

California Passes “Workaround” To Federal Limit on State Tax Deduction For Certain Owners of Pass-Through Entities

Article By:

Justin J. Hepworth

On July 16, 2021, Governor Newsom signed California Assembly Bill 150 into law, allowing certain owners of passthrough entities to find a way around the current \$10,000 federal cap on state and local tax (SALT) deductions for individuals. The new law, applicable to tax years beginning on or after January 1, 2021 and ending before January 1, 2026, allows for many partnerships, limited liability companies taxed as partnerships, and S-Corporations to pay an entity level tax based on electing individual owners’ share of income, and then grants the owners a credit against California personal income tax for the full amount of tax paid at the entity level on their distributive share of California taxable income.

Entity Election & Payment

A pass-through entity is eligible to make the election provided:

1. Its owners consist solely of individuals, fiduciaries, trusts, estates, or entities taxable as corporations;
2. It is not a publicly-traded partnership; and
3. It is not permitted or required to be included in a California combined report.

Eligible entities that make the election will pay a 9.3% tax on the total of each consenting owner’s pro rata share of the entity’s income that is subject to tax in California—for California residents all of their distributive share, and the distributive share of California source income for nonresidents. Individual owners can choose whether or not they consent to have their income included when an entity makes this election, and consent of all owners is not required in order for the entity to make the election.

The election is irrevocable, and must be on an annual basis on a timely filed return for the year of the election. For tax years beginning in 2021, the tax is due on or before the due date of the entity’s return, without regard to extensions. For tax years beginning in 2022 through 2025, the elective tax is due in two installments: the greater of \$1,000 or 50% of the tax paid in the prior year is due by

June 15th of the taxable year of the election, and the remaining amount is due on or before the due date of the original return (without regard to extensions).

Owner Credit

Consenting owners of entities making the election may claim a credit on their California tax return equal to 9.3% of tax paid by the entity on the owner's share of income subject to tax in California. Excess credits can be carried forward for up to five years. Consenting nonresident or part-year resident owners may face limitations on claiming other California credits, including the renter's credit and the credit for taxes paid to other states.

If the owner is not able to use the credit in the initial year, they may carry the credit forward for 5 years. Nonresident and part-year resident California taxpayers are eligible to take this credit in its entirety. However, owners that are business entities that are disregarded for tax purposes, and the members or partners of such an entity, are specifically excluded from claiming this credit.

This election and the associated credit for taxpayers can be made for tax years beginning on or after January 1, 2021, and before January 1, 2026; however, entities should be aware that their ability to claim this election goes away if the federal cap on SALT deductions is removed, as the law automatically repeals itself should that happen. We advise any taxpayers interested in this election to contact their accountant or lawyer to explore if this election is right for them.

The provisions sunset on December 1, 2026, and are automatically repealed earlier if the Federal limitation on state tax deductions is repealed.

Nayan Karanth, a law clerk in the firm's Century City office, also contributed to this article.

Copyright © 2024, Sheppard Mullin Richter & Hampton LLP.

National Law Review, Volumess XI, Number 201

Source URL: <https://natlawreview.com/article/california-passes-workaround-to-federal-limit-state-tax-deduction-certain-owners>