Indiana Enacts SALT Deduction Cap Workaround

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The Indiana General Assembly unanimously passed its first enacted law of the 2023 legislative session, Senate Bill 2, earlier this year, which Governor Eric Holcomb signed into law on February 22, 2023. The bill was fast-tracked through the House and the Senate, where it passed 98-0 and 48-0, respectively.

The Rationale and Structure of a SALT Cap Workaround

Like similar laws throughout the country, the law responds to the federal Tax Cuts and Jobs Act of 2017—specifically, the $10,000 cap on state and local tax deductions that an individual can claim against their federal taxable income. This is usually a problem for owners of pass-through entities (PTE), which do not pay state or local income tax at the entity level; instead, the income passes through to the individual owners, who must pay substantial state and local income taxes. In contrast, C corporations pay state and federal tax at the entity level and their owners only must pay tax on income specifically distributed to the owner as a dividend.

State and local tax (SALT) deduction cap workaround bills have popped up in state legislatures throughout the United States over the past few years to address this problem. While the details vary state-to-state, these laws generally allow pass-through entities to pay a tax at the entity level, rather than at the individual level. While passthrough owners must still pay state and local tax on any income from the entity, the entity **first** deducts their entity-level tax payment from the owner's gross income. Alternatively, the owner may take a credit for their pro rata amount of the state tax paid at the entity level. This, in turn, lowers the state income tax that the owner must pay. Approximately 30 states have enacted a SALT cap workaround; the legislatures in West Virginia and Vermont are currently considering similar laws this legislative session.

Ultimately, these laws benefit companies and are at worst neutral to state coffers: (1) the state gets the same or similar amount of money; (2) the entity can deduct the entity-level payment on its federal tax return; (3) the owner receives less taxable income from

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the entity and; (4) the owner can then use their limited SALT deduction at the federal level on other taxes they paid that are not attributable to a passthrough entity.

Indiana's SALT Cap Workaround

Specifically, Senate Bill 2 creates an optional tax under Indiana Code § 6-3-2.1 (the "PTE Tax"), which allows S corporations and partnerships to pay Indiana income tax at the entity level. The tax equals the individual income tax rate (currently 3.23%) on the aggregate adjusted gross income attributable to the entity of the entity's direct owners. This is calculated after allocation and apportionment with respect to nonresident shareholders, and either before or after allocation and apportionment, at the entity's election, with respect to resident shareholders.

This tax then flows through to the direct owner and is reported on their Indiana individual income tax returns, but the law also provides a corresponding credit against the tax for the owners' pro rata portion of the income tax paid. Both items will appear on forms as determined by the Indiana Department of Revenue—likely a revised version of the owner's Indiana Schedule K-1.

The law is effective retroactive to January 1, 2022, meaning that companies may take advantage of this law for the 2022 tax year. Entities must first elect to pay Indiana state tax at the entity level. The Department of Revenue will issue forms and further instructions on how the election must be made.

There are some restrictions on *when* the election must be made. For tax year 2022, the election can be made between March 31, 2023 and August 31, 2024. For tax year 2023 and thereafter, the election must be made either during the taxable year, or after the taxable year before the entity timely files its return for the year. Affected companies may wish to extend their 2022 Indiana tax return until the Department of Revenue provides guidance on how it will implement this law. Companies may change their election for 2022, but only if they file the entity's tax return by April 18, 2023, and later file an amended return by August 24, 2024 that makes the election. An election is irrevocable once it is made.

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Entities electing to pay the PTE Tax will need to make estimated tax payments beginning in tax year 2024. If the PTE Tax is due at any time on or before August 31, 2024, both interest and penalty for failure to make estimated tax payments will be waived. Any audits, federal audit adjustments, or amended returns will generally be subject to Indiana's partnership audit rules.

Indiana's law only applies to the Indiana income tax; it does not apply to county income taxes. While these taxes are calculated on the Indiana individual income tax return, and are administered by the Department of Revenue, Senate Bill 2 is silent as to county taxes, and so does not allow for an entity to pay local income taxes. Owners will remain liable for these taxes.

Finally, while not centrally related to the Indiana PTE Tax, Senate Bill 2 also provides a credit against other states' taxes that the direct owners' paid that are "substantially similar" to the PTE Tax under Indiana law.

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