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The North Carolina Pass-Through Entity Tax Election

A policy research strategist we revere often refers to different parts of legislation as "candy" and "spinach." Candy and spinach refer to tax cuts and revenue raisers, respectively. The idea is that legislators (like children) have to eat their spinach before they can have any candy. We've written a lot about various pieces of candy in the 2017 Tax Cuts and Jobs Act (the "TCJA" or the "Trump Tax Cuts"). This writing stems from a serving of spinach in the TCJA, the $10,000 cap on the SALT (state and local tax) deduction.

What Is the SALT Cap?

The SALT cap imposes a limit on how much a taxpayer can use as an itemized deduction for their payment of other taxes deemed SALT taxes. The taxes covered by SALT include state income taxes, real estate taxes, and personal property taxes. The $10,000 cap applies to all taxpayers (except married filing separately, who have a $5,000 cap). So, no matter how much a taxpayer shells out in state and local taxes, the maximum amount that can be deducted for federal income taxes is $10,000. This imposition only exists for individuals, not corporate entities.

To be clear, one intent behind the rule was to make it easier on a lot of individual taxpayers to file their returns. And further, another change to personal income taxes in the TCJA was more than doubling the standard deduction. A byproduct of those two changes is that fewer personal returns actually itemize deductions. And if you don't itemize, then the SALT cap will not be impactful. (It was also a politically motivated change that produced a lot of revenue at the federal level, largely on the backs of taxpayers in traditionally "blue" states.)

But for those itemized filers with large incomes, the SALT cap can be very punitive. Like every other aspect of TCJA, the SALT cap is structured to sunset (expire) after 2025 unless Congress takes some action before then. In the meantime over the next 3 years, many taxpayers are going to be taxed federally on money that they've used to pay SALT taxes unless they can find a way around the SALT cap.

Hence the reason for this writing, which is to make you aware of a state law in North Carolina (and many other states at this juncture) that seeks to help many of the state's taxpayers most negatively impacted by the SALT cap. While not all of them, many

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high earners in NC who are affected by the SALT cap are owners of closely held businesses, and many of those businesses are or can be "pass through entities," which means that the income tax associated with the entity can or does pass through the entity to the owner(s).

What Can Be Done About It?

One beautiful concept behind the Framers' intent in the creation of our national government and its interaction with state governments is the notion of fair and free competition among and between the several states. Not to get too philosophical, but the Constitutional framework provides a healthy balance between coercion and competition. Federal laws imposed on all citizens and states are a form of coercion; leaving open application of those laws to the states could be viewed as a competitive marketplace.[1]

Against this backdrop, many state legislatures realized that in order to prevent a significant outflux of high earning taxpayers, consideration should be given to some means to offset the damage from the SALT cap. It's also worth noting that this decision is completely revenue-neutral to the state. Since the issuance of IRC Notice 2020-75 offering guidance on this issue, more than half of the 50 states have passed a state Pass Through Entity Tax Election law.[2]

North Carolina is one such state.[3] The NC legislation was enacted Nov 18, 2021 to become effective beginning in 2022 and is aimed at reducing the impact of the federal SALT cap to NC taxpayers. Individual states have a significant amount of variance in the kinds of laws that have been passed. For example, Connecticut makes it mandatory; Georgia makes an election impossible if the owners of the entity are not qualified S Corp owners; and so forth and so on. The North Carolina Department of Revenue recently released some helpful guidance on the application of NC's PTE Election law.[4]

Under the NC rule, S Corps and partnerships are eligible for the election (and would become a "Taxed PTE." The tax paid by the eligible PTE would be the individual state income tax rate, which was 4.99% for 2022, is 4.75% for 2023 and will gradually be reduced down to 3.99% in 2027. The Taxed PTE will report to its owners (i) that it made the election, (ii) the amount of the owner's share of income or loss from the Taxed PTE, and (iii) the amount of tax paid by the Taxed PTE on the owner's share of the taxed PTE's NC taxable income.

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[1] As an aside, it's worth noting that competition exists among the various states in the form of different state income tax levels. For instance, just in the southeastern United States alone, Florida and Tennessee have no state income tax. North Carolina is at 4.75% in 2023 and is one of 11 states with individual income tax reductions taking effect this calendar year.

[2] At the time of this publication, 30 states and NY City have passed PTE legislation. Add the states that don't have any state income tax to make it relevant, and you can see that there is a lot of pressure on states (like Pennsylvania)

[3] https://legiscan.com/NC/text/S105/2021

[4] https://www.ncdor.gov/important-notice-regarding-north-carolinas-recently-enacted-pass-through-entity-tax-0

How to Take Advantage of NC's PTE Laws

The short version of this is that your business and personal accountant(s) need(s) to advise of whether your entity is eligible to benefit from the NC PTE Election law to avoid the $10,000 SALT cap on your personal return, and then to evaluate the potential benefit to you.

An Example

> Let's assume John Q. Public is a North Carolina resident. Mr. Public and his wife, Jane, file their taxes jointly. John is a 50% owner of Public & Private, LLC, a North Carolina LLC taxed as a partnership. The partnership had $1mm of gross profit in 2022, and John is entitled to a $500k distribution. Mr. and Mrs. Public have adjusted gross income separate from P&P of $250k. That AGI alone translates into $12,475 of NC state tax ($250k x 4.99%). So before any income attributable to P&P, the Publics are capped out at $10,000 of SALT deductions.
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> If P&P does not make the election, then John's additional $500k of income would yield further state income taxes of $24,950, for a total state tax of $37,425. That means the Publics would be unable to deduct a total of $27,425 of actual state taxes paid from their federal income tax return.
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> If P&P does elect to be a Taxed PTE, then the Publics will be able to use the deduction, missing out only on the $2,475 of state tax paid at the individual level against the $10,000 SALT cap.
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> The net benefit to the Publics of the PTE Election will depend on many factors, but the oversimple math would be their tax savings would be their effective tax rate (e.g., 35%) multiplied by the amount of state tax payments over $10k that the PTE elects to pay.

Conclusion and Summary

At the federal income tax level, the deductibility of state and local income tax payments for individual taxpayers was capped at $10,000 in 2018. More recently, North Carolina and many other states have passed legislation to help some individual taxpayers avoid the result of double taxation that stems from the TCJA imposition of SALT caps. The state laws are referred to as PTE Election laws. And if you're the owner of an S-corp or entity taxed as a partnership, you may be eligible to sidestep the SALT cap by having your entity pay its state income tax liability directly and pass the full benefit on to you as an owner and individual state income tax payer.

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