



## California Plans to Join the Party – Pass Through Entity Tax Deductions to Provide Breaks to the SALT Limitation

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In 2018, taxpayers can recall the moment that their state and local tax deductions were taken away, whereby the IRS limited the category of Schedule A itemized deductions to \$10,000. Several states have fought back to protect their constituents, including New York, New Jersey, and Connecticut – amongst several other states. California is poised to become the next state in the pack that challenges Federal tax reform and provide a break to those with passthrough entities doing business in their state. As part of the California Small Business Relief Act, the State intends to include an elective pass-through entity tax program giving its individual shareholders a federal tax deduction for state and local taxes, similar to other states programs.

The pending legislation will allow “qualified entities” doing business in California to elect to pay an entity-level tax equal to 9.3% of qualified net income, deduct the state taxes paid as a business deduction, and pass a credit to the shareholder/partner/member to be claimed on their respective income tax return for California taxes paid. This credit works around the individual itemized deduction limitation of \$10,000 for state taxes paid. Qualified entities include S corporations or partnerships (including limited liability companies), that do not have any owners/partners which are partnerships, are not permitted or required to include in a combined reporting group and are not publicly traded partnerships. Thus, eligible entities must have shareholders, partners or members that are exclusively corporations or taxpayers identified under the individual income tax law.

The qualified entity may make the election to pay the pass-through level tax annually on an original, timely filed return. The election is **irrevocable**. The tax rate imposed is 9.3% on qualified net income, meaning the pro rata shares or distributable net income of partners, shareholders, or members upon their consent to pay the tax. However, if a partner, shareholder, or member does not consent, that does not prevent an entity from making the election to pay the effective tax. This entity level tax is in addition to all other tax or fees imposed by the State of California. For 2021, the tax is due by the due date of the original return, without regard to any extension. For tax years 2022 through 2025, at least 50% of the elective tax must be paid by June 15<sup>th</sup> of the taxable year with the balance of the tax due by the due date of the original return.

If the credit on the shareholder/partner/member’s return exceeds their net tax due, they can carry over the excess to the following year. This provision means the credit under the legislation is not refundable. Further, the current legislation has a provision that would make the pass-through entity tax inoperative if the federal law limiting state tax deductions to \$10,000 is repealed.

We will keep you up to date as this Bill hopefully becomes law, and the details of how to elect and participate in this tax saving program is transparent. As we continue to prepare tax plans for many of our clients in states that participate in programs like this, we are aware of the complications in planning revolving around the benefit of the pass-through entity tax deduction, tied together with qualified business income deductions, and state and local tax minimization. If you have any questions, we recommend that you contact your friends at SKP for professionally delivered guidance.

As always, Spielman Koenigsberg & Parker, LLP is here to assist you with your needs. Please feel free to reach out to your SKP tax professionals for guidance and planning opportunities.