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In This Issue:

A Closer Look at Minnesota's Proposed SALT Cap Workaround

Guest contributor, MCFE member, and former Minnesota House of Representatives legislative analyst Joel Michael examines the design, implications, and tax policy issues of the bill allowing pass through business entities to elect to pay state income tax at the entity level and thereby circumvent the federal government's $10,000 cap on state and local tax deductibility.

The Tax Cuts and Jobs Act or TCJA, the $1.5 trillion federal tax cut, presented high tax states, like Minnesota, with two challenges:

- A conformity challenge – how to adapt the state's income and corporate tax rules to the federal changes. The legislature largely resolved these issues in the 2019 tax bill.

- A price shock – by capping the itemized deduction for state and local taxes (SALT), TCJA dramatically raised the price of state and local taxes for many itemizers. For an itemizer in the top federal tax bracket, the SALT deduction cap raised the tax price of state taxes (i.e., how much they reduce after-tax income) by almost 60%. The relative or percentage effect is the same for all states but for a high tax state like Minnesota, the absolute effect is especially harsh.

The ink from signing TCJA was barely dry before high tax states began searching for workarounds to the SALT cap and its resulting tax price increase. The first effort, converting income and/or property taxes to charitable contribution deductions which remain uncapped under TCJA, was blocked by the IRS, reducing it to a legal challenge with little probability of success. A second approach gives pass through entities (PTEs) like S corporations and partnerships the option of paying state income tax at the entity level, thereby making the tax deductible. Whether that approach "worked" was uncertain. But in a November announcement, which immediately captured the attention of business owners, tax practitioners, and government officials in "blue states" across the nation, the IRS blessed that approach.[1]

The IRS decision all but ensures that states with income taxes will enact PTE elective entity taxes. Failure to do so would forgo a large helping of federal tax savings for owners of in-state PTEs at no state budget cost. The potential federal tax savings are large. If half of PTEs with top tax bracket owners participate, federal tax savings to owners of Minnesota PTEs could be more than $150 million annually. The amounts make it more a matter of when and how, rather than whether to enact a PTE entity tax option. But PTE entity taxes can be structured in different ways and enacting one has tax policy implications.

"Election 101"

PTEs as entities are exempt from income taxation. Instead, they "distribute" or report their income and other tax attributes to their owners who pay any resulting tax on their individual tax returns. State and local income taxes are reported separately and are allowed to the owners as itemized deductions. Put another way, state income taxes are not treated as business expenses that reduce the PTE's reported income, but are subject to itemized deduction rules, including TCJA's cap on SALT deductions.[2] But longstanding IRS guidance allows state income taxes imposed on the entity itself to reduce the income distributed to the owner, treating them like a deductible expense, thereby avoiding the itemized deduction rules. That presents a SALT cap workaround possibility with two conceptually simple elements:

- Convert the state tax on PTE income to an entity tax, making it effectively deductible without regard to the cap. The income reported/distributed to owners on their K-1s would be net of the state income tax paid by the entity.

- Hold owners harmless at the individual level (under the federal rules their shares of the entity's income will be in their AGI carried over to state returns) by providing either a tax credit for their shares of the state entity level taxes paid or by allowing them to deduct the entity's income before calculating state tax.

Six states have enacted PTE entity tax workarounds to the SALT cap as shown in the table. The table's last row shows how the Minnesota bill, S.F. No. 263, compares.

Under the IRS announcement and as a practical matter, the earliest the legislature could provide a PTE option is for tax year

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[1] Notice 2020-75, 2020-49 IRB 1453 (Nov. 9, 2020) (announcing the plan to issue proposed regulations allowing optional PTE entity income taxes to reduce distributed PTE income).

[2] PTE owners like to claim they pay their business taxes on their individual returns. That is partially true if the income is retained by the entity as working capital. But it is also the case that those taxes are their individual income taxes, comparable to taxes paid by workers and investors on wages, interest, and dividends. Federal and state law resolves this ambiguity by subjecting them to the same rules that apply to wage earners and passive investors' taxes – that is, they are deductible only as itemized deductions.

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Table 1: State PTE Entity SALT Cap Workaround Taxes

State	Citation	Limited to tax entities*	Elective	Entity tax rate	Top state PIT rate	Top state corporate rate	Entity tax base	Coordination with individual tax
Connecticut	Conn. Gen. Stat. Ann. § 12-699	Yes	No	6.99%	6.99%	7.5%	PTE distributions	Credit limited to 87.5% of entity tax
Louisiana	La Rev. Stat. § 2:287.732.2	Yes	Yes, by owners of > 50% of capital	Graduated with top rate of 6%	6%	8%	C corp rules	Exclude income
Maryland	MD Tax-Gen § 10-102.1; ch. 641. Laws 2020	No	Yes, annual	Top state rate plus lowest county rate	5.75% (state)	8.25%	PTE distributions	Credit; nonresident PTE owners do not qualify – entity tax is withholding tax
New Jersey	N.J. Rev. Stat. §54A:12-3	Yes	Yes, by consent of all owners	Graduated; top rate of 10.75%	plus county rates	9%	PTE distributions	Refundable credit.
Oklahoma	2019 Okla. Stat. tit. 68 Revenue and Taxation § 68-2355.1P-4.	Yes	Yes, until revoked	5% (individuals) 6% (corporate)	10.75%	6%	PTE distributions	Exclude income
Rhode Island	R.I. Gen. Laws § 44-11-2.3	No	Yes, annual	5.99%	5%	7%	PTE distributions	Credit
Wisconsin	2017 Wis Act 368	Yes	Yes, annual by majority of owners	7.9%	5.99%	7.9%	C corp rules	Exclude income
Minnesota bill	S.F. 263; H.F. 501	No	Yes, by owners of majority interest	9.85%	7.65%	9.8%	C corp rules	Exclude income

*Entities qualifying under federal law as S corporations or as tax partnerships

2021. The proposed regulations are unlikely to be published before the end of the regular session. So, some uncertainty will remain as to exactly what they require. If the primary goal were to simplify crafting legislation meeting the IRS requirements, it may make sense to wait. But given the federal tax savings at stake, I expect the 2021 legislature to enact a PTE entity option, effective for tax year 2021. If the IRS regulations require changes, the 2022 legislature can do so.

How to do it?

That leaves the question of how to formulate the PTE entity tax beyond the obvious basics of satisfying both the IRS regulations and constitutional requirements. Since details of the IRS regulations remain uncertain, that likely counsels adopting a narrower law that can be expanded later.

Constitutional considerations dictate that an entity option apply only to the PTE's Minnesota source income. By contrast, the individual income tax on residents with PTE income applies to all their PTE income, including from sources outside Minnesota. Residents are allowed a credit for tax they pay to another state on that income to avoid double taxation. To prevent a state revenue loss, this non-Minnesota source income needs to remain taxable under the individual income tax when received by residents. Whether that tax becomes deductible will depend on the other state enacting a PTE entity tax.

The features of other states PTE taxes in the table suggest at least four design issues or alternatives:

- Should the tax be mandatory or elective?
- Which entities should qualify?
- What should the tax base and rate be?
- How should the entity tax be coordinated with the individual income tax?

Mandatory or elective — This is the easiest of the issues to resolve. An entity level tax can disadvantage some PTE owners (e.g., if they are using the PTE losses to reduce other income or other losses to reduce the PTE's income), creating winners and losers. Since a mandatory tax is unnecessary to satisfy the IRS, an elective tax seems a given politically to minimize losers. A mandatory tax makes sense mainly if a goal is to raise revenue, rather than to score federal tax savings for owners of PTEs subject to Minnesota tax. All states, except Connecticut, have enacted optional taxes.

Qualifying entities — There are two main questions regarding which entities should qualify:

- Should the option be limited to tax partnerships and S corporations or should it also be allowed for disregarded LLCs? The Minnesota bill and some state laws appear to allow these "entities" (for legal but not tax purposes) to make the PTE entity election. Because the theory outlined in the IRS announcement is based on tax code provisions that apply to tax partnerships and S corporations, that may be a stretch. Prudence probably dictates waiting to see if the IRS regulations will permit it. Related questions are how to treat PTEs with both individual and C corporation owners and whether trusts should qualify.

- How should entities be allowed to make the election? Most states and the Minnesota bill allow a majority of the owners to make annual elections. The Minnesota bill is unique in requiring a five-year, revocable election. Revocation will disqualify making another election for four years. The multiyear requirements will prevent PTEs from toggling back and forth between paying the PTE entity tax in high income years and opting out in low income or loss years. But it will discourage use and increase the complexity of tax planning.

Tax base, rate, and calculations — Most states use the deemed income tax distributions of PTE in-state source income as the entity tax base. That mirrors PTEs' existing tax reporting; they would simply sum the distributions of in-state source income reported for purposes of federal tax law, apply the relevant tax rate(s) and pay the tax. Louisiana, Wisconsin, and the Minnesota bill instead apply their C corporate taxes as the entity tax. In Minnesota that will result in slight differences in the tax base and require the entity to go through an additional step of applying state corporate tax rules to determine its tax. It may have a modest constitutional advantage by mirroring the time-tested state corporate tax model and treating PTEs the same as C corporations.

For an itemizer in the top federal tax bracket, the SALT deduction cap raised the tax price of state taxes (i.e., how much they reduce after-tax income) by almost 60%.

Most states and the Minnesota bill use the top individual income tax rate as the PTE entity tax rate. Other states apply their graduated individual rates or the rate under the corporate tax (Wisconsin). The choice of a rate obviously is one key to determining the effect of the option on both state revenues and participation by taxpayers.

Coordination with the individual income tax —To prevent PTE income from being taxed again at the individual level (recall it is included in AGI, the starting point for the Minnesota individual income tax), owners can either be allowed to claim their share of the PTE entity tax as a credit against their state liability or they can exclude the PTE's in-state income in calculating their state income tax. Four of the existing PTE entity taxes use the former method. The Minnesota bill and three states the latter. The credit more accurately compensates the taxpayer, while the income exclusion approach may yield slightly higher state revenues. That is so because the income exclusion could reduce tax paid personally by the taxpayer at rates lower than the top bracket. That, of course, assumes that the rate selected is the top individual income tax rate, as the Minnesota bill provides.

Other states' enactment of PTE entity taxes effectively means Minnesota should modify its credit for taxes paid to other states, even if it does not enact a PTE entity tax option, to satisfy constitutional requirements. The credit prevents Minnesota residents who derive income from other states, including because they own a PTE with operations in another state, from paying tax twice on the same income. Like all states, Minnesota taxes its residents on all their income and provides a credit for taxes paid on that income to other states.[3] Minnesota's credit applies to entity taxes paid by S corporations, but not partnerships.[4] Prior to SALT cap workarounds, states rarely, if ever, taxed partnerships as entities. But with enactment of PTE entity taxes, the Minnesota credit should be extended to partnerships paying PTE entity taxes to prevent double taxation of that income. The Minnesota bill does that only for partnerships electing the Minnesota entity tax; it should be extended to all partnerships if they pay entity taxes in another state.[5]

The Revenue Impact Question

Revenue neutrality is not an essential feature of an optional PTE entity tax proposal. One could be constructed either as a tax increase, clawing back some of the federal tax savings it confers, or as a tax reduction, lowering PTE business taxes beyond the federal savings. Revenue neutrality will make a proposal a better candidate for legislative approval by avoiding political objections to tax increases or cuts and the state budget crossfire.

Revenue neutrality can be achieved by setting the tax rate at the appropriate level to hold state tax revenues constant. The challenge, of course, is determining what that rate should be. I do not have access to the data necessary to estimate and am not a revenue estimator, in any case. Even with access to data, the task is not easy. DOR Research so far has punted, scoring the effect as "unknown." [6]

It is useful to note some of the moving parts that affect the estimate:

- **Flat rate** — The PTE entity tax in S.F. No. 263 uses a flat rate of 9.85%, the top individual tax rate, rather than the slightly lower corporate franchise tax rate of 9.8%. Since the individual income tax has four brackets with rates ranging from 5.35% to 9.85%, an entity tax election could cause the loss of the benefit of paying tax on some income at the lower rates for some PTE's owners. Owners who have sufficient other income to put them in the top bracket will not be affected. But the flat rate will discourage PTEs whose owners with lower incomes from making the election, but even so some electing PTEs may cause more Minnesota tax to be paid as a result of using the top rate.

- **Base differences** — There are modest base differences between the corporate and individual taxes. For example, corporations pay tax on federally exempt municipal bond interest (individuals can

[3] It is not clear that a credit for taxes paid to other states is constitutionally required. But a credit is one path to satisfy constitutional requirements and if that is the path taken, it almost certainly must be fully effective.

[4] Minn. Stat. § 290.06, subd. 22(g). *White v. Comm'r of Revenue*, Docket No. 6558 (MN Tax Court, Aug. 18, 1995), confirmed that this rule applied when a state imposed both individual and entity taxes.

[5] For an explanation of the constitutional rationale see Walter Hellerstein and Andrew Appelby, "State Tax Credit Issues Raised by SALT Cap Workaround Legislation," Tax Notes State, January 14, 2021.

[6] DOR, Analysis of S.F. No. 263 (Bakk), As proposed to be amended (January 25, 2021).

exempt Minnesota bond interest), capital loss rules differ, percentage depletion does not apply, and so on. All the differences should raise revenues or discourage PTE elections.

- **Participation** — How many PTEs will make the election is an unknown. One assumes a PTE will make the election if it would cause its owners' combined federal and Minnesota taxes to drop. For multistate PTEs with income from states with income taxes, the effects on those states' credits may become a factor because some states' credits may not apply to entity taxes.[7]

The benefit of an election for an individual owner of a PTE will vary based on their federal and Minnesota marginal tax rates. For a PTE owner to benefit from an election, the federal tax savings (a function of the federal marginal rate) must exceed any higher tax from the flat tax rate. An election could reduce some of a PTE's owners net taxes, while increasing them for others. S.F. No. 263, as introduced, authorizes owners of a majority of the PTE "ownership interests" (I presume that refers to capital, not income or profits, interests) to make the election. How PTEs will act when their owners have conflicting interests is uncertain. Some may be reluctant to raise the taxes on minority owners or may feel obligated to make compensating adjustments holding owners who would pay more harmless.

Taxpayers with income from a PTE below the top Minnesota rate bracket are unlikely to make the election because the federal tax savings would be insufficient. However, that may not be true if other (non-PTE) income puts enough owners in the top federal tax bracket. To state the obvious, elections are likely to be most beneficial to top-bracket taxpayers and those with the most tax on PTE income. For top bracket taxpayers, the federal tax savings should make an election attractive financially.

The complexity and uncertainty estimating the potential revenue effects are apparent. Accurately estimating the effect requires modeling PTE behavior, a function of their owners' personal tax situations, and then, linking that back to the owners' tax returns. The state's models (at least based when I was working a few years ago) are not well designed to do that, nor do the tax return samples have all the necessary data. Beyond the lack of necessary data and modelling capacity is the inherent challenge of making assumptions about owner behavior. DOR's initial score of "unknown" is understandable.

Revenue neutrality will make a proposal a better candidate for legislative approval by avoiding political objections to tax increases or cuts and the state budget crossfire.

My intuition is that a large share of PTEs whose owners are in the top two federal tax brackets will make the election if Minnesota enacts S.F. No. 263 or a similar bill and that it will slightly increase state revenue or, at least, not reduce them. But that is simply a guess on my part. Experience in the other states whose laws applied in tax year 2019 may help guide DOR in estimating the potential effects.

Beyond the Numbers: Other Policy Considerations

Although I believe enactment of PTE entity tax option is all but inevitable, it is worth reflecting on some of its basic tax policy implications:

- **Equity or fairness** — By favoring recipients of PTE income, a PTE entity election will reduce horizontal equity. PTE owners will pay lower effective tax rates than those with wages, interest, dividends, and similar investment income, the deductibility of whose taxes will remain subject to the SALT cap.[8] It would benefit professionals whose income for their services flows from PTE ownership, compared with similar professionals who are employees (e.g., a private practitioner physician compared with one employed by the Mayo Clinic or a law firm partner compared with an in-house corporate counsel). Because taxpayers in higher tax brackets are the prime beneficiaries, it will reduce progressivity. However, it would just restore something close to the pre-TCJA status quo for electing PTE owners.

- **Complexity** — It will significantly increase both the planning and compliance/administrative complexity by moving away from federal conformity. PTE owners will need to spend time, effort, and expense determining whether to make elections and/or reverse them. If they do, compliance and administration costs will rise, as PTE income/loss must be disentangled from the owners' individual returns and additional entity returns filed with associated record keeping obligations. The Minnesota bill, unlike any of the enacted laws in other states, requires multi-year elections increasing planning complexity. That trades off access to federal tax savings for some unknown minimization of state revenue effects.

- **Behavioral effects** – An unknown is to what extent the potential tax savings will induce proprietors to form PTEs to qualify. The Minnesota bill and some other state laws allow disregarded LLCs to make the election. Since the IRS announcement is premised on partnership and S corporation taxation, I am skeptical that the proposed regulations will permit that. If my assumption is correct, proprietors would need to form entities that are either tax partnerships or S corporations to qualify, creating additional complexity and compliance costs for them. The potential tax benefits could encourage more use of contractors (rather than employees) so they too can form PTEs and benefit. Many would consider that an unfortunate result. Tax compliance is lower for independent contractors compared with employees and the social safety net weaker (no unemployment compensa-

7 Steven N.J. Wlodychak, "IRS Just Raised State Taxes for Multistate Passthrough Entity Owners," *Tax Notes State*, vol. 98, pp. 1159-65 (Dec. 14, 2020) describes this issue, as well as Hellerstein and Appleby article cited in note 5.

8 For example, the Tax Foundation suggests states should be cautious about enacting PTE entity taxes on that basis. Moreover, it would compound TCJA's favoritism for taxpayers with business income. With one hand TCJA conferred on many PTE owners the much criticized 20-percent deduction for qualified business income, while with the other suspended employees' ability to deduct their business expenses.

tion, poorer access to retirement savings options, and so on). Another effect is to further encourage owners of S corporations who are also employees to minimize their salaries as much as legally possible in favor of distributions, a strategy now encouraged by the uncapped Medicare tax.

Concluding thoughts

Unless the federal SALT deduction rules change, it seems inevitable that a PTE entity tax election law will be enacted. If not in 2021, then in a future legislative session. The federal tax savings are simply too compelling for a high tax state like Minnesota to pass on. That is particularly true, since legislators persistently raise concerns about business owners leaving the state and/or the challenges that Minnesota high income tax creates for attracting business investment. The legislature passing on "free" federal tax benefits that would reduce the state income tax by a third or more for some of the state's highest earners or potential investors seems unthinkable. States have a long history of changing their tax and nontax laws to enable their residents to capture federal tax savings for better or worse.[9] The resulting distortions of state tax policy illustrates the potentially unintended effects that can be triggered by federal tax changes, like TCJA's SALT deduction cap. ■

Session Odds and Ends

The Governor's budget, federal Covid relief, tax conformity, and the imminent February forecast are dominating the discussion, but hearings on a few other reports have caught our attention over the last few weeks. Here's a brief look at a couple lower-profile reports on tax and fiscal matters of relevance to taxpayers.

The 2021 Homestead Property Tax Burden, a.k.a "Voss," Report (for taxes payable 2019) — For folks like us, the one-time appropriation of $200,000 in FY 2009 to reestablish the Voss Report is some of the best money the state has ever spent. That's because it fills an absolutely crucial information void regarding the tax taxpayers love to hate (and therefore the tax lawmakers love to flog). It matches homeowner property tax burdens with their household income to track how big a claim on income property taxes really represent. To protect taxpayers' privacy, the report reports aggregates results at 20 regional levels based on distributions from median values, so as the expression goes, "your mileage may vary." Nevertheless, it's by far the best information source available on what property tax ability to pay really looks like around the state.

The report for property taxes payable 2019 is now available. (As with most all reports of this nature, data must be collected and verified and inaccurate records corrected or eliminated. This process of "data cleaning" results in a time lag of around two years before the data is available for use.) A comparison of 2019 to the previous year's results finds a slight uptick in the tax's claim on homeowner income in most areas of the state. Net tax (after refunds) for the median metro homestead was $2,871, or 75.8% higher than the median Greater Minnesota homestead net tax ($1,603). Median homestead income in the metro was $100,291, or 34% higher than the median Greater Minnesota homestead income ($74,661). Median net burdens after refunds range from 1.7% to 3.2% of homestead income.

Longer-term trend information offers the most interesting perspective. For example, the median tax to income ratio is still lower in nearly every area of the state than it was 12 years ago. Even as recently as payable 2015, following a period of essentially stagnant local aids, not only was homestead income growth substantially outpacing property tax growth, in several areas of the state the median homestead tax burden had declined over the previous eight years. But in the last four years of data, the median net property tax growth rate has jumped to around two times the average annual growth rate of homestead income. As the song goes, there's something happening here, but what it is ain't exactly clear. Regardless, it's likely a contributing factor for the burst of interest in revisiting local aid distribution design and local sales tax authority.

Pension-related reports — The FY 2020 valuation reports are in, and the findings show state plans collectively have largely treaded water over the last fiscal year. Due to a Covid-induced swoon last spring, Minnesota public plans missed their return target realizing 4.2% for the year. However, the impact of that investment shortfall, was offset by other factors such as lower than anticipated salary increases and some favorable assumption changes (e.g. lowering price inflation expectations and assumed salary growth rates going forward). The result is Minnesota's aggregate unfunded pension liabilities (including St. Paul Teachers) remains right around $17 billion on an actuarial basis based on a discount rate of 7.5% — slightly higher on a market value of assets basis.

Good news lies in the market's performance so far in FY 21. Thanks to an environment of nearly free money augmented by both the TCJA provisions plus COVID stimulus policy that in the words of one investment guru "was like dropping a gasoline truck onto a forest fire," the SBI is reporting a whopping 22% fiscal year to date return.

Such is the current context for the digestion of a special report prepared by the Legislative Commission on Pensions and Retirement on annual pension cost of living adjustments or COLAs. The report was mandated as part of the sustainability reforms of 2018 to examine whether current governing statutes are consistent with the purpose of postretirement adjustments and explore alternative methodologies for determining postretirement adjustments.

Even small annual COLA adjustments have a profound compounding impact on plan costs. The report offers a comprehensive look at the history of these adjustments, the relationship between these adjustments and senior expenditures, how well these adjustments have delivered on inflation protection in the past, and potential variations on COLA design features found in other states. Ideally the pension actuaries would now be hired to follow up on this report and undertake some sensitivity analysis of possible reforms to see what kind of cost savings and sustainability gains could be achieved.

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9 States' adoption of community property laws to qualify for income splitting for married couples under the Supreme Court's 1930 decision in *Poe v. Seaborn* provides a striking example. Even though adopting community property rules made material changes in substantive spousal property law, state began change their laws to qualify for the federal tax benefits under Poe's income splitting rule. When that appeared poised to become a trend after WWII, Congress responded by allowing income splitting without regard to state property law. In response, most states that had enacted them repealed their community property laws. See Stephanie Hunter McMahon, *To Save State Residents: States' Use of Community Property for Federal Tax Reduction,1939-1947*, *Law & History Review*, vol. 27, pp. 587 - 628 (2009) for an account. Professor McMahon observes, "Although it was not guaranteed that states' adoption of community property statutes would yield the same tax benefit as in *Poe v. Seaborn*, wealthy residents' ability to vote with their feet forced states to try as competition for taxpaying residents produced a race between states to lower federal income taxes." *Ibid.* 588.

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However, we don't expect that to happen anytime soon with the investment environment communicating such a powerful "if it ain't broke, don't fix it" vibe.

But it's important to reflect on the fact that even though we are in year twelve of what might be described as one of most favorable environments for capital markets imaginable and our ten year return has been 9.7%, the trend line of our funded ratios in aggregate continue to look like the topography of Kansas. It brings to mind George Orwell's cautionary observation, "whoever is winning at the moment will always seem to be invincible." ■