

The Oregon SALT Cap Workaround for Pass-Through Entities Is Finally Here - Governor Kate Brown Has Signed Senate Bill 727 Into Law

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Last fall, the IRS announced, with respect to pass-through entities (LLCs or other entities taxed as partnerships or S corporations), that, if state law allows or requires the entity itself to pay state and local taxes (which normally pass through and are paid by the ultimate owners of the entity), the entity will not be subject to the \$10,000 state and local taxes deductibility cap (the "SALT Cap").

On February 4, 2021, Senate Bill 727 ("SB 727") was introduced in the Oregon Legislature. SB 727 is Oregon's response to the IRS announcement (see discussion below).

On June 17, 2021, after some amendments, SB 727 was passed by the Senate and referred to the House. Nine days later, the House passed the legislation without changes. On June 19, 2021, Oregon Governor Kate Brown signed SB 727 into law, effective September 25, 2021. In general, it applies to tax years beginning on or after January 1, 2022. Interestingly, SB 727 sunsets at the end of 2023.

In relevant part, SB 727 allows pass-through entities to make an annual election to pay Oregon state and local taxes at the entity level. For pass-through entities that make the election, their owners will potentially be able to deduct more than \$10,000 of Oregon state and local taxes on the federal income tax return. However, it gets even better-SB 727 includes a refundable credit feature that may result in further tax savings for some owners of pass-through entities.

Background

The Tax Cuts and Jobs Act imposed a cap on the amount of state and local tax (including property tax and income tax) that an individual may deduct from federal taxable income each

year.

Pass-through entities generally do not pay income taxes. Instead, income is passed through to the owners and reported on Schedules K-1. The owners pay income taxes on their share of the entities' income.

The SALT Cap generally applies to all state and local tax paid by an individual, including the individual's share of any state and local taxes paid with respect to the income from a pass-through entity of which the individual is an owner.

As we have been discussing, [legislation pending](#) in the U.S. House of Representatives, which reflects the Biden Administration's tax plan, does not restore the SALT Cap to pre-TCJA levels, in whole or part. While there has been talk by moderate Democrats that we will see some SALT relief, it has not appeared in any of the drafts of the pending tax legislation. Time will tell whether relief is forthcoming. For pass-through entities, Oregon, like many other states, has a temporary workaround in place.

IRS Notice 2020-75

IRS Notice 2020-75 (the "Notice"), issued on November 9, 2020, provides that the IRS will issue proposed regulations to provide that state and local taxes paid directly by a pass-through entity in accordance with qualifying state or local laws will not be subject to (and do not count toward) the SALT Cap.

A state or local law qualifies under the Notice if the law either:

- Requires a pass-through entity to directly pay income taxes at the entity level; or
- Permits a pass-through entity to make an election to directly pay income taxes at the entity level.

Taxpayers do not have to wait until the proposed regulations are issued, because the Notice states that taxpayers can, in the interim, rely on the Notice, effective November 9, 2020 (provided a qualifying state or local law exists).

Senate Bill 727

As initially introduced, SB 727 only offered a directive to the Legislative Revenue Officer to conduct a study of potential legislative options to address the SALT Cap, including establishing an election to allow pass-through entities to pay income tax at the entity level. Later, an amendment was introduced in the Senate, providing an actual remedy to the SALT problem. SB 727, as amended, gives pass-through entities an opportunity to elect to be liable and pay a "business alternative tax."

The election may be made if each member of the entity, or any officer, manager, or member

authorized under law or the entity's organizational documents, consents to make the election and represents under penalties of perjury that he or she has the authority to make the election.

If an election is made for a tax year, the entity files an entity return for that year. The election is made annually on or before the due date of the entity's return. It may not be made retroactively.

Members may revoke an election after it is made, provided they do so on or before the due date for the entity's return. A revocation must be agreed to by all members who were members at the time of the revocation.

Each entity that makes an election must annually report to each member his or her share of "distributive proceeds" (defined as the entity's "net income, dividends, royalties, interest, rents, guaranteed payments and gains of the pass-through entity, derived from or connected with sources within [Oregon]").

The tax imposed on the entity is based on the entity's total distributive proceeds as follows:

Total Distributive Proceeds Tax on Total Distributive Proceeds Not over \$250,000 9%
Over \$250,000 9.9%

If an entity makes the election, each member of the entity is given a credit against the taxes that are otherwise due under ORS Chapter 316, equal to the member's pro rata share of tax paid by the entity.

If the amount of a member's credit (plus any tax prepayments or refundable credits) exceeds the tax imposed under ORS chapter 314 and 316 for a tax year, the excess amount is refunded to the member.

SB 727 is effective for tax years beginning on or after January 1, 2022. This new law, however, sunsets at the end of 2023.

Note: Additional rules apply to nonresidents of Oregon.

Individual Income Tax Rates in Oregon

As a general rule, single individual Oregon residents are taxed on their income at the following rates for 2021:

Taxable Income Tax on Taxable Income Not over \$3,650 4.75% Over \$3,650 but not over \$9,200 \$173 plus 6.75% of the excess over \$3,650 Over \$9,200 but not over \$125,000 \$548 plus 8.75% of the excess over \$9,200 Over \$125,000 \$10,681 plus 9.9% of the excess over

\$125,000

However, single individual owners of pass-through entities that meet certain criteria pay tax on a reduced tax table, which for 2021 is as follows:

Nonpassive Income Tax on Nonpassive Income

Not over \$250,000	7%	Over \$250,000 but not over \$500,000	\$17,500 plus 7.2% of the excess over \$250,000
Over \$500,000 but not over \$1,000,000	\$35,500 plus 7.6% of the excess over \$500,000	Over \$1,000,000 but not over \$2,500,000	\$73,500 plus 8% of the excess over \$1,000,000
Over \$2,500,000 but not over \$5,000,000	\$193,500 plus 9% of the excess over \$2,500,000	Over \$5,000,000	\$418,500 plus 9.9% of the excess over \$5,000,000

Examples

The following examples illustrate how SB 727 works. For simplicity sake, the examples do not consider any personal exemptions or deductions.

Example 1

Facts. Roberta is a 50% owner in Company, a pass-through entity. Roberta is an individual, an Oregon resident and single. Roberta meets the criteria to use the pass-through entity owner rate table discussed above. Company has income of \$400,000 for the year at issue, all of which is nonpassive income, of which 50% (\$200,000) is allocable to Roberta. Company makes a business alternative tax election pursuant to SB 727. Roberta has no income other than her distributive share from the Company.

Analysis. Company is liable to pay tax of \$37,350 (\$22,500.00 plus 9.9% of \$150,000 (the excess of \$400,000 over \$250,000)). Roberta's 50% share of the tax is \$18,675.00. Roberta's tax liability in the absence of the election is \$14,000 (\$200,000 x 7%). Roberta is entitled to use her credit of \$18,675.00 against her tax liability of \$14,000, so she will receive a refund of \$4,675 (\$14,000 tax liability less \$18,675 credit = \$4,675 refundable credit). Pursuant to the Notice, Roberta's share of the Company's state tax liability will not be subject to the SALT Cap. Thus, the SALT Cap will not limit Roberta's ability to deduct any state taxes.

Example 2

Facts. The facts are the same as **Example 1** except that Company has income of \$2,500,000 for the year at issue (of which Roberta's 50% share is \$1,250,000), all of which is nonpassive income.

Analysis. Company is liable to pay tax of \$245,250.00 (\$22,500.00 plus \$222,750.00 (9.9% of \$2,250,000 (the excess of \$2,500,000 over \$250,000))). Roberta's 50% share of the tax is \$122,625.00. Roberta's tax liability in the absence of the election is \$93,500 (\$73,500 plus \$20,000 (8% of \$250,000 (the excess of \$1,250,000 over \$1,000,000. Roberta is entitled to a credit of \$122,625.00, which is \$29,125.00 more than her regular tax liability of \$93,500. Roberta will be entitled to a refund of \$29,125.00, and her share of the Company's state tax liability will not be subject to the SALT Cap.

Conclusion

SB 727 provides pass-through entity owners the opportunity to reduce or eliminate the SALT Cap with respect to Oregon state and local taxes flowing through from the entities. It goes even further-it may provide a state tax refund in some cases.

SB 727 has at least one shortcoming. It does not apply to a sole proprietorship. Further, it does not apply to a LLC unless the LLC is taxed as a partnership or S corporation. SB 727 creates some incentive for single-member LLCs to elect to be taxed as an S corporation or to add an additional member so that the entity is taxed as a partnership.

Be aware, SB 727, unless the Oregon legislature acts, will sunset after 2023.

It will be interesting to see what the U.S. Congress does with the SALT Cap. I suspect there will soon be some reprieve from lawmakers, but I do not have an expectation that we will see pre-TCJA restoration. Consequently, at least for 2022 and 2023, SB 727 could be of assistance to our pass-through entity clients subject to Oregon taxes.

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