

CLIENT ALERT

# Increased Flexibility and Clarity for Owners of California Pass-Through Entities

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## AUTHORS

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On February 9, 2022, California Governor Gavin Newsom signed into law Senate Bill 113 (the “Bill”). The Bill introduced much-needed revisions and clarifications to the pass-through entity elective tax (“PTET”) enacted in 2021. Significantly, many of these changes are retroactive to 2021.

To recap, the IRS issued a notice of proposed rulemaking in 2020 (IRS Notice 2020-75) that acknowledged, and effectively blessed, state legislative framework allowing pass-through entities (partnerships and S corporations) to make an election to pay state tax at the entity level and generate an equivalent state tax credit that passes through to the individual owners. In California, the PTET legislation allows certain qualifying partnerships and S corporations to elect to pay a 9.3% California income tax on certain qualifying income at the entity level. Qualifying owners who consent to the entity level tax receive a credit proportionate to the PTET paid with respect to their allocable share of pass-through income. The net effect is that the individual owner pays no more California income tax than he or she would have paid had the election not been made, but effectively allowing such owner to bypass the federal cap on deductions of state and local taxes against federal taxable income.

Due to legislative glitches, many taxpayers did not take advantage of the election in 2021. For example, the Bill repealed the tentative minimum tax limitation on the PTET credit. Previously, taxpayers who owed a certain minimum tax under California’s alternative minimum tax regime could not use the PTET credit to reduce their tax liability below their tentative minimum tax amount; now, taxpayers who owe the tentative minimum tax may reduce this tax liability by the amount of their PTET credit. Further, beginning in 2022, in determining how much a taxpayer’s net tax is reduced by various credits, the PTET credit will be applied against net tax after credits for taxes paid to other states. Finally, the Bill repeals one year

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early a prior limitation whereby taxpayers could not use credits to reduce their income taxes by more than \$5 million for taxable years beginning on or after January 1, 2020, and before January 1, 2023; this limitation now applies to taxable years before January 1, 2022.

The Bill also provides greater clarity and flexibility on the types of owners that may own qualifying pass-through entities and make the PTET election. Specifically, prior to the Bill, a pass-through entity owned by a partnership and individuals was not eligible to make the PTET election; whereas, under the Bill, a partnership can make the election on behalf of its individual owners, although it still cannot make the election with respect to any partner that is, itself, a partnership. Further, a limited liability company that is disregarded for federal tax purposes and owns an interest in a qualified pass-through entity will now be considered a qualified taxpayer if (i) it is a partner or shareholder of an electing qualified entity and (ii) it is owned by a taxpayer who consented to the entity-level PTET tax. Guaranteed payments will also be included in calculating the amount of a qualifying pass-through entity's income subject to the 9.3% tax, clearing up a prior ambiguity in the legislation.

Importantly, pass-through entities may make the PTET election with respect to the 2021 taxable year by March 15, 2022. For many taxpayers, the PTET was paid in 2021 in order to generate the federal tax deduction in 2021. For other taxpayers who did not pay the PTET in 2021 due to the legislative uncertainty prior to the Bill, the PTET may still be paid with respect to 2021 by March 15, 2022. The resulting California credit will apply against the individual taxpayer's 2021 California tax, but the federal tax deduction would be recognized in the year paid, 2022. Taxpayers should consult their personal tax advisors to evaluate whether to make the election prior to March 15, 2022.

Finally, unrelated to the PTET, the Bill repeals the net operating loss suspension for higher income taxpayers for the 2022 taxable year. Existing law suspended the net operating loss carryover deduction for taxable years beginning on or after January 1, 2020, and before January 1, 2023, for taxpayers with income above \$1 million. The Bill essentially removes such suspension one year early and lifts the suspension for taxable years beginning on or after January 1, 2022.

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