

Reducing Your New Jersey Tax Liability with BAIT

January 25, 2022



The \$10,000 federal limitation on the deductibility of state and local taxes, known as the State and Local Tax (SALT) deduction, continues to be a major concern for many taxpayers, particularly those in high-tax jurisdictions. To circumvent this cap, several states have introduced entity-level taxes on pass-through entities (PTEs), which ostensibly treat the entity tax as a deduction by the trade or business rather than an itemized deduction at the individual partner level, which would be subject to the SALT limitation. Individual partners, in turn, receive a credit for the entity-level taxes paid. Questions loomed regarding whether the Internal Revenue Service would respect such deductions until it released Notice 2020-75 in November, indicating that the deductions of these tax payments are in fact permitted.

What is BAIT?

New Jersey joined the SALT workaround bandwagon in 2020 by establishing its Business Alternative Income Tax (BAIT). Signed into law in January, the BAIT is a new elective business tax regime in which New Jersey PTEs – partnerships, limited liability companies and S corporations – can elect to pay an entity-level tax. In return, a proportionate share of the BAIT paid is credited to the PTE partners', members' or shareholders' Gross Income Tax or Corporation Business Tax liability.

Effectively, electing into the BAIT allows the PTE owners to reduce their respective federal income by the full amount of BAIT paid by the PTE because such amount is deducted from the owners' taxable distributive share from the PTE. This provides the same result as what was previously a full deduction against federal income tax for the SALT paid on the PTE income passed through to the owner.

New Jersey's law works by imposing an alternative income tax, at graduated rates, on a PTE owner's "distributive proceeds." Distributive proceeds do not refer to cash distributions, but rather is defined by statute to include net income, interest, dividends, rent, royalties, guaranteed payments and other gains derived from sources within New Jersey.

The BAIT Election Process

To elect the BAIT, each member of a PTE must consent to an annual election due on or before the original due date, without extensions, of the PTE's New Jersey return (e.g., March 15th for calendar year filers). Alternatively, the election can be made by an officer, manager or member who is authorized to make the election on behalf of the PTE. Note, however, that the election cannot be made retroactively.

For New Jersey residents, electing the BAIT can be an especially viable workaround to the SALT limitation. Residents are allowed a refundable credit against their New Jersey income tax equal to 100% of their pro rata share of the BAIT paid. The BAIT credit is applied against the taxpayer's state tax liability after all other credits available to the member have been applied.

BAIT Considerations

Despite the benefit of New Jersey's BAIT, PTE owners are cautioned that there are open questions and potential pitfalls in deciding to elect into the tax. First, New Jersey's law does not change the existing non-resident withholding requirements for those PTEs that elect to pay the BAIT. Accordingly, duplicative payment requirements may be created if individual non-resident taxpayers are subject to both regimes. A second and highly impactful issue is whether a state, such as New York, will permit its resident partners a credit for BAIT paid to New Jersey by the PTE.

Typically, states grant residents a credit for personal income taxes paid to other jurisdictions, but they may not necessarily allow a credit for an entity-level tax even if paid on the resident taxpayer's behalf. Finally, further consideration is needed for fiscal year PTE filers, as their individual members generally file on a calendar-year basis. This can create timing difficulties in claiming individual income tax credits for the BAIT paid at the PTE level.

2022 Changes

New Jersey Governor Phil Murphy later [signed legislation](#) modifying the state's Business Alternative Income Tax (BAIT) regime.

While many pass-through entities have opted into the BAIT since its inception in 2020, the new law changes enhance the regime's tax benefits and may provide great appeal for those considering an election for the 2022 tax year. Specifically, the bill includes the following changes that are effective as of January 1, 2022:

- It modifies how the BAIT is calculated so that more income is subject to the tax, thus enabling a larger credit to be obtained. Under the revisions, a partnership's distributive proceeds upon which the tax is computed now includes both in-state and out-of-state income for resident partners. Previously, the elective tax was calculated only on New Jersey-sourced income. Under the rule change, New Jersey resident partners, who are subject to New Jersey gross income tax on all income wherever sourced, can now have the BAIT applied to all their allocated partnership income resulting in a larger BAIT credit. Note that this change is limited to partnerships and does not apply to S corporations, which must continue calculating their BAIT on New Jersey-sourced income only.
- The BAIT tax brackets are now updated to closely align with the recent changes to the state's gross income tax brackets that went into effect in 2020.
- The treatment of BAIT overpayments is modified so that they can be applied to the estimated tax liability in the subsequent year as opposed to only being refunded.
- The changes also provide that pass-through entities do not need to make

nonresident withholding payments on behalf of a nonresident partner if the nonresident expects a refund of the withholdings as a result of the BAIT credit.

- Furthermore, a BAIT credit will be permitted for tiered partnerships and S corporations that are partners in partnerships. Such credits can be passed through to the partners or shareholders, or applied against the tax liabilities of the partnership or S corporation and its BAIT liabilities.

These are welcome changes to the BAIT regime, particularly for New Jersey resident partners who stand to benefit from the increased credits available to them. Additionally, aligning the BAIT rates to the state's gross income tax brackets will further ensure that taxpayers maximize the value of electing into the tax.

With the 2022 changes, the New Jersey Division of Taxation announced that it would expand the due date of BAIT from April 18, 2022 to June 15, 2022, inclusive of:

- 2021 PTE Election,
- 2021 PTE-100 Tax Return,
- 2021 PTE-200-T Extension of Time to File,
- 2021 Revocation Form, and
- 2022 Estimated Payments.

Learn More with Anchin

As is the case with many tax decisions, careful planning is needed to determine whether New Jersey's BAIT is the right choice for you. If you have questions with regard to electing into the BAIT, please contact Alan Goldenberg, Leader of Anchin's State and Local (SALT) group, at alan.goldenberg@anchin.com or your Anchin Relationship Partner.