

Proposed Federal Tax Legislation Would Effect Three Key Changes to State and Local Tax Deductibility Limits

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On May 22, the House of Representatives passed proposed tax legislation titled, “The One, Big, Beautiful Bill” (TOBBB), which will now be debated in the Senate. Among other proposals, if enacted into law, TOBBB would make three significant changes to the limitation on deductibility of state and local taxes under current law. First, TOBBB would make permanent the limitation on the itemized deduction for state and local taxes (SALT cap), which is otherwise scheduled to expire at the end of this year. Second, for taxpayers with income below certain income thresholds, TOBBB would increase the SALT cap from \$10,000 to \$40,000. Third, TOBBB would prevent taxpayers in certain industries – including legal, medical and investment management – from using pass-through entity tax (PTET) elections to circumvent the SALT cap.

Under current law, the federal deduction for certain state, local and foreign taxes is capped at \$10,000 per year for taxpayers who itemize deductions. This cap is scheduled to expire for taxable years beginning after December 31, 2025. TOBBB would permanently extend the SALT cap but increase it to \$40,000 per year starting in 2025 (i.e., for taxable years beginning after December 31, 2024). For taxpayers with modified adjusted gross income of more than \$500,000 per year (as defined specially for this purpose), the allowable deduction is reduced (but not below \$10,000) by 30% of the excess of the taxpayer’s modified adjusted gross income over \$500,000. Starting in 2026, both the revised cap and modified adjusted gross income limit would increase by 1% each year until 2033 (after which they would stay at the 2033 levels going forward).

More critically, for owners of professional service and investment management entities, TOBBB also limits those taxpayers’ ability to use PTET elections to avoid the SALT cap. Although they vary in specifics, PTET elections generally permit entities, such as partnerships and S corporations (pass-through entities), to elect to pay state income taxes on behalf of their owners. These entities deduct the full amount of such taxes from their federal taxable income, and the owners receive a tax credit or other benefit from the state with respect to the taxes paid by the entity on the owners’ behalf. The result is that the state and local tax deduction – without any cap – is passed through to the owners as a reduction in their distributive share of the pass-through entity’s net taxable income.

In IRS Notice 2020-75, the US Department of the Treasury and IRS blessed the use of the PTET workaround by announcing an intent to issue proposed regulations confirming that PTET payments would be deductible pass-through entity expenses not subject to the SALT cap. Although no regulations have been proposed, many states have adopted legislation facilitating these PTET payments, and the structure is popular among pass-through entities and their owners.

If passed in its current form, TOBBB would break from IRS Notice 2020-75 to treat PTET payments as subject to the SALT cap. TOBBB generally would extend the SALT cap to state and local taxes paid on behalf of an individual by a pass-through entity with respect to a “specified service trade or business” (as defined in section 199A(d) of the Internal Revenue Code), which includes trades or businesses involving the performance of services in the fields of health, law, accounting, consulting and financial services, among other industries, or the performance of services that consist of investing and investment management, trading or dealing in securities. By contrast, TOBBB notably excepts from the SALT cap any PTET payments made by a pass-through entity that derives at least 75% of its gross receipts from a “qualified trade or business” (as defined in Section 199A(d) of the Internal Revenue Code to exclude a specified service trade or business and the trade or business of providing services as an employee) if such PTET payments are made with respect to such business.¹

If TOBBB is voted into law, these changes will be effective for taxable years beginning after December 31, 2025 (except for the SALT cap increase, which takes effect for taxable years beginning after December 31, 2024).

1. A glitch in initial drafts of the bill was construed by some to shut down the PTET workaround to the SALT cap, even as to such pass-through entities in connection with a “qualified trade or business,” but the manager’s amendment from the House Rules Committee included revisions that clarify the exclusion.

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