



The SALT workaround for owners of passthrough entities!

- **A reminder of the SALT limit:** The Tax Cuts and Jobs Act of 2018 reduced the total state and local income tax (SALT) deduction to a maximum of \$10,000 per taxpayer. This meant that taxpayers could not deduct property taxes and state income taxes in excess of \$10,000. In California especially, this was a HUGE lost deduction for taxpayers, many of whom pay well over \$10,000 a year for property taxes alone.
- **AB 150 is California's (and many other states') solution:** For tax years 2021-2025, a qualified passthrough business, such as an S-corporation, partnership, or multi-member LLC, can elect to pay a tax equal to 9.3% of qualified income on behalf of the shareholders/partners.

Will the SALT limit be repealed anyway?

If the \$10,000 SALT limitation is repealed, this elective passthrough entity tax will be inoperable.

- **How it works:** The passthrough entity will pay the state tax directly to the agency. The state tax will be a deduction to the passthrough entity, thereby reducing total federal taxable income that is passed through to the owners. It does NOT reduce state taxable income passed through to the owners. The owners will then take a non-refundable credit on their individual state income tax returns equal to the amount of tax paid on their behalf, thereby reducing their state tax liability.

So, the owners will have to report less federal taxable income as a way to make up for the lost itemized deduction if they had paid the state tax personally.

- **Entities that are excluded from making this election** include single member LLC's, entities that have shareholders or partners that are partnerships themselves, and publicly traded partnerships.
- **Guaranteed payments are not included in the calculation of qualified income.** For purposes of determining 9.3% of each owners' qualified income, guaranteed payments are specifically excluded. Passthrough entities that distribute income in the form of guaranteed payments may want to reconsider weighting owner draws and guaranteed payments in a different manner.
- **All partners/shareholders do NOT have to agree.** The election does not have to be unanimous or even a majority vote. The entity will calculate 9.3% of each partner/shareholder's qualified net income (distributive income reported on their K-1's) for only the partners/shareholders that want to participate.

***Caution for S-corporations!** Partnerships by law are allowed to "specially allocate" expenses, meaning the partnership can specifically apply the expense to only those partners that opt in. S-corporations are not allowed to specially allocate expenses. So if you are in a shareholder in an S-corporation with other shareholders who opt-out, they will still benefit from the additional tax deduction based on their ownership percentage even though they opted out of this election. The AICPA has currently asked the IRS to issue a regulation to fix this major issue with the passthrough entity election.*

- **Paying the tax:** For calendar year entities, the tax for 2021 would be due 3/15/22. The partners/shareholders would take the credit on their 2021 state tax returns, however, as the law is currently written, the tax is actually deducted in 2022 by the passthrough entity (so the passthrough income reduction wouldn't be reflected until 2022). For tax years after 2021, the tax payment is split into two payments.
- **Tax payments before 12/31/21:** Passthrough entities can make the payments before the end of 2021 in order to both reduce 2021 federal income *and* enable the owners to take the credit for 2021. The FTB has created a voucher (form 3893) and updated its online WebPay for Business for the corresponding payment. The form can be found here: <https://www.ftb.ca.gov/forms/2021/2021-3893.pdf>
- **Some reasons not to rush into making the payment for 2021:**
 - ✓ The credit is non-refundable and only carries forward for 5 years. If the owner cannot use the full credit, it gets carried forward to a future year. Future year income should be considered carefully if reduced income is expected. Additionally, prepayment is essentially giving the state agencies interest free loans. If there is no immediate benefit to the owner, it might be better to hold off.
 - ✓ Estimated tax payments are refundable; this credit is not. It is unclear of the ordering rules if the taxpayer has a state overpayment resulting from a combination of estimated tax payments and this credit. Will it be refunded or not? Many taxpayers have already paid most of their estimated tax payments for 2021 personally. The entity might want to consider waiting until 2022 to begin paying this elective tax.
 - ✓ The credit does not reduce a taxpayer's California tentative minimum tax (TMT). This means that the benefits of the passthrough entity tax may be limited for some taxpayers, especially those with larger amounts of income from their passthrough entities.
 - ✓ The entity will need to quickly calculate an estimate of qualified income in order to make a payment before 12/31/21. While there are no underpayment penalties, overpaying potentially depletes cash without reason.

This is a complex and brand new law that still has some major flaws. While overall this is a great way to work around the SALT limit for owners of passthrough entities, we recommend reaching out to us to discuss your individual situation before making any payments before 12/31/21.