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NJ Passes New Workaround Rule for SALT Deductions

Legal Alert

January 29, 2020

Background

On January 13, 2020, New Jersey Governor Phil Murphy signed into law the “Pass-Through Business Alternative Income Tax Act” (the Workaround Act). The Workaround Act establishes an elective entity level tax on an individual’s distributive share of income derived from a pass-through entity, and provides a corresponding refundable tax credit that is equal to the tax an individual pays on his or her distributive share of income for New Jersey gross income tax purposes.

The Workaround Act is effective for tax years beginning on or after January 1, 2020, and is intended to help business owners circumvent the individual taxpayer federal deduction limit applicable to state and local taxes, which is limited to a combined total deduction of $10,000 ($5,000 if married filing separately). Sponsors of the Workaround Act have declared it to be “IRS-Proof” since federal tax laws allow uncapped state and local tax deductions for businesses.

Overview

In general, the Workaround Act permits partnerships, S-corporations, and limited liability companies with at least two members (“eligible pass-through entities”) to elect to be liable for, and pay, a pass-through business alternative income tax.

The tax imposed on an eligible pass-through entity will be equal to an eligible pass-through entity member’s share of distributive proceeds for the taxable year, multiplied by the following rates:

Election and New Entity Level Tax Return Required

All of the eligible pass-through entity’s members must consent to pay this tax. Additionally, the eligible pass-through entity is required to file an entity tax return and pay the tax on or before the 5th day of the third month following the close of the entity's taxable year for federal income tax purposes. In addition, the entity must make quarterly estimated tax payments throughout the applicable tax year.

Tax Credits

Individual and corporate members of an eligible pass-through entity will receive a tax credit equal to such member’s pro-rata share of tax paid by the pass-through entity to avoid double taxation. Credits in excess of the amount of tax paid by an eligible pass-through entity may be refundable to individuals, but not corporate members. Instead, excess credits given to corporate members may be carried over for up to 20 years.

Example. Assume a New Jersey resident is a 30% partner in a partnership doing business only in New Jersey. Also, assume the profits allocated for all partners of the partnership are $500,000, and all allocations of profits are made pro-rata.

- The elective entity level tax equals $30,487.50 (($250,000*5.675%) + ($250,000*6.52%)). This tax will be treated as a business expense of the eligible pass-through entity, which will lower the federal taxable income that is allocated to the partners of the partnership.
- The New Jersey resident partner's share of the entity level tax equals $9,146.25 ($30,475*30%).
- The New Jersey resident partner will receive a corresponding New Jersey tax credit of $9,146.25. As a New Jersey resident, his or her entire profit will also be subject to New Jersey income tax. The credit received under the Workaround Act will be used to offset tax paid by this partner at the individual taxpayer level.

New Jersey resident taxpayers with non-New Jersey based businesses will be allowed a credit against gross income tax due to another state that the New Jersey Division of Taxation determines to be substantially similar to its tax. For example, Connecticut applies a similar tax scheme that mandates that its pass-through entities pay each member's gross income tax at the entity level. If a New Jersey resident is a member of a Connecticut pass-through entity, which is subject to the entity level tax under Connecticut Tax law, then that member would be eligible to receive a tax credit from New Jersey under the Workaround Act.

Future Guidance

The Division of Taxation of New Jersey is expected to release forms and adopt guidance necessary to administer the Workaround Act. This legal alert and summary are subject to change pending release of such regulatory guidance, which is expected to provide additional detail and clarity regarding the Workaround Act.

For more information on the details contained in this alert or for legal guidance on navigating this new tax regulation, please contact Eric Loi, Joseph Hayes, Steven Poulathas, or any member of Flaster Greenberg's Taxation Practice Group.

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