

# CALIFORNIA ENACTS CHANGES TO ELECTIVE PASS-THROUGH ENTITY TAX

February 10, 2022

Governor Newsom signed Assembly Bill (“A.B.”) 87 on February 9, 2022. This alert is primarily focused on the portion of the bill involving legislative corrections to the California elective pass-through entity (“PTE”) tax rules enacted under A.B. 150 on July 16, 2021. It also summarizes the portion of the bill that makes changes to California NOL and credit utilization for tax years beginning after January 1, 2022, that had been enacted as part of A.B. 85 on June 29, 2020. The newly enacted law makes changes and corrections as indicated in the tables below.

Effective for tax years beginning on or after January 1, 2021:

Previous Rule enacted under A.B. 150	New Rule enacted under A.B. 87
The PTE tax credit was limited to offset only regular tax in excess of California Tentative Minimum Tax (“TMT”).	The PTE tax credit can now reduce net income tax below the California TMT.
Guaranteed payments were not considered part of an entity’s qualified net income for the PTE elective tax purposes since they were not part of the PTE tax distributive share.	Guaranteed payments are now allowed to be included in the California PTE tax base of a qualified taxpayer.
Business entities disregarded for federal tax purposes, such as single member limited liability companies (“SMLLCs”), and their owners were not qualified taxpayers eligible to be included in the PTE tax base.	SMLLCs owned by individuals, estates, or trusts are now included in the definition of a qualified taxpayer, allowing them and their owners to be included in the PTE tax base.
Only qualifying entities were eligible to make the PTE Tax election, which did not include pass-through entities with owners that are partnerships.	Pass-through entities that have partnerships as partners are now included in the definition of a qualified entity, allowing them to make the PTE tax election. However, partnerships are not qualified taxpayers, so their income is not included in the PTE tax base and they will not receive any PTE tax credit.

Effective for tax years beginning on or after January 1, 2022:

Previous Rule enacted under A.B. 150	New Rule enacted under A.B. 87
The credit for taxes paid to other states (“OSTC”) was claimed by a qualified taxpayer after their PTE tax credit. As a result, certain qualified taxpayers could permanently lose a portion of their OSTC.	The OSTC will now be claimed by a qualified taxpayer before their PTE tax credit.

# CALIFORNIA ENACTS CHANGES TO ELECTIVE PASS-THROUGH ENTITY TAX

Effective for tax years beginning on or after January 1, 2022 (continued):

Previous Rule enacted under A.B. 85	New Rule enacted under A.B. 87
The utilization of California business tax credits for tax years 2020, 2021 & 2022 was limited to \$5M per year.	The \$5M business credit limit for tax years beginning on or after 1/1/2022 is eliminated.
The utilization of California NOLs for taxpayers with net business income of \$1M or more was suspended for tax years 2020, 2021 & 2022.	The suspension of California net operating loss utilization for tax years beginning on or after 1/1/2022 is removed.

## Summary of Benefits, Key Consideration, and Next Steps

- Partnerships that were previously not considered qualified entities as a result of having partnerships as partners, should reconsider if these legislative corrections would now allow them to make the PTE election. These pass-through entities should re-assess their PTE tax liability prior to the required annual election on an original, timely filed return and corresponding payment.
- Qualified entities making the PTE election whose owners are SMLLCs that were previously not considered qualified taxpayers should reconsider if these legislative fixes would now allow them to include their pro-rata or distributive income in the PTE tax base. The inclusion of pro-rata or distributive income from these entities could increase a qualified taxpayer's federal deduction for state and local taxes.
- Qualified taxpayers should re-compute their PTE tax credit and see if any of these legislative corrections remove previous limitations to the amount of their available PTE tax credit.

If you have any questions about the changes to PTE, please contact your HCVT tax professional or Doug Andersen or Goran Jovicic.

Douglas Andersen, Partner | [douglas.andersen@hcv.com](mailto:douglas.andersen@hcv.com) | (562) 216-5512

Goran Jovicic, Senior Manager | [goran.jovicic@hcv.com](mailto:goran.jovicic@hcv.com) | (562) 216-5539