revenue gain due to the possibility that some taxpayers that are eligible for the credit will not claim it. This phenomenon occurs with respect to existing credits for a variety of reasons including lack of familiarity with the credit and the additional compliance work needed to claim the credit.

### **Administrative Challenges for Massachusetts**

Implementation of a Massachusetts PTE tax and corresponding credit would present a number of challenges for the DOR. Some of these challenges could be lessened by drafting the PTE legislation with a view toward administrative efficiency.

A PTE tax would shift the tax burden from PTE owners to the PTEs themselves. To administer a revenue neutral PTE tax the DOR would have to develop a reporting, accounting, and enforcement system that as nearly as possible collects the same amount of tax as would have been paid by the PTE owners. At least four existing tax types would be affected: partnership reporting, S corporation tax, personal income tax, and related estimated and withholding taxes. The DOR would have to integrate its current systems with the new PTE tax. Implementation of a PTE tax would require the following:

- Ensuring that the new PTE tax base replicates the current tax base for PTE owners;
- Correctly applying credits for taxes paid to other states in light of potential disparities in tax rates and income inclusion rules;
- Monitoring and giving effect to basis adjustments caused by the PTE tax;
- Applying the PTE tax and corresponding credit to tiered entities (i.e., PTEs owned by other PTEs);
- Auditing PTEs and their owners to ensure compliance.

None of these is insurmountable. The DOR navigates similar issues in administering existing taxes. However, programming DOR systems to include a new tax type and integrating the new tax with existing systems would be resource-intensive. In addition, taxpayer outreach and internal DOR training would be needed to familiarize stakeholders with the PTE tax and corresponding credit. Finally, DOR would have to devote audit resources to enforcement of the new tax.

### **Legislation Required**

Legislation would be required to adopt a PTE tax and corresponding credit in Massachusetts. The statutory imposition of the tax would have to be shifted from eligible individual PTE members to partnerships and S corporations. In addition, personal income tax credits would have to be established for individuals to receive the benefit for taxes paid by the entity. Conforming changes to the personal income tax, corporate excise and tax administration rules would have to be included or authorized to be adopted by regulation.

Various policy decisions would be required in drafting the legislation. First there is a question whether to make the PTE tax mandatory or elective. As noted above, most other states that have adopted PTE taxes in response to the federal SALT limitation have made these taxes optional. The advantage of this approach is that it avoids the complexity of changing the entire pass-through entity tax system, while allowing owner-taxpayers that would benefit to elect the PTE tax and corresponding credit. In addition, an elective system could provide flexibility if the federal SALT limitation were repealed.

Second, there is a question whether such an election should be made at the PTE level or by individual owners. All of the other states with PTE tax elections require the election to be made by the PTE and also make the election binding on each eligible owner. This approach avoids the problems that would arise from treating the owners of the same PTE differently. To do otherwise would multiply the administrative challenge of implementing the PTE and corresponding credit.

Third, there is a question whether to include or exclude corporate owners of PTEs from the tax and credit system. As per the discussion above, other states take different positions on this matter. C corporations, however, are not subject to the federal SALT limitation and therefore would not benefit from inclusion.

In addition to addressing the issues described above, the legislation should:

- Adopt a new chapter of the General Laws governing the PTE tax and corresponding credit;
- If made elective, allow the election to be made on an annual basis by a PTE and be irrevocable for the year it is made;
- Define which entities are eligible to elect to pay PTE tax;
- Adopt filing requirements for the PTE tax;
- Set computational rules for determining the amount of the PTE tax;
- Authorize rules requiring pass-through entities to report the entity level tax paid and pass-through credit to members;
- Authorize rules for pass-through entities that are owned by other pass-through entities (i.e., tiered structures);
- Allow individual partners and S corporation shareholders a credit for their pro-rata shares of tax paid by the PTE;

- Authorize apportionment rules for PTE doing business in multiple states;
- Provide that the PTE tax will be administered under General Laws, Chapter 62C, which applies to all of the other taxes administered by DOR;
- Set a sunset date to repeal the PTE tax when the federal limitation on the state and local tax deduction either expires or is repealed;
- Provide the DOR broad authority to promulgate regulations necessary to administer and enforce the PTE tax and corresponding credit.

In fact, the Baker-Polito Administration's FY22 budget proposal provides for an optional PTE tax, which, if elected by a partnership or other pass-through entity, would allow owners of the entity to benefit from a higher federal deduction for state and local taxes.

### **Conclusion**

If Massachusetts were to enact legislation to allow a PTE tax and corresponding credit, it would provide meaningful tax benefits to partnerships and S corporations, which make up a large number of businesses in Massachusetts, and to their owners. Further, it would help to maintain the Commonwealth's competitiveness with other states that have adopted similar provisions. By making the tax and credit equal, such legislation would be revenue neutral, while creating federal tax savings for owners of Massachusetts PTEs. The DOR would have to expend resources to implement the PTE tax and corresponding credit, but implementation of the PTE tax and credit would be feasible. Legislation that follows the model described above would simplify implementation and administration of the tax. As mentioned above, such a proposal was included in the Governor's Fiscal Year 2022 Budget Recommendations.