California Offers a Workaround to the Federal Limitation on Tax Deductions

As most of you may recall, the 2017 Tax Cuts and Jobs Act ("TCJA") included a provision that imposed a $10,000 cap on the amount of state and local taxes individual taxpayers could deduct ("SALT cap"), applicable for tax years 2018 through 2025. Notably, this limitation does not apply to state taxes paid by business entities, a distinction that California Assembly Bill 150 ("AB 150"), recently signed into law, seeks to capitalize on.

AB 150 provides certain owners of passthrough entities doing business in California a workaround to the SALT cap by allowing passthrough entities that meet certain criteria to elect to pay an additional 9.3% entity-level CA income tax on the distributive share of income allocated to its owners that consent. This entity-level state income tax would be a business expense and therefore not subject to the SALT cap.

Here is an example to illustrate how this CA elective entity-level tax would work:

> Assume Partnership AB does business solely in California, generates $500k of trade or business income in 2021, and is owned 50/50 by Andy and Bill. Further assume that both are CA residents, have no other sources of income or deductions, and are subject to the highest marginal tax rates of 37% for federal and 13.3% for California.
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> Before AB 150:
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> - Andy and Bill would each be allocated $250k of income from the partnership and pay $33,250 ($250k x 13.3%) of CA income tax.
> - Each would only be able to deduct $10,000 of that for federal income tax purposes due to the SALT cap, **a $3,700 federal tax benefit** ($10,000 x 37%).
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> With the enactment of AB 150, assuming Andy and Bill both consent and the partnership makes the election to pay the entity-level tax for tax year 2021:
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> - The partnership would pay $46,500 ($500k x 9.3%) of CA tax, resulting in $453,500 of net federal taxable income ($500k - $46,500), allocated 50/50 to Andy and Bill, or $226,750 each. As with all state income taxes, this tax would remain nondeductible for CA, so they would still be allocated $250k each of income for CA tax purposes. Furthermore, the partnership would pass through CA tax credits of $23,250 ($46,500 x 50%) to each of them for taxes it has already paid on their distributive share of income.
> - As with the previous scenario, Andy and Bill each have $33,250 of CA tax liability but now can claim a $23,250 credit against those taxes, resulting in $10,000 of net CA tax due for each of them.
> - For federal income tax purposes, Andy and Bill now each gets to deduct the $23,250 paid by the partnership on their behalf (by way of a reduction of partnership income allocated to them) and the $10,000 they had to pay personally, **resulting in a $12,300 federal tax benefit** ($33,250 x 37%).

Net tax savings with the enactment of AB 150 = $8,600 of federal taxes each to Andy and Bill ($17,200 tax savings in total). There is no change to the CA tax liability, when considering the total amount paid by the business and Andy/Bill.

One additional note on this example: The timing of the deductions would be based on the year they are paid.

Because AB 150 just recently passed, there are quite a few unanswered questions, which we expect the Franchise Tax Board will address in forthcoming procedures and guidance. Here is what we know so far:

1) What entities can make this election?

   To qualify to make this election, an entity must meet all of the following criteria:
   - Does business in California and is required to file a California tax return
   - Is taxed as a partnership or an S corporation
   - Is not a publicly traded partnership or an entity permitted or required to be in a combined reporting group
   - Only has the following types of owners: corporations, individuals, fiduciaries, estates, and trusts.
     Therefore, entities that have partnerships as an owner would not qualify. It is currently unclear whether having owners that are S corporations or disregarded entities such as a single-member LLC would disqualify an entity from making the election.

2) Must all owners consent in order for a qualified entity to make the election?
   No, each owner can decide whether to consent or not. An owner that does not consent does not prevent a qualified entity from making the election.

3) What tax years does this apply to?
   This elective entity-level tax is available for tax years 2021 through 2025. It is designed to expire when the SALT cap sunsets in 2025 under TCJA. Note that there are proposals being discussed to repeal the SALT cap for federal tax purposes, but it is unclear whether any will gain traction. If the SALT cap were to be repealed, AB 150 includes a provision that would also repeal this new elective entity-level tax for subsequent tax years.

4) Is the election revocable?
   This is an annual election, and it is irrevocable once made for that tax year. Therefore, a qualifying entity can choose yearly whether to make this election or not, and its owners can decide yearly whether to consent or not.

5) When must the election be made?
   The election must be made on an original, timely-filed tax return. The FTB is expected to come out with more guidance on how to make the election.

6) When would the partnership be required to pay the elective entity-level tax?
   - For tax year 2021 only, the tax would be due March 15, 2022.
   - For tax years 2022 through 2025, a partnership making the election would be required to pay the tax in two installments: The greater of 50% of the elective tax paid the prior taxable year or $1,000 is due by June 15th of that tax year. The rest would be due March 15th the following year.

Thus, if the elective tax paid in 2021 were $20,000 and the partnership were making the election again for 2022, it would be required to make a $10,000 payment by June 15, 2022 for tax year 2022. Any remaining elective tax owed for 2022 would be due March 15, 2023.

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