State Tax Observations

California – Latest State to Provide SALT Relief via Pass-Through Entity Tax

By Alan S. Kufeld, CPA, Partner and Steven J. Eller, JD, CPA, Partner

California joined the growing list of states by recently enacting a pass-through entity (PTE) tax effective for tax years beginning on or after January 1, 2021 and ending before January 1, 2026, unless repealed sooner. The law allows electing qualifying entities to pay and deduct state income tax at the entity level thereby circumventing the individual $10,000 State and Local Tax (SALT) deduction limitation imposed by the 2017 Tax Cuts and Jobs Act.

Eligibility

A qualified PTE is eligible to make the election as long as:

- It is a partnership or an S-Corporation;
- Its owners consist solely of individuals, fiduciaries, trusts, estates, or entities taxable as corporations, and
- It is not permitted or required to be included in a California combined group report.

Qualified entities do not include publicly traded or tiered partnerships and disregarded entities.

Annual Election

The election, which is irrevocable, is made with the timely filing of the original tax return, including extensions, as long as estimated taxes were paid. However, unlike other states, PTE owners can elect out of this tax without affecting other owners.

Tax Rate

The tax rate is a flat 9.3% of the PTE's qualified net income which includes a resident owner's share of the qualified entity's net income from all sources and the total of the nonresident owners' share of the qualified entity's net income.

Estimated Tax Payments

For tax years beginning January 1, 2021, the first year of the election, no estimated tax payments are required, but the total amount of the tax due must be paid by the filing deadline of the return, without regard to any extensions. For tax years beginning on or after January 1, 2022, electing PTEs must make an estimated tax payment equal to the greater of (a) 50% of elective tax paid in the prior taxable year, or (b) $1,000 by June 15th of the taxable year of the election. Failure to make the estimated payment by the June 15th deadline will disqualify a PTE from making the election for that taxable year.

Nonrefundable Tax Credit

A qualified PTE owner may claim a full nonrefundable credit for the amount of tax paid on the owner's distributive share of the PTE's qualified net income. A credit that exceeds a qualified owner's actual tax liability can be carried forward for up to five years.

Will California Allow a Credit for Other States' PTE Tax?

Unlike other states, California's law does not explicitly provide for a tax credit for other states' PTE tax.

Observations

As with other states that have recently enacted a PTE tax, there are several unanswered questions. One such question is whether a general partnership is eligible to make this election. While the California Franchise Tax Board is expressly authorized to provide regulations, it will take some time before they are issued.

Contact Us

For questions concerning the California PTE tax or if you have state tax questions generally, contact a member of your client service team or the following:

Alan S. Kufeld, CPA
Partner
akufeld@pkfod.com | 646.449.6319

Steven J. Eller, JD, CPA
Partner, Co-Head of State and Local Tax
seller@pkfod.com | 551.249.1836

About PKF O'Connor Davies

PKF O'Connor Davies, LLP is a full-service certified public accounting and advisory firm with a long history of serving clients both domestically and internationally. With roots tracing to 1891, fourteen offices in New York, New Jersey, Florida, Connecticut, Maryland and Rhode Island, and more than 1,000 professionals, the Firm provides a complete range of accounting, auditing, tax and management advisory services. PKF O'Connor Davies is ranked 27th on *Accounting Today's* 2020 "Top 100 Firms" list. It is also ranked among the top 20 best accounting employers to work for in North America by *Vault*.

PKF O'Connor Davies is the lead North American representative in PKF International, a global network of legally independent accounting and advisory firms located in over 400 locations, in 150 countries around the world.