GattoMcFerson
Certified Public Accountants

May 31, 2022

Dear Friends and Colleagues,

California is requiring a "down-payment" on the Pass-Through Entity Tax Credit (PTE) for 2022, due June 15, 2022.

This amount is calculated one of two ways:

1. If you did not take advantage of the PTE credit for the 2021 tax year, then you are required to pay $1,000 to California, with the remaining balance of the 2022 credit payable by December 31, 2022;
2. If you did take advantage of the PTE credit for the 2021 tax year, then you are required to pay 50% of the 2021 credit, with the remaining balance of the 2022 credit payable by December 31, 2022.

Taxpayers must pay the greater of these two amounts. There are no exceptions to this requirement. Taxpayers who don't pay the correct amount by June 15, 2022 will not be able to take advantage of the PTE credit for 2022.

As a review, several states, including California, 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).

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

When do you pay the PTE "Down-Payment" on the 2022 Elective Tax?

As mentioned above, the payment is due June 15, 2022, no exceptions.

How is the PTE "Down-Payment" for 2022 calculated?

The greater of:

- $1,000; or,
- 50% of the 2021 PTE credit.

What if you decide to not pursue the PTE credit after you've made the June 15 payment?

Any payment you make on June 15 will be refunded to you when you file your 2022 corporate tax return, due March 15, 2023. An analysis should be made prior to June 15 to make sure the PTE credit is worth pursuing for 2022.

What if your income turns out to be much lower in 2022 than it was in 2021?

You're still required to pay 50% of your 2021 PTE credit, regardless of what 2022 looks like. Any excess payment will be refunded when you file your 2022 corporate tax return, due March 15, 2023. An analysis should be made prior to June 15, to make sure the PTE credit is worth pursuing for 2022.

What if you're on extension and you're not sure exactly what your 2021 PTE credit will be?

Figure the 2021 PTE credit as best you can, then calculate 50% of this amount AND add a cushion. You don't want to be short of the 50% mark, since the Franchise Tax Board has clearly stated your participation in the 2022 PTE will be disallowed, no exceptions.

When do you get the federal deduction for PTE Credit?

To get the full deduction on your 2022 tax return, the entire PTE credit needs to be paid in 2022. A calculation will likely need to be made at the end of the year, and the remaining payment made by December 31, 2022.

What about deducting the 2021 payment made March 15, 2022?

This you also get to deduct on your 2022 tax return. So, a double deduction is likely for PTE payments made towards 2021 and 2022.

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. 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.

Does this credit impact the amount of California estimated taxes I should pay?

Yes! The credit is essentially a large tax payment made by you. You absolutely should factor this amount in when calculating your quarterly estimates.

What if you form a new entity (S Corporation, LLC) after June 15, 2022? Are you still eligible?

Yes. Any PTE tax payment due would be payable at the end of the year, based on the number of months the new entity is in existence.

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.

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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