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Beat the Unfair $10,000 SALT Cap with a C Corporation

C corporations cause double taxation for business owners, so you probably think you want to avoid them at all costs.

And for many of you, this is true, as the S corporation often provides the lower overall tax outcome.

But for some of you, the C corporation could provide the best tax outcome because it bypasses the $10,000 state and local tax (SALT) deduction cap, which was introduced by the Tax Cuts and Jobs Act (TCJA).

Prior to the TCJA, you could deduct as itemized deductions on your Form 1040, Schedule A—without limit—the following foreign, state, and local taxes:

- Income taxes
- Real property taxes
- Personal property taxes
- Foreign income and real property taxes

Tax reform took two direct actions against your Form 1040 itemized deductions for foreign, state, and local taxes. Beginning in tax year 2018,

- you can't deduct foreign real property taxes, and
- your combined state and local income, real property, and personal property tax deductions may not exceed $10,000 ($5,000 on a married filing separate return).

If you operate your business as an S corporation, the S corporation passes its net income to your individual tax return. This causes you, the individual, to pay state income taxes on the S corporation income. Those state income taxes are subject to the $10,000 cap.

C Corporation Loophole

But there is an exception: This $10,000 limit applies only to individuals—meaning, taxes deducted on your Form 1040, Schedule A. The limit does not apply to C corporations.

If you operate your business as a C corporation, then your C corporation pays state income taxes on its net income and deducts those taxes on its corporate income tax return

Husband-Wife Partnerships: The Tax Angles

When both members of a married couple participate in an unincorporated business venture, must it be treated as a husband-wife partnership for federal tax purposes? Answer: maybe, or maybe not. Figuring out the answer is important because it can have a huge impact on the couple's self-employment tax situation.

Husband-wife partnerships must also file annual federal returns on Form 1065 along with the related Schedules K-1. As you know, partnership returns can be a pain. For these reasons, you generally want to avoid husband-wife partnership status when possible.

Example: Self-employment Tax Hit on Profitable Husband-Wife Partnership

Your husband-wife partnership will produce $250,000 of net self-employment income in 2020 (after applying the 0.9235 factor that reduces net income to taxable self-employment income on Schedule SE).

Assume the $250,000 is properly split 50/50 between you and your spouse ($125,000 for each). You owe $19,125 of self-employment tax (15.3 percent x $125,000), and so does your spouse, for a combined total of $38,250.

The problem with husband-wife partnership status in your situation is that the maximum 15.3 percent self-employment tax rate hits $125,000 of net self-employment income not once but twice (first on your Schedule SE and again on your spouse's separate Schedule SE).

In contrast, if you could say that your business is a sole proprietorship run only by you, only you would be on the hook for the self-employment tax.

You would pay the maximum 15.3 percent self-employment tax rate on the first $137,700 of your 2020 net self-employment income, but the self-employment tax hit would be "only" $24,325 [(15.3 percent x $137,700) + (2.9 percent x $112,300) = $24,325]. That's a lot better than the $38,250 self-employment tax hit if your business is classified as a 50/50 husband-wife partnership.

When Does the Husband-Wife Partnership Actually Exist for Tax Purposes?

Good question. As you can see from the preceding example, the self-employment tax can make the husband-wife partnership an expensive proposition. Of course, the IRS would love it if you had to treat it that way.

Not surprisingly, several IRS publications attempt to create the impression that involvement by both spouses in an unincorporated business activity usually creates a partnership for federal tax purposes.

IRS Publication 334 (*Tax Guide for Small Business*) says the following:

If you and your spouse jointly own and operate an unincorporated business and share in the profits and losses, you are partners in a partnership, whether or not you have a formal partnership agreement.

In other words, you don't have to believe that you have a husband-wife partnership to have a husband-wife partnership for tax purposes.

Similarly, IRS Publication 541 (*Partnerships*) says:

If spouses carry on a business together and share in the profits and losses, they may be partners whether or not they have a formal partnership agreement. If so, they should report income or loss from the business on Form 1065.

But in many (if not most) cases, the IRS will have a tough time prevailing on the husband-wife partnership issue. Consider the following direct quote from IRS Private Letter Ruling 8742007:

Whether parties have formed a joint venture is a question of fact to be determined by reference to the same principles that govern the question of whether persons have formed a partnership which is to be accorded recognition for tax purposes. Therefore, while all circumstances are to be considered, the essential question is whether the parties intended to, and did in fact, join together for the present conduct of an undertaking or enterprise.

The following factors, none of which is conclusive, are evidence of this intent:

1. *the agreement of the parties and their conduct in executing its terms;*
2. *the contributions, if any, that each party makes to the venture;*
3. *control over the income and capital of the venture and the right to make withdrawals;*
4. *whether the parties are co-proprietors who share in net profits and who have an obligation to share losses; and*
5. *whether the business was conducted in the joint names of the parties and was represented to be a partnership.*

In many (if not most) real-life situations where both spouses have some involvement in an activity that has been treated as a sole proprietorship, or in an activity that has been operated using a disregarded single-member LLC that has been treated as a sole proprietorship for tax purposes, only some of the five factors listed in Private Letter Ruling 8742007 will be present. Therefore, in many such cases, the IRS may not succeed in making the husband-wife partnership argument.

Regardless of the presence or absence of the other factors listed above, the husband-wife partnership (LLC) argument is especially weak when (1) the spouses have no discernible partnership agreement and (2) the business has not been represented as a partnership to third parties (for example, to banks and customers).

If You Don’t Want 100 Percent Depreciation, Elect Out or Else

As you likely know, the TCJA increased bonus depreciation to 100 percent. Unlike most tax provisions that involve a tax election, this one requires you to elect out if you don’t want it.

For example, you (or your corporation) buy two $50,000 trucks, each with a gross vehicle weight rating of 6,500 pounds and a bed length of 6.5 feet. You use the trucks 100 percent for business. Because of the weight and bed size, the trucks are exempt from the luxury passenger vehicle depreciation limits.

You have five choices on how to deduct the vehicles on your 2019 tax return (the one you are filing or about to file—we are in tax season):

1. Do nothing. This forces you to use bonus depreciation and deduct the entire $100,000 cost in year one. In addition, you deduct your operating expenses such as gas, oil, and insurance.

2. Elect out, choose Section 179 expensing of any amount of your $100,000 cost of the trucks, and depreciate the balance. For example, you could elect to deduct $30,000 of Section 179 expensing on each truck and then depreciate the remainder using MACRS. In addition, you deduct your operating expenses such as gas, oil, and insurance. (**Note.** The trucks are not subject to the $25,000 SUV ceiling because of their weight and bed length.)

3. Elect out, don’t use Section 179, and depreciate the trucks using the five-year MACRS depreciation schedule (which takes six years).

4. Elect out, don’t use Section 179, and depreciate the trucks using the five-year straight-line depreciation schedule (which also takes six years).

5. Use the 57.5 cents IRS standard mileage rate for each business mile driven. The 57.5 cents per mile rate includes operating expenses and 27 cents a mile for depreciation.

Okay, you get the big picture. Two trucks, each with a cost of $50,000 and both exempt from the luxury vehicle limits. Five choices as to the deduction.

Luxury Vehicles

Because of their gross vehicle weight, the vehicles mentioned above were exempt from the luxury vehicle depreciation limits that apply to

- cars with **curb weight** of 6,000 pounds or less, and
- SUVs, pickups, and crossover vehicles with a **gross vehicle weight rating** of 6,000 pounds or less.

Had the vehicles failed the weight test, their bonus depreciation for 2019 would have been limited to $18,100.