AICPA & CIMA — Together as the Association of International Certified Professional Accountants

The One Big Beautiful Bill Act:
Impact of Proposed Changes to PTET SALT Deduction

The House version of the *One Big Beautiful Bill Act* (OBBB) would overly complicate the determination of whether pass-through entities (PTEs) are eligible for state and local tax (SALT) deductions and would unfairly penalize certain professional service businesses by disallowing any state or local income tax deduction. Meanwhile, the SALT deduction for C corporations remains intact and straightforward.

Prior to the Tax Cuts and Jobs Act of 2017 (TCJA), SALT deductions typically passed through to the entity partners/owners, and the deduction was not limited. TCJA added a layer of complexity by limiting individual SALT deductions. Following guidance issued in IRS Notice 2020-75, 36 states and one locality enacted legislation that facilitated the payment of SALT and, therefore, a PTE SALT deduction at the entity level.

The OBBB would introduce a more complicated, multilayered, and less administrable SALT deduction regime by disallowing SALT deductions generally for PTEs and subsequently carving out exceptions based on several criteria. The OBBB would also create a multifaceted category of disallowed SALT deductions called substitute payments, which is designed to cease the effect of state pass-through entity tax (PTET) SALT deduction legislation. In some states, SALT that have always been deductible (e.g., the franchise tax in Tennessee or Texas) could now be disallowed as a deduction. Ultimately, the proposal creates excessive complexity, increases the tax administration burden for all parties, expands the disparity between PTEs and C corporations, and essentially raises the income tax burden of many PTE partners/owners.

Key Provisions of Proposal

- Individual SALT deduction limit - $40K all filers, except married filing separately $20K
- Pass-through entities
    - Specified taxes (separately stated)
        - State and local real property tax
        - State and local personal property tax
        - State and local income tax
        - Substitute payments (prevents effect of state PTET legislation)
            - Substitute payment is any payment of SALT (other than specified taxes and state and local income tax paid by non-SSTBs) where one or more persons would be entitled to specified tax benefits equal to or exceeding 25% of the payment
    - Excepted taxes (allowed as business expense at PTE-level)
        - State and local property tax in connection with business/investment activity

        - State and local income tax paid by non-SSTBs (if 75% of gross receipts arise from a qualified trade or business)

    - General Rule – Specified taxes (that are not excepted) and substitute payments will be separately stated, will not be treated as a business expense at the entity level, and will pass through to the partner, subject to the SALT cap

Impact of Proposal

- Pass-through entities

    - State and local property tax deduction
        - Permitted if connected to a business activity
        - But may be disallowed under substitute payments provision
    - State and local income tax deduction
        - Permitted if PTE is a non-SSTB and 75% or more of PTE's gross receipts are from a qualified trade or business
        - Not subject to substitute payment provision
    - Other state and local taxes under section 164 (flush language)
        - Permitted, subject to the substitute payments provision

- Specified service trades or businesses (SSTBs)

    - State and local property tax deduction
        - Permitted if connected to business activity
        - But may be disallowed under substitute payments provision
    - State and local income tax deduction
        - NOT permitted
    - Other state and local taxes under section 164 (flush language)
        - Permitted, subject to substitute payments provision

- States that have enacted PTET SALT deduction legislation

    - **Only SSTBs are not eligible for state and local income tax deduction under the substitute payments rule**
    - The following states have enacted PTET SALT deduction legislation:

Alabama	Arkansas	Arizona
California	Colorado	Connecticut
Hawaii	Georgia	Iowa
Idaho	Illinois	Indiana
Kansas	Kentucky	Louisiana
Maine	Michigan	Maryland
Minnesota	Missouri	Mississippi
Montana	North Carolina	Nebraska
New Jersey	New Mexico	New York
Ohio	Oklahoma	Oregon
Rhode Island	South Carolina	Utah
Virginia	Wisconsin	West Virginia

- What SALT deductions are subject to the substitute payments limitation?
    - State and local property tax deduction
    - Deduction for SALT under section 164 (flush language)
        - Example: If an SSTB pays a gross receipts tax at the entity-level and the partners receive credits against their state income tax liabilities, the partnership payment is a substitute payment and will be a separately stated specified tax.
        - Under the OBBB, it is **uncertain** whether SSTBs may deduct the following state PTE-level taxes which were in existence pre-TCJA:

State	PTET Tax	Tax Type
California	1.5% tax on S corporations	Franchise
Illinois	1.5% replacement tax	Franchise
Ohio	Commercial activity tax (measured by gross receipts)	Gross receipts
Oregon	Corporate activity tax (taxable commercial activity in Oregon above $1 million)	Gross receipts
Nevada	Commerce tax on gross revenue	Gross receipts
New Hampshire	7.5% on business profits/.55% business enterprise value	Gross receipts
Tennessee	Franchise tax of $.25 per 100 of net worth and 6.5% of net earnings	Gross receipts
Texas	Franchise tax of .375% (retailers and wholesalers) or .75% for all other businesses; lesser of three different calculations involving total revenue	Franchise
Washington	Business occupation tax based on gross receipts	Gross receipts
Alaska	N/A	N/A
Florida	N/A	N/A
South Dakota	*De minimis* reporting fees	N/A
Wyoming	N/A	N/A
***Note**: Each state and local tax would need to be analyzed as to whether it constitutes a substitute payment. Furthermore, guidance could be issued after OBBB enactment recharacterizing such taxes as state income taxes pursuant to section 164(a)(3).*		

Key Conclusions

Under the OBBB proposal, PTEs will need to carefully classify the types of SALT, determine whether each SALT is a specified tax and/or an excepted tax, and then analyze applicability of the substitute payments provision. In addition to the needless complexity of the proposal, no PTE will fare better under this proposal than the existing PTE tax SALT deduction regime. Some PTEs will be worse off than under current law; while most SSTBs will be worse off than under current law.

Generally, non-SSTBs will be entitled to a state and local income tax deduction, while SSTBs will pass through such deduction to partners/owners. While most SSTBs will be precluded from an entity-level state and local income tax deduction, some SSTBs may be worse off than pre-TCJA and immediately post-TCJA due to local income taxes that would be disallowed under section 164(a)(3). For example, below are some local taxes that SSTBs will not be entitled to take because they are clearly income taxes:

Locality	**PTET Tax**	**Tax Type**
Ohio Municipalities	Differing amongst municipalities	Income
New York City UBT	4% of taxable income allocated to NYC	Income

Ultimately, the proposed SALT deduction changes increase the complexity of our tax laws, needlessly raise the tax administrative burden for all PTEs, and effectively increase taxes on professional service businesses. Furthermore, this tax increase gives C corporations a significant and unnecessary economic advantage over all PTEs, but primarily SSTBs.