

February 21, 2022

Dear Friends and Colleagues,

As we have mentioned before, several states, including California, have recently enacted legislation that allows S-Corporations and partnerships to pay state income taxes at the business level via their Pass-Through Entity (PTE) tax return - Form 1120S or Form 1065. This treatment allows state taxes paid at the entity level to be deductible by the shareholder/partner for Federal income tax purposes. This “work-around” was designed to avoid the current \$10,000 limitation on the deductibility of state and local taxes for Federal tax purposes.

Here is how it works:

The shareholder/partner will report their share of the corporate or partnership net income to the Internal Revenue Service, but this net will be reduced by the amount of the state tax paid at the entity level. For California, the state tax deducted on the federal return will be added back into net income on the California K-1, but the owners will receive a California tax credit for the tax paid.

Boiling it down, this allows the K-1 recipient to reduce their federal AGI by the state tax paid, rather than having a state tax deduction on Schedule A. As you know, the state taxes deduction is subject to the \$10,000 state and local tax (SALT) limit.

This type of SALT workaround has been approved by the IRS (IRS Notice 2020-75).

California recently passed additional legislation that clarifies the process and makes it favorable for most business owners. The credit limitations have been removed, and those who are allowed to use this process have been expanded.

Still, before making the election, one must consider current income levels, future business growth, and the real possibility that a taxpayer won't be able to use the entire credit he/she paid for in the initial year.

Here are several Frequently Asked Questions about the Pass-Through Entity Tax.

What is a Qualified Pass-Through Entity (PTE)?

A qualifying PTE is an entity taxed as a partnership or S corporation. Single member LLCs, in some cases, are now eligible. C Corporations don't qualify.

Who is a Qualified Taxpayer?

Can be an individual, fiduciary, estate, or trust subject to California personal income tax. They must also be a partner, member, or shareholder of a Qualified PTE.

How do you make the election?

An annual election is made on an original, timely filed tax return (California Form 100S, 565 or 568), using Form 3804. Once the election is made, it is irrevocable for that year and is binding on all partners, shareholders, and members of the PTE. An extended tax return will be considered a timely filed return for the purposes of making the election.

When do you pay the Elective Tax?

For the 2021 taxable year, you must pay the elective tax on or before the due date of the original tax return, which is March 15, 2022. The tax is due without regard to extensions. Payment Voucher FTB 3893 is used to make the payment.

What is the PTE elective tax calculation?

The elective tax is 9.3% of the entity's qualified net income, which is basically the total taxable income subject to California personal income tax. There is no adjusting this percentage.

When do you get the federal deduction for PTE Tax?

The payment needs to be made on or before March 15, 2022. Because the payment is made in 2022, the federal deduction would be taken on your 2022 tax return.

What is included in an entity's qualified net income?

In general, for an S Corporation, this will be the sum of lines 1-10 (all different types of income) minus the sum of lines 11 and 12 (Section 179 and donations) that are on the K-1 (100S). For a partnership, it will be the same, including guaranteed payments made to partners on the K-1 (565/568).

Incidentally, a gain from the sale of an entity level asset (goodwill, for instance) is also included.

How does a taxpayer claim his/her tax credit?

Qualified taxpayers are eligible to claim a nonrefundable credit for the amount of tax paid on their portion of the PTE's qualified net income. Unused credits can be carried over for up to 5 years. The credit is claimed on their personal income tax return.

The credit is applied to your taxes before withholding and estimated payments. So, if your PTE credit causes you to overpay your taxes, that amount will be refunded or applied to future years.

Can you walk us through a simple calculation?

McFerson Enterprises, Inc. is taxed as an S Corporation, has one shareholder, and has qualified net income of \$200,000 for the year. Using the required 9.3% tax rate, the corporation makes a payment of \$18,600 to the FTB. The corporation then reports \$181,400 (\$200,000 - \$18,600) of net income on the Federal Form 1120s. The California returns filed will report \$200,000 of net income, and a credit of \$18,600 will be available for use against the sole shareholder's individual California income tax.

The shareholder then reports this credit on his/her personal California tax return. Whether this \$18,600 credit can be used in its entirety in the first year depends on the individual taxpayer's personal tax situation. If the credit isn't used in full by year five, then the remaining balance is forfeited.

What happens if the current SALT limitation is repealed by Congress?

If the \$10,000 SALT limitation is repealed, then AB 150 states that the PTE will be pulled on the following January 1. So, as an example, if the SALT limitation is repealed in 2022, the PTE will remain in effect for 2021 and 2022, but not for 2023 and beyond. If the SALT limitation is only modified (increasing it from \$10,000 to \$40,000, for instance) then the PTE will stay in place.

Again, there are still several unanswered questions about this process, and the Pass-Through Entity Tax will not financially benefit everyone. We will keep you posted on further developments and legislative updates.

Please let us know if you have any questions.

Sincerely,



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