

Part III – Administrative, Procedural, and Miscellaneous

Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes

Notice 2020-75

SECTION 1. PURPOSE

This notice announces that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to issue proposed regulations to clarify that State and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment.

SECTION 2. BACKGROUND

.01 Computing taxable income or loss

(1) Section 164(a) of the Internal Revenue Code (Code) generally allows a deduction for certain taxes for the taxable year within which paid or accrued, including: (i) State and local, and foreign, real property taxes; (ii) State and local personal property taxes; and (iii) State and local, and foreign, income, war profits, and excess profits taxes. In addition, section 164 allows a deduction for State and local, and foreign, taxes

not described in the preceding sentence that are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 of the Code. Section 164(b)(2) provides that, for purposes of section 164, a “State or local tax” includes only a tax imposed by a State, a possession of the United States, (U.S. territory), or a political subdivision of any of the foregoing, or by the District of Columbia.

(2) Section 703(a) of the Code generally provides that the taxable income of a partnership is computed in the same manner as in the case of an individual except that the items described in section 702(a) of the Code must be separately stated and certain enumerated deductions are not allowed to the partnership. For example, section 703(a)(2)(B) disallows the deduction for taxes provided in section 164(a) with respect to taxes described in section 901 of the Code, which include not only taxes paid or accrued to foreign countries but also taxes paid or accrued to U.S. territories (which are treated as State and local taxes under section 164(b)(2)). Section 1363(b)(1) and (2) of the Code generally provides the same with respect to an S corporation.

(3) Section 702(a) provides that a partner, in determining the partner’s income tax, is required to take into account separately the partner’s distributive share of certain partnership items of income, gain, loss, deduction, or credit (tax items) that are set forth in that section, as well as the non-separately computed income and loss. For example, section 702(a)(6) requires that a partner take into account separately the partner’s distributive share of taxes, described in section 901, paid or accrued to foreign countries and to U.S. territories.

(4) Section 1366(a)(1) of the Code provides that, in determining the tax of a shareholder of an S corporation, the shareholder is required to take into account

separately the shareholder's pro rata share of the S corporation's tax items, the separate treatment of which could affect the liability for tax of any shareholder of the S corporation, as well as the non-separately computed income and loss. For this purpose, section 1366(a)(1) requires, in part, that a shareholder take into account separately the shareholder's pro rata share of the S corporation's taxes, described in section 901, paid or accrued to foreign countries and to U.S. territories.

(5) Revenue Ruling 58-25, 1958-1 C.B. 95, holds that a Cincinnati, Ohio tax imposed upon and paid by a partnership on the net profits of the partnership's business conducted in Cincinnati was deductible in computing the taxable income or loss of the partnership. The ruling holds that "any tax imposed upon and paid by a partnership on the net profits of its business conducted in Cincinnati is deductible in computing the taxable income of the partnership and the partners are not precluded from claiming the standard deduction." Thus, the partners' distributive shares of the net profits tax were not separately stated and the partners' distributive shares of the partnership's non-separately stated income or loss, which reflects a deduction for the tax paid by the partnership, could be taken into account by the partners in computing adjusted gross income under section 62 of the Code, not as itemized deductions.

.02 State and local tax (SALT) deduction limitation

(1) Section 164(b)(6), as added by section 11042(a) of Public Law 115-97, 131 Stat. 2054 (December 22, 2017), commonly referred to as the Tax Cuts and Jobs Act, limits an individual's deduction under section 164(a) (SALT deduction limitation) to \$10,000 (\$5,000 in the case of a married individual filing a separate return) for the aggregate amount of the following State and local taxes paid during the calendar year:

(i) real property taxes; (ii) personal property taxes; (iii) income, war profits, and excess profits taxes; and (iv) general sales taxes. This SALT deduction limitation applies to taxable years beginning after December 31, 2017, and before January 1, 2026, and does not apply to taxes described in section 164(a)(3) that are imposed by a foreign country or to any taxes described in section 164(a)(1) and (2) that are paid and incurred in carrying on a trade or business or an activity described in section 212.

(2) In enacting section 164(b)(6), Congress provided that “taxes imposed at the entity level, such as a business tax imposed on pass-through 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).

(3) Certain jurisdictions described in section 164(b)(2) have enacted, or are contemplating the enactment of, tax laws that impose either a mandatory or elective entity-level income tax on partnerships and S corporations that do business in the jurisdiction or have income derived from or connected with sources within the jurisdiction. In certain instances, the jurisdiction’s tax law provides a corresponding or offsetting, owner-level tax benefit, such as a full or partial credit, deduction, or exclusion. The Treasury Department and the IRS are aware that there is uncertainty as to whether entity-level payments made under these laws to jurisdictions described in section 164(b)(2) other than U.S. territories must be taken into account in applying the SALT deduction limitation at the owner level.

SECTION 3. FORTHCOMING PROPOSED REGULATIONS

.01 Purpose and scope. The Treasury Department and the IRS intend to issue proposed regulations to provide certainty to individual owners of partnerships and S corporations in calculating their SALT deduction limitations. Based on the statutory and administrative authorities described in section 2 of this notice, the forthcoming proposed regulations will clarify that Specified Income Tax Payments (as defined in section 3.02(1) of this notice) are deductible by partnerships and S corporations in computing their non-separately stated income or loss.

.02 Forthcoming regulations. To achieve the purpose described in section 3.01 of this notice, the Treasury Department and the IRS expect to propose regulations consistent with the provisions set forth in this section 3.02.

(1) Definition of Specified Income Tax Payment. For purposes of section 3.02 of this notice, the term “Specified Income Tax Payment” means any amount paid by a partnership or an S corporation to a State, a political subdivision of a State, or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or the S corporation. This definition does not include income taxes imposed by U.S. territories or their political subdivisions. Thus, this definition solely includes income taxes described in section 164(b)(2) for which a deduction by a partnership is not disallowed under section 703(a)(2)(B), and such income taxes for which a deduction by an S corporation is not disallowed under section 1363(b)(2). For this purpose, a Specified Income Tax Payment includes any amount paid by a partnership or an S corporation to a Domestic Jurisdiction pursuant to a direct imposition of income tax by the Domestic Jurisdiction on the partnership or S corporation, without regard to whether the imposition of and liability

for the income tax is the result of an election by the entity or whether the partners or shareholders receive a partial or full deduction, exclusion, credit, or other tax benefit that is based on their share of the amount paid by the partnership or S corporation to satisfy its income tax liability under the Domestic Jurisdiction's tax law and which reduces the partners' or shareholders' own individual income tax liabilities under the Domestic Jurisdiction's tax law.

(2) Deductibility of Specified Income Tax Payments. If a partnership or an S corporation makes a Specified Income Tax Payment during a taxable year, the partnership or S corporation is allowed a deduction for the Specified Income Tax Payment in computing its taxable income for the taxable year in which the payment is made.

(3) Specified Income Tax Payments not separately taken into account. Any Specified Income Tax Payment made by a partnership or an S corporation during a taxable year does not constitute an item of deduction that a partner or an S corporation shareholder takes into account separately under section 702 or section 1366 in determining the partner's or S corporation shareholder's own Federal income tax liability for the taxable year. Instead, Specified Income Tax Payments will be reflected in a partner's or an S corporation shareholder's distributive or pro-rata share of non-separately stated income or loss reported on a Schedule K-1 (or similar form).

(4) Specified Income Tax Payments not taken into account for SALT deduction limitation. Any Specified Income Tax Payment made by a partnership or an S corporation is not taken into account in applying the SALT deduction limitation to any individual who is a partner in the partnership or a shareholder of the S corporation.

SECTION 4. APPLICABILITY DATE

The proposed regulations described in this notice will apply to Specified Income Tax Payments made on or after **November 9, 2020**. The proposed regulations will also permit taxpayers described in section 3.02 of this notice to apply the rules described in this notice to Specified Income Tax Payments made in a taxable year of the partnership or S corporation ending after December 31, 2017, and made before **November 9, 2020**, provided that the Specified Income Tax Payment is made to satisfy the liability for income tax imposed on the partnership or S corporation pursuant to a law enacted prior to **November 9, 2020**. Prior to the issuance of the proposed regulations, taxpayers may rely on the provisions of this notice with respect to Specified Income Tax Payments as described in this section 4.

SECTION 5. DRAFTING INFORMATION

The principal author of this notice is the Office of Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, contact Kevin I. Babitz or Robert D. Alinsky at (202) 317-5279 (not a toll-free number).