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Massachusetts Enacts Work Around to Federal \$10,000 SALT Deduction Limitation

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On July 16, 2021, Governor Baker [enacted legislation](#) that allows (a) individual, trust and estate taxpayers who are partners in partnerships (or limited liability companies taxed as partnerships) and (b) individual, trust and estate taxpayers who are shareholders in subchapter S corporations to avoid the \$10,000 limitation on the federal income tax deduction for state and local income taxes ("SALT") for income from such business entities. Investors in partnerships or S corporations that make the election described below will face a slight increase in Massachusetts income tax, however, on their associated business income.

The Massachusetts House and Senate included the above legislative change in their Fiscal Year 2022 budget (H. 4002) passed on July 9, 2021. Section 39 of the new law adds new Chapter 63D to the Massachusetts General Laws ("Taxation of Pass-Through Entities") which allows S corporations and partnerships to elect to pay an excise tax on qualified income taxable in Massachusetts at a rate of 5% (the Massachusetts individual income tax rate). This excise tax adds to a partner's/shareholder's current Massachusetts income tax on income from partnerships and S corporations. However, the new law provides individual, trust and estate partners/ subchapter S shareholders with a refundable credit equal to 90% of the partner's/shareholder's share of the new excise tax.

What does this law mean for an individual, trust or estate taxpayer's total income tax burden? Let us take the following assumptions:

Massachusetts Income Tax Rate	5%
Federal Marginal Tax Rate	37%
Massachusetts Excise Tax Rate	5%
Refundable Credit	90%

Below is a comparison of income tax consequences for investors in partnerships or S corporations that do not adopt the excise tax vs. those that do:

	No Excise Tax	Elect Excise Tax
Partner's Share of Income	\$ 1,000,000	\$ 1,000,000
Massachusetts Income Tax on Partner's Share	50,000	50,000
Massachusetts Excise Tax	–	50,000
Refundable Credit for Massachusetts Excise Tax	–	45,000
Total Massachusetts Income Taxes	50,000	55,000
Federal Deduction for State and Local Taxes on Partner's Share	10,000	10,000
Federal Deduction for Massachusetts Excise Tax	–	50,000
Federal Income (Net of State and Local Taxes)	\$ 990,000	\$ 940,000
Federal Income Taxes	\$ 366,300	\$ 347,800
Total Massachusetts and Federal Income Taxes	\$ 416,300	\$ 402,800

With the facts above, the Massachusetts law reduces an individual's federal income taxes on allocable partnership or Subchapter S corporation income by \$18,500 but increases the taxpayer's Massachusetts income taxes by \$5,000. The net is an overall tax decrease for partners and subchapter S shareholders of \$13,500.

The Treasury Department sanctioned such state law workarounds to the federal SALT deduction limitation in [Notice 2020-75](#) issued on November 9, 2020. In the Notice, the Treasury clarified that such excise taxes will be treated as "Specified Income Tax Payments" that are deductible for federal income tax purposes by partnerships and S corporations. The Treasury concluded such excise taxes will not be taken into account in applying the SALT deduction limitation, even if partners or shareholders receive a state tax credit/refund for such excise taxes.

The Notice cites legislative history in support of its position. It states, when Congress passed legislation limiting the deduction for state and local taxes, Congress provided that "taxes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner's or S corporation shareholder's distributive or pro-rata share of income or loss on a Schedule K-1 (or similar form) will continue to reduce such partner's or shareholder's distributive or pro-rata share of income as under present law." (Notice 2020-75 at 4, citing H.R. Rep. No. 115-466, at 260 n. 172 (2017)).

With the Treasury's adoption of the above position, many other states have enacted similar workarounds to the Federal SALT deduction limitation for partnerships and subchapter S corporations. Talk with your tax adviser to discuss whether it makes sense for your partnership or Subchapter S corporation to elect the imposition of the new Massachusetts excise tax.