New Jersey Tax Savings for Construction Companies

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New Jersey pass-through entity tax (new for 2020) provides significant tax savings opportunities for construction companies.

On January 13, 2020, New Jersey Governor Phil Murphy signed legislation creating the Business Alternative Income Tax (BAIT), an elective entity-level tax on pass-through businesses for tax years beginning on or after January 1, 2020. As many construction companies are organized as pass-through entities (partnerships or S-corporations), this election could potentially provide significant tax savings for the business owners. At the onset, the COVID-19 pandemic slowed issued guidance and forms from the NJ Division of Taxation. However, recently the state and IRS have both released more information. Below are some of the highlights and important points regarding the BAIT.

Purpose:

The purpose of this law change is clear: to effectively eliminate the federal limitation on the state and local tax (SALT) deduction of $10,000 imposed by the 2017 Tax Cuts and Jobs Act (TCJA). By imposing an income tax directly on the pass-through entity (PTE), the state's tax on pass-through entity income would now become deductible by the pass-through entity for federal income tax purposes and would not be limited.

Notable points:

- Pass-through entities can elect to pay New Jersey income tax at the entity level, and the owner(s) would receive a **credit on their personal return**(s) for the entity-level tax paid.
    - Credit is derived from the tax imposed on each member's share of distributive proceeds attributable to the PTE for the tax year (i.e., NJ sourced income).
    - For individuals, the credit is refundable, and any excess credit is treated as an overpayment.
- Election is made **annually** and must be made **on or before the original due date** (March 15th for calendar year filers).
    - Election is not covered by extension to file return (election must be made electronically on or before the original due date, not including extension).
    - It appears as though there will be an electronic form for the election, and the state has set up a mechanism on its website to e-file the election and pay estimated taxes.
- Election **cannot be made retroactively.**
- Revocations of the election must also be made on or before the original due date.
- For fiscal year filers, effective taxable years begin on or after January 1, 2020.
- At least one partner or shareholder must be subject to NJ gross income tax (GIT) to make the election.
    - The PTE must have the consent of:
        - all members; *or*
        - an officer, manager, or member of the electing entity who is authorized to make the election.
- Several other states have passed similar workarounds in recent years, including Connecticut. However, Connecticut's change was mandatory, not elective.

- Per the NJ Division of Taxation, since 2020 is the first year the election is available, **taxpayers will not be penalized** under the safe harbor provisions for the failure to file or make estimated payments this year.
    - Post-2020, quarterly estimated tax payments for the BAIT will be required to avoid penalties.
    - Taxpayers must use Form PTE-100 to file and pay.
- Estimated tax payments made for the BAIT tax return will not be transferred to other taxes.
- Refund and revocation forms are currently not available.
- The IRS issued Notice 2020-75 in response to several states who have recently enacted laws to allow entity-level income tax. The notice provides that partnerships and S corporations are not subject to the $10,000 state tax deduction limitation, which ultimately gives the green light for the NJ BAIT and confirms the IRS will allow it.
- Although the state has given a pass on underpayment of estimated tax penalties in this first year, the IRS notice has made it clear that to get the benefit of the **federal deduction in 2020**, the deduction is permitted in the year tax payments are made. Therefore, **payments need to be made by December 31, 2020.**

Risks and considerations:

- Per the statute, the BAIT is pursuant to the NJ GIT Act, which generally applies the partnership apportionment rules. Thus, an S-corporation could potentially be subject to different apportionment/receipts sourcing rules by making the election.
- The election doesn't eliminate the requirements to file other returns or pay additional taxes, such as NJ-CBT-1065 for non-resident withholding. This presents a cash flow concern; potentially, non-resident taxpayers could have to make duplicated estimated payments, paying both BAIT and NR withholding on the same income. In this case, they would then have to wait to file a personal return to recover a refund for the duplicate payments.

- Because election is not made until after the yearend, consideration needs to be given to which estimated tax payments partners or shareholders make – that is, whether the payments were made at the individual level or at the entity level. There is potential for underpayment penalty exposure by paying in estimates on the wrong forms and not transferring the payments.

- It is possible that the resident state of a non-resident member may not allow a resident credit on their individual returns for taxes paid at the entity level in New Jersey.

Conclusion:

Now that the IRS has given its blessing, the NJ BAIT is a great tax savings opportunity, primarily for New Jersey-based construction companies with resident partners and shareholders. Although the election itself doesn't have to be made for a few months and the state has put a pause on BAIT estimated tax penalties for 2020, the time is now to consider your options and make a decision on whether or not to elect. To get the benefit of the federal deduction, which is the point of this entity-level tax, you will need to make an estimated tax payment before the end of this crazy year, so act now.

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