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Massachusetts Legislature Passes Legislation Enacting Work Around to Federal \$10,000 SALT Deduction Limitation, but Governor Baker Sends it Back with Amendment

BY SANDRA F. O'NEILL • AUGUST 10, 2021

On July 16, 2021, Governor Baker [approved a \\$47.6 billion fiscal 2022 budget, but sent back a provision](#) the Massachusetts Legislature passed creating a workaround for the federal cap on the state and local tax deduction.

The Massachusetts House and Senate included the workaround in their Fiscal Year 2022 budget (H. 4002) passed on July 9, 2021. Section 39 of the budget would add new Chapter 63D to the Massachusetts General Laws ("Taxation of Pass-Through Entities"). The provision 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). Such an excise tax is fully deductible for federal income tax purposes. The proposed excise tax adds to a partner's/shareholder's current Massachusetts income tax on income from partnerships and S corporations. However, the provision 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.

Governor Baker sent [this section](#) of the budget back to lawmakers with a recommendation that the provision be amended to allow a credit equal to 100 percent of each partner's/shareholder's share. In his amendment letter, he states "While I strongly support providing this type of benefit to Massachusetts residents who are members of pass-through entities, 100% of the optional excise should be returned to the taxpayer." "Where struggling businesses are still emerging from the pandemic and state revenues are strong, taxpayers should be allowed to reap the full benefit of this policy."

The Massachusetts' House has rejected Governor Baker's amendment to the provision. The legislature now waits for a new session to override Governor Baker's veto of its original provision.

What would the Massachusetts legislature's provision 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	-	<u>45,000</u>
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 excise provision 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 such state law workarounds.

For more information, please contact the alert author or your Bowditch attorney at 508-791-3511.

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