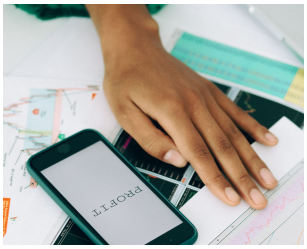

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Authors:

Elizabeth M. Ethington
Mark F. Sommer
Daniel G. Mudd
Patrick W. Thomas

Kentucky Tax Talk: Pros, Cons of the SALT Cap Workaround

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Kentucky H.B. 360 went through quite the transformation before it was enacted at the end of the session. Initially introduced during the 2023 legislative session as a single page focused on ad valorem taxes on distilled spirits, the bill quickly ballooned to nearly 150 pages encompassing other important tax-related changes.

When distilled, H.B. 360, coupled with H.B. 5, which was passed after H.B. 360 to provide additional clarity, amends Kentucky's income tax statutes allowing pass-through entities to elect to pay income tax at the entity level as opposed to the individual partner/owner flow-through level.

This article will explore the details of the Kentucky pass-through entity bill, as well as some of the issues and questions we believe the language may create for taxpayers.

SALT Cap Workarounds

Like similar laws enacted throughout the country, the law is a response to the federal Tax Cuts and Jobs Act —specifically, the $10,000 cap on state and local tax deductions that an individual can claim against their federal
taxable income. The cap is typically problematic for owners of pass-through entities as they do not pay state or local income tax at the entity level; rather, the income passes through to the owners, who must then pay substantial state and local income taxes.

In response to this challenge, SALT deduction cap workaround bills have popped up throughout the country. While they vary from state to state —about 30 states have workarounds —these laws generally allow pass-through entities to pay a tax at the entity level, rather than at the individual level.

While pass-through entity owners must pay state and local tax on any income from the entity, the entity first deducts its entity-level

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tax payment from the owner's pass-through share of gross income. Then, in many instances, the owner may take a benefit 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.

At their best, these laws benefit companies and their equity owners. At their worst, SALT cap workarounds are neutral to state coffers:

- The state gets the same or similar amount of money;
- The entity can deduct the entity-level payment on its federal tax return;
- The owner receives less taxable income from the entity;
- The owner can then use their limited SALT deduction at the federal level on other taxes they paid that are not attributable to a pass-through entity; and
- Usually the owner can claim a home state tax paid credit for taxes paid in other pass-through entity states.

Kentucky's SALT Cap Workaround

As for Kentucky, H.B. 360 added a new section to Kentucky Revised Statues, Chapter 141, creating a pass-through entity tax in which a pass-through entity may elect to pay tax at the entity level on behalf of its individual owners, as opposed to such income being passed through to its owners.

The legislation uses the general definition of a pass-through entity, which includes "partnership, S Corporation, limited liability company, limited liability partnership, limited partnership, or similar entity recognized by the laws of this state that is not taxed for federal purposes at the entity level, but instead passes to each partner, member, shareholder, or owner their proportionate share of income, deductions, gains, losses, credits, and any other similar attributes."

A disregarded entity for tax purposes, such as a single-member limited liability company, might not qualify.

H.B. 360 was drafted to largely mimic Indiana's pass-through entity legislation, which also passed this year. Like Indiana's legislation, after creating the ability for tax to be paid at the entity level, H.B.

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360 then authorizes owners to take a credit against their individual income tax liability for 100% of the tax paid by the entity on behalf of its owners.

The credit, like the tax imposed, is based on the owner's pro rata share of income from the entity.

Unlike Indiana's pass-through entity legislation, H.B. 360 initially provided that this credit would be nonrefundable and could not be carried forward. However, H.B. 5 amended the law, and now allows resident owners of pass-through entities to take a credit for income paid for the entity in other states to include tax assessed and paid at the entity level.

The law is retroactive to Jan. 1, 2022, meaning that taxpayers may take advantage of this law for the 2022 tax year, though much administrative procedure is lacking.

As for making the election, the pass-through entity election must be made "by the fifteenth day of the fourth month upon the close of the taxable year, or the fifteenth day of the tenth month upon the close of the taxable year," if the return is filed with an extension.

Uncertainty About H.B. 360 and H.B. 5

Although H.B. 360 was modeled after Indiana's pass-through entity legislation, which has been praised nationwide as one of the more comprehensive pass-through entity bills, there were several holes in H.B. 360 that left taxpayers unsure how to fully benefit from the pass-through entity election.

First, by originally making the credit nonrefundable and not able to be carried forward (pre-H.B. 5), it created the possibility that a maximum benefit would not be able to be utilized by pass-through entity owners.

Additionally, some taxpayers raised concerns of whether the legislation merely provided a payment of the individual's tax, such that it would still be subject to the SALT cap in federal law, as the legislation provided that the entity can pay the tax "on behalf of" the individual owner.

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Recognizing some of the potential flaws in H.B. 360, the General Assembly quickly passed H.B. 5, which included some clean-up provisions in relation to the pass-through entity changes in H.B. 360.

For example, H.B. 5 modified several definitions, clarified that the pass-through entity tax is imposed on the pass-through entity rather than being paid on behalf of owners, clarified the election process and made the individual tax credit refundable.

Despite the clarifications included in H.B. 5, there are still several unanswered questions as to how the pass-through entity tax will be implemented and how taxpayers can best benefit from the changes.

One glaring issue is whether the pass-through entity election can apply to disregarded entities, single-member LLCs and sole proprietors. While it seems contrary to the legislative purpose of the pass-through entity changes, some tax professionals are interpreting the legislation to exclude such entities as the income is not considered "passed through" but is instead disregarded and the liability of the sole owner.

The legislative intent behind passing the pass-through entity is a strong reason for it to prevail and apply to disregarded entities, single-member LLCs and sole proprietors, but the legislation itself does not provide any clarity on this subject.

A Path Forward

With H.B. 360 passing quickly with several amendments, the clarification of H.B. 5 and a retrospective application, it is inevitable that the Kentucky Department of Revenue will need to issue additional guidance as to how it interprets and plans to implement the changes included in this legislation.

If some of the holes discussed above continue to provide discourse among taxpayers, the General Assembly may very well need to provide additional clarity during the 2024 legislative session. Generally, this legislation has been well received and could result in significant savings for taxpayers.

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