

California Adds To List Of States Allowing State And Local Tax Cap Workaround

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Highlights

California now allows a workaround on the \$10,000 limitation on the deduction of state and local taxes of certain taxpayers

The workaround applies to qualifying limited liability companies, partnerships and “S” corporations

The qualifying entity can elect annually to pay a 9.3 percent tax of its qualified net income to the California and the consenting owner(s) of the entity will receive a credit equal to the tax paid by the entity on such owner’s behalf

The State of California has become the latest state to allow a workaround on the \$10,000 limitation on certain taxpayers to deduct state and local taxes on their federal income tax returns.

Under the Tax Cuts and Jobs Act, starting in 2018, itemized deductions for certain state and local taxes during the tax year are restricted to a maximum of \$10,000. This limitation especially hurts taxpayers that reside in states that have higher taxes, such as California.

On July 16, 2021, California Gov. Gavin Newsom signed AB 150, which provides that for tax years beginning on or after Jan. 1, 2021, and before Jan. 1, 2026, a qualified pass-through entity that is required to file a California tax return can annually make an irrevocable election to pay a California 9.3 percent tax on its qualified net income.

The new California law will apply to a limited liability company, partnership or S Corporation that:

- Is not publicly traded
- Does not have a partnership owner

- Is not permitted or required to be in a combined reporting group
- Is not disregarded for federal tax purposes

A member, partner or shareholder can consent to have the pass-through entity include in its qualified net income such owner's pro rata share or distributive share of income; however, a member, partner or shareholder that does not consent to same will not prevent the pass-through entity from making an election to pay the elective tax. Qualified net income is the sum of the pro-rata shares or distributive shares of income of the consenting members, partners or shareholders of the pass-through entity. Those members, partners or shareholders that consent will receive a nonrefundable credit that will equal the amount of State of California tax paid by the pass-through entity on such owner's behalf enabling a workaround of the cap on the deduction for state and local taxes.

Further guidance is expected from the California Franchise Tax Board.

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