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California Enacts Elective Pass-Through Entity Tax

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The California Governor signed Assembly Bill 150 on July 16, 2021. This alert is focused on the Small Business Relief Act Portion of the bill and the related establishment of a California pass-through entity ("PTE") elective tax.

California now joins several other states, such as New York and New Jersey, that have created a PTE tax, providing qualified pass-through entity owners a workaround of the federal $10,000 limit on state and local taxes deductions.

PTE Tax Eligibility

The PTE tax is effective for elective qualifying entities for tax years beginning on or after January 1, 2021, through December 31, 2025. Qualifying entities are partnerships or S corporations with owners that are exclusively corporations, individuals, fiduciaries, estates, and trusts. Qualifying entities do not include PTE's with owners that are partnerships, publicly traded partnerships, or entities required to be included in a California combined reporting group.

Additionally, "qualified taxpayers" include individuals, fiduciaries, estates, and trusts (does not include corporations) that consented to have their pro-rata or distributive income be subject to the PTE Tax.

PTE Tax Structure

The PTE tax is 9.3% of qualified net income, which is the qualified taxpayers' pro-rata or distributive income subject to California income tax.

- For California resident owners, the qualifying entity's pre-apportioned income is included in the PTE tax base.
- For nonresident owners, the California source portion of the qualifying entity's income is included in the PTE tax base.

- The income of corporations, disregarded entities, and other non-qualified taxpayers are not included in the PTE tax base.

PTE Owner Tax Credit

A qualifying taxpayer may claim a nonrefundable credit to offset their California individual income taxes equal to 9.3% of the qualified taxpayer's qualified net income subject to the PTE tax. PTE tax credit exceeding the qualified taxpayer's current year California personal income tax may be carried forward for up to five years.

PTE Tax Election

The PTE tax requires an annual election on an original, timely filed return, which is irrevocable for that year and is binding on all owners of the PTE.

PTE Tax Payments

For taxable years beginning on or after January 1, 2021, and before January 1, 2022, the PTE tax is due on or before the due date of the original return ignoring any extensions.

For taxable years beginning on or after January 1, 2022, either 50% of the PTE tax paid in the prior year or $1,000, whichever is greater, is due by June 15 of the taxable year. If no payment is made by June 15 of the taxable year, the qualifying entity may not make the PTE election for that taxable year. The remainder of the PTE tax is due by the original due date of the PTE return ignoring extensions.

Summary of Benefits and Key Considerations

Benefits

- Provides qualified taxpayers a viable workaround of the federal $10,000 limitation on the deduction of state and local taxes.
- California resident and nonresident qualified taxpayers may claim PTE tax credit to offset their California income taxes.

Key Considerations

- The PTE tax election is required to be made annually on or before the original due date of the qualified entity's tax return.
- For applicable years beginning on or after January 2022, the PTE tax election is invalid unless a PTE tax payment has been made by June 15 of the taxable year.
- The PTE tax election is irrevocable for the tax year once made.

- PTEs with partnership owners are specifically excluded from being eligible to make a valid PTE tax election.

Next Steps

- Partnership or S corporations eligible to be considered as electing qualifying entities should consider whether making the election and paying the elective tax on or before the original due date of these 2021 tax returns would help maximize the qualified taxpayer's federal deduction for state and local taxes.
- Consider whether highly compensated California employees may benefit by restructuring their wages as pass-through entity income and electing California PTE tax.

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