IRS PASS-THROUGH ENTITY GUIDANCE PUTS MARYLAND SALT WORKAROUND IN MOTION

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Since Maryland passed **Senate Bill 523** on May 8, 2020, providing a state and local tax (SALT) workaround, professionals in the accounting industry have been impatiently waiting for additional guidance on how this new bill would work.

When Maryland issued **Administrative Release No. 6** on September 15, 2020 in an effort to provide guidance on paying tax at the entity level and to whom the tax would apply, a great deal of questions remained—and skepticism the IRS would accept.

Much to the surprise of many accounting professionals, the IRS released **Notice 2020-75** on November 9, 2020, giving the thumbs-up for S-Corporations and LLCs to pay Maryland taxes at the pass-through entity level rather than on individual Income tax returns. Bottom line, this workaround moves the deduction off of Schedule A Itemized Deductions (limited to $10,000) and moves them over Schedule E as an ordinary deduction (not limited to $10,000).

Here's What We Do Know:

- The tax is calculated based on distributive income found on Maryland Form K-1 at **8% for individuals and fiduciary members** and **8.25% for entities**
- The annual election will be made at the entity level and not at the member or shareholder level
- Schedule C tax filers will not be eligible
- Maryland decoupling modification adjustments are not taken into consideration in the calculation of the tax
- The IRS is requiring both accrual and cash basis taxpayers to pay the tax on or before 12/31/2020
- The tax is calculated based on the entire year, not just Q4 when official guidance came out. It's important to note that this workaround is only available to those taxpayers with tax years starting 1/1/2020 or after.
- Maryland residents will get a credit for Maryland taxes paid on their behalf
- Maryland will not allow Q1, Q2, and Q3 payments made at the individual level to be moved over to the pass-through entity level
- The draft of Maryland Form 510 for 2020 is not yet available

Here's What We Don't Know:

- Will Maryland Non-Residents be able to participate at the entity level tax?
- If the pass-through entity files in multiple states, does the Maryland resident need to pay tax for all income in Maryland, along with payments to other states?
- Will Maryland abate underpayment penalties if the payment for the entire year is made in Q4?

Key Considerations Moving Forward:

- **Cash Flow, Cash Flow, Cash Flow.** It is very possible that an individual taxpayer has already paid in ¾ of the year in estimated taxes. For 2020, the entity would be paying the entire 2020 tax liability with the Q4 voucher. While a timing difference, it is a lot of cash out in Q4.

- **Tax Matters Partner or Shareholder Consideration.** The one making the decision to pay the tax at the entity level should have something to the LLC members or shareholders explaining the decision. Consider adding language to the Operating Agreement or Shareholders Agreement that addresses this specific matter, and who is in charge of making the election.

- **S-Corporation Profit and Loss.** Remember that allocations are generally pro rata. Should there be changes in the S-corporation ownership during the course of the year, the above workaround may benefit some more than others.

- **Know Your Tax Rates.** Individuals who receive a credit at 8.0% for taxes paid at the entity level may be under-withheld if taxed at a higher rate. For example, a high income earner in Baltimore City would have a maximum rate of 8.95%.

As with most guidance from taxing authorities, **several unanswered questions remain**. We are committed to providing you with the information and resources needed to make informed decisions for the future of your organization. We strongly encourage you to talk to your accountant and financial advisor to decide what's right for you. For more information, please contact Tax Director Dan Thrailkill at dthrailkill@ellinandtucker.com.