SALT Cap Workarounds Are Necessary, Not Discriminatory

To the Editor:

In his August 14 letter, Patrick Driessen wrote, "Yet workarounds defeat progressivity within higher-income groups by exempting passthrough income, in effect *discriminating against labor income* and corrupting the separate statement tax accounting rule to boot."[1] (Emphasis added.) I confess that I have no idea what the "separate statement tax accounting rule" is, but I do know what labor income is. I assume that the discrimination Driessen refers to is the discrimination between labor and capital income. And if indeed a "workaround" discriminated between labor and capital income, that would be a bad thing. But Driessen misunderstands the function of the "workaround" he so loathes.

A fundamental design flaw of the SALT cap was that, in limiting the deduction only to individuals, it discriminated between workers who are employed by C corporations and workers who are partners, S corporation shareholders, or sole proprietors. Many S corporations and partnerships, including LLCs taxable as partnerships, are engaged in active business operations in connection with which the owners as well as employees provide services. But when a worker is employed by a C corporation, any state and local taxes borne by the corporation are deductible and are not subject to the SALT cap. If instead the worker is an owner of a passthrough entity or a sole proprietor, state and local taxes are borne by the worker personally and, due to the SALT cap, are not deductible above $10,000. There is no principled reason for these disparate outcomes.

As Notice 2020-75, 2020-49 IRB 1453, points out, "In enacting section 164(b)(6), Congress provided that 'taxes imposed at the entity level, such as a business tax imposed on passthrough 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.' H.R. Rep. No. 115-466, at 260 n. 172 (2017)." The workarounds adopted by many states and blessed by the IRS allow a partnership (or S corporation) to bear state and local taxes at the entity level. They effectively equate labor income earned by working for a C corporation with labor income earned by working as an owner of a passthrough entity. To my mind, the only flaw with the workaround is that it did not go far enough and include sole proprietors, due to the lack of any "entity" that could be subject to tax at the entity level. This was a flaw in the statute; any rule that purports to limit the deductions of an individual on the evident assumption that an individual cannot be engaged in a business is by definition a terrible rule.

Kimberly S. Blanchard
Partner
Weil, Gotshal & Manges LLP
Aug. 21, 2022 ■

[1] Driessen, "The Sneaky SALT Cap Workaround That Almost Passed," *Tax Notes Federal*, Aug. 22, 2022, p. 1278.