Arkansas's Answer to the SALT Cap for Business Owners: The Arkansas Pass-Through Entity Tax Act

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The *Tax Cuts and Jobs Act of 2017* (The "TCJA") imposes a $10,000 cap on the amount an individual may deduct for federal tax purposes for the payment of state and local income, property and sales taxes (referred to as "SALT"). The IRS issued a Notice in November 2020 (Notice 2020-75) confirming that state taxes paid by a pass-through business entity, such as a partnership or S Corporation, are not subject to the SALT cap. In other words, if a partnership or S corporation could pay its own state income tax obligation, rather than passing the tax liability through to its owners, the SALT cap wouldn't apply.

In response, Arkansas joined 21 other states by passing legislation in 2021 that creates a workaround of the SALT cap for the owners of pass-through entities. Act 362 of 2021, *The Elective Pass-Through Entity Tax Act* (the "Act"), allows pass-through business entities to elect to pay Arkansas state income taxes directly rather than passing through the tax liability to its owners, with the intent of allowing business owners to take advantage of a full deduction of the state tax payment for federal tax purposes.

The Act is effective for tax years beginning on or after January 1, 2022. It applies to partnerships and S Corporations (including LLCs that are taxed as either partnerships or S Corporations) that are required to file an Arkansas income tax return. It does not apply to C corporations, sole proprietorships, or single-member LLCs treated as disregarded entities for tax purposes. A business wishing to take advantage of the Act must elect to do so on an annual basis on or before the due date of the business's income tax return for the year. The election must be approved by the business owners holding more than 50% of the voting rights of the business.

An electing business entity will pay a "pass-through entity tax" ("PET") at a flat rate of 5.9% on the business's net taxable income from Arkansas sources, which is the current top individual tax rate in the state. Capital gains are taxed at 50% of 5.9%, similar to the current capital gains rate for individuals. Since the tax is imposed at a flat rate rather than a graduated rate, the business may pay slightly more in Arkansas income taxes than the individual business owners would pay if the income were passed through. However, this increase will likely be offset by the federal tax savings if an individual's SALT payments would exceed $10,000. The deduction for payment of the PET at the entity level reduces the taxable income that the business passes through to the owners for their federal tax returns, thereby allowing the owners the benefit of the full deduction, not subject to the SALT Cap.

Although businesses technically have until the due date of their 2022 tax return to elect to pay the PET directly, most should make a decision much sooner. The DFA has determined that quarterly estimated tax payments for the PET are not required in 2022; however, businesses that distribute cash to its owners for quarterly estimates will need to decide by April 15, 2022, the first quarterly payment due date of the year, whether to distribute tax to its owners for quarterly payments or to pay the PET directly with their 2022 tax return. For businesses still wishing to pay the PET in quarterly estimates for 2022, the DFA will be providing voucher forms and procedures for making the quarterly PET payments, but those details have not yet been finalized. The DFA is not expected to allow businesses to move estimates from the owners to the business or vice versa.

The PET election may not make sense for every pass-through business. For example, if a business makes the election and then operates at a loss for the year, the net operating loss credit would not pass through to the owners for state tax purposes to be applied against other income they've earned. For some businesses, it may be better to wait to make the election until after the tax year is completed prior to filing the tax return. However, a business in this situation may incur underpayment penalties if the business does make a profit and hasn't made quarterly estimated payments throughout the year.

It's important to note that the SALT cap passed under the TCJA is set to expire at the end of 2025. It's also possible that Congress could act sooner to either increase the SALT cap or repeal it completely, making the PET election unnecessary.

Although the PET election could certainly result in tax savings for Arkansas business owners, the details of implementing the new tax are still being finalized, and changes at the federal level may negate any benefit. While it would be nice to be able to take a "wait-and-see" approach, most businesses will need to make a decision before April of 2022 about whether to take advantage of the program.

We will continue to provide updates as more details emerge.