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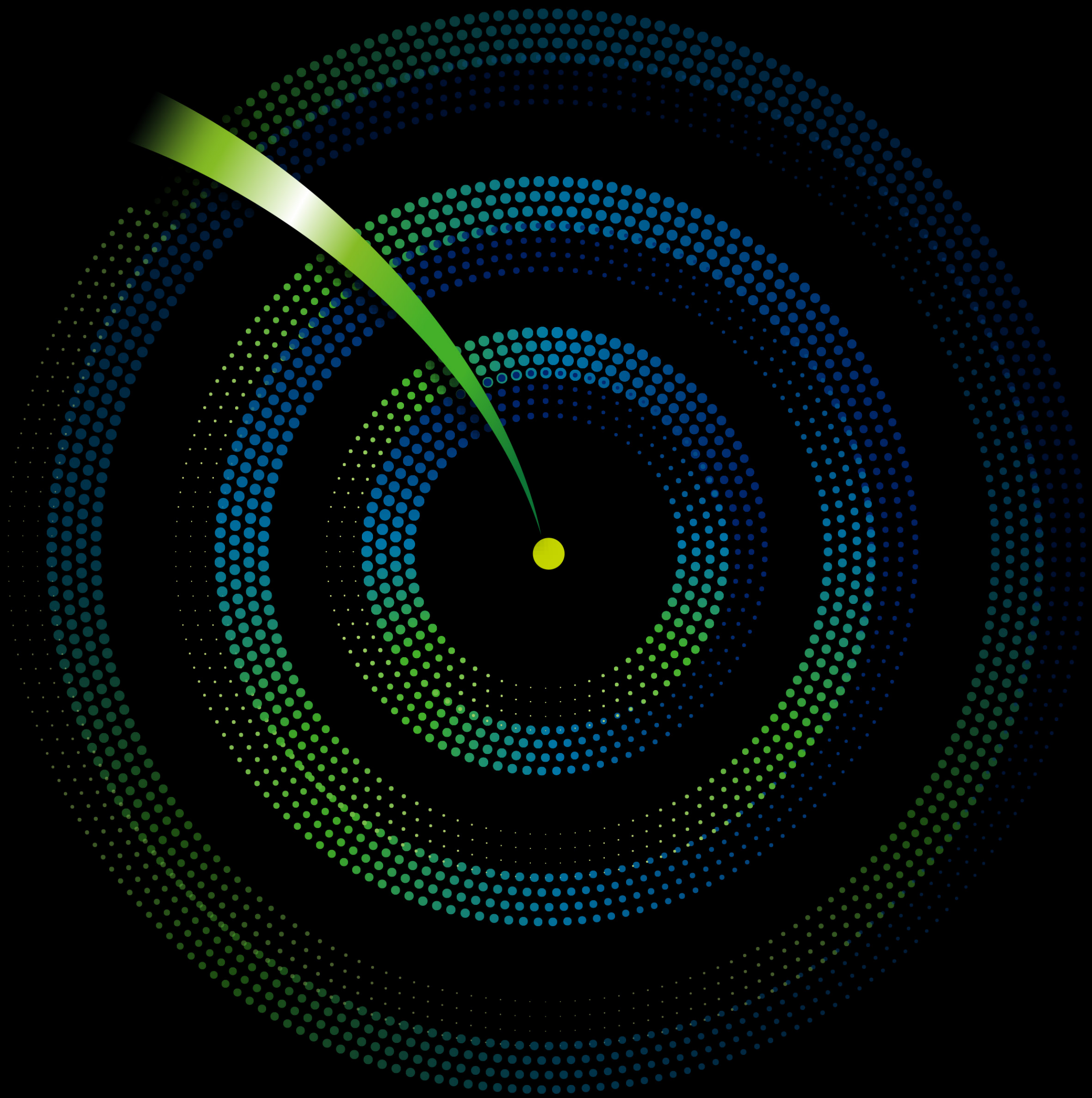

Considerations for California's pass-through entity tax

Introduction[1]

In this article, we provide an overview of the origins of pass-through entity tax (PET) regimes and take a closer look at California's recently enacted pass-through entity tax (CA PET).[2] Through this lens, we will highlight considerations that should be made before electing into the CA PET. As with all things tax, it is important to consult with your tax adviser to appropriately plan and analyze the implications, if any, of electing into a new regime.

History of PET

The Internal Revenue Code (IRC) allows individual taxpayers who itemize their deductions to claim a federal income tax deduction for state and local taxes (SALT) paid.[3] Prior to the Tax Cuts and Jobs Act (P.L. 115-97) (TCJA), there was no limitation on the deduction, meaning taxpayers could deduct all their SALT payments paid during the calendar year to the extent of their federal taxable income.[4] TCJA limited an individual's aggregate deduction for tax years 2018 through 2025 (the SALT cap or SALT limitation).[5] As a result, SALT payments in excess of the SALT cap are not deductible on the federal income tax return, Form 1040, and thus provide no benefit to an affected taxpayer. Notably, the SALT limitation does not apply to real and personal property taxes paid or accrued in carrying on a trade or business or certain other activities relating to expenses for the production of income.[6]

Many states contemplated so-called workarounds to the SALT cap to protect resident individuals from a potential increase in federal tax resulting from the limitation. The most prevalent of these is the pass-through entity tax (PET), which imposes a state and local income tax directly on the pass-through entity as opposed to the partners, members, or shareholders.

On November 9, 2020, the IRS issued Notice 2020-75 (the Notice), in which the Department of the Treasury and the Internal Revenue Service announced an intention to issue proposed regulations to clarify that state and local income taxes imposed on and paid by a partnership or S corporation on its income are allowed as an entity-level deduction in computing non-separately stated taxable income or loss for the taxable year of payment.[7] The Notice adds that such payments made by a pass-through entity to a state and local jurisdiction are generally not taken into account when applying the SALT limitation to any individual who is a partner, member, or shareholder of a pass-through entity, notwithstanding that the PET payments are creditable against the individual's state income taxes. The Notice prompted a wave of PET legislation across multiple states.

PET regimes

As of February 9, 2022, twenty-two states have enacted PET legislation.[8] While many of the state PETs target similar goals, each regime is unique, and the differences between them are often stark. These differences make the implications of electing into a PET dependent on the pass-through entity's geographic footprint, income profile, and business needs, in addition to tax classifications, residencies, and activities of each of the pass-through entity's partners, members, or shareholders. To better understand some of the moving pieces, let's take a closer look at California's recently enacted pass-through entity tax, including technical corrections made by the California legislature in February 2022.

Understanding California's pass-through entity tax

California's pass-through entity tax election is effective for tax years beginning on or after January 1, 2021, and before January 1, 2026, for qualified entities required to file a California return.[9] An electing qualified entity pays the 9.3% CA PET. Qualified taxpayers receive a credit for their share of CA PET paid.[10]

Qualified entity

A qualified entity is defined as an entity that is taxed as a partnership or S corporation and has owners that consist solely of individuals, partnerships, corporations, fiduciaries, trusts, or estates.[11] In the original legislation, the definition of a qualified entity did not include entities that have a partnership as an owner.[12] The legislature retroactively removed this exclusion when Senate Bill 113 was signed by Governor Newsom on February 9, 2022.[13] A qualified entity cannot be a publicly traded partnership, or be permitted or required to file in a combined return.[14] A general partnership may be a qualified entity, if it is treated as a partnership for California tax purposes and otherwise meets the other qualified entity requirements.[15] Entities that have disregarded entities as owners may also qualify as a qualified entity.[16]

Qualified taxpayer

Qualified taxpayer means a taxpayer as defined in California Revenue and Taxation Code Section 17004, excluding partnerships, that is an owner that consented to have their pro rata share or distributive share of income subject to the CA PET.[17] Taxpayers as defined under section 17004 include individuals, fiduciaries, estates, and trusts.[18] Qualified taxpayer does not include a business entity that is disregarded for federal tax purposes unless the disregarded entity is a single member limited liability owned by an individual, fiduciary, estate or trust subject to tax under CRTC Section 17004.[19] The Franchise Tax Board (FTB) has clarified that grantor trusts can be qualified taxpayers and that the PET credit would flow from the trust to the grantor.[20] Corporations and tax-exempt entities are not qualified taxpayers.[21] Owners that do not consent to subjecting their income to the CA PET are not qualified taxpayers.[22]

The election

California's pass-through entity tax election is irrevocable for the year in which it was made and must be made on an original, timely filed return including extensions.[23] A nonconsenting owner will not disqualify the entity from making the election to pay the CA PET.[24] For tax year 2021, payment of the CA PET must be made on or before the due date of the original return excluding extensions.[25] For tax years beginning on or after January 1, 2022, and before January 1, 2026, an amount equal to the higher of 50% of the elective tax paid the prior taxable year or $1,000 must be remitted on or before June 15 of the taxable year of the election.[26] The balance of tax due, if any, must be remitted on or before the due date of the original return without regard to any extension of time to file.[27] If a payment is not made by June 15 or the amount remitted does not equal the higher of 50% of the elective tax paid the prior taxable year or $1,000, the qualified entity may not make the election for that taxable year.[28] Qualified entities must use Pass-Through Entity Elective Tax Payment Voucher (FTB 3893) or the Franchise Tax Board's online portal to remit payment.[29] While the payment for tax year 2021 is not due until the due date of the 2021 return (March 15, 2022, for a calendar year taxpayer), FTB did provide a payment voucher and an online option for eligible entities that wanted to remit payment during calendar year 2021.[30]

The tax base

A qualified electing entity will pay tax on its qualified net income computed at a rate of 9.3%. Qualified net income in this context means the sum of the pro rata or distributive share of income of all qualified taxpayers subject to California personal income tax.[31] A qualified taxpayer includes individuals, fiduciaries, estates, and trusts that consent to have their income included in the CA PET base.[32] Business entities that are disregarded for federal tax purposes are specifically excluded from the definition of qualified taxpayer, and the disregarded business entity and its partner or member are precluded from taking the CA PET credit unless the disregarded entity is a single member limited liability company owned by an individual, fiduciary, estate or trust subject to tax under CRTC Section 17004.[33] The CA PET tax base will include the full amount of consenting California residents' distributive share of income and the California sourced portion of consenting nonresidents' share of income. Any distributive income belonging to partners or members that are corporations, nonqualifying disregarded entities, nonconsenting owners, or otherwise not qualified taxpayers will be excluded from the CA PET base.

Guaranteed payments are included in the CA PET tax base.[34] In the original legislation, guaranteed payments had to be backed out of the CA PET tax base before calculating the credit.[35] The recent amendments specifically included guaranteed payments of consenting taxpayers in the CA PET tax base as part of the corrective legislation.[36]

Net negative amounts are not included when determining the tax due or credit amount.[37]

The credit

Owners that consent to have their pro rata share or distributive share of income included in the qualified net income of the electing entity are allowed a credit for the 9.3% of tax paid on their distributive share of income.[38] Under the original legislation, the CA PET credit could not reduce tax below the tentative minimum tax. This was changed with the passage of Senate Bill 113, thus removing the tentative minimum tax limitation, which would have added complexity to the CA PET for many. Any CA PET credit in excess of the tax is not refundable but may be carried forward for up to five years.[39] Credit for taxes paid to other states by California residents is at risk of being lost for tax year 2021 due to California's credit usage ordering rules. For 2021 the CA PET credit comes before the credit for other state taxes. Any unused Other State Tax Credits (OSTC) would disappear, as there are no carryover or refund provisions for OSTC. Corrective legislation included in Senate Bill 113 corrected the credit ordering issue for tax years 2022–2025 and the OSTC would come before the CA PET credit; however, tax year 2021 is still impacted. Analysis is important as many taxpayers will find that their credit usage is not as straightforward as claiming the entire credit on their return. Potential limitations and credit usage are discussed below.

Issues and considerations

As with many new tax regimes, the CA PET has issues that need to be analyzed and further clarified. The following are a few issues to consider and discuss with your tax adviser when considering California's new pass-through entity tax regime.

Nonresident issues. Among state PET regimes, California is unique in that the state does not require all owners to be included. The decision to consent to inclusion in the CA PET base is an analysis that should be done at the owner level. California nonresidents should take into consideration whether they are eligible to receive a tax credit for the CA PET on their resident state return filing. A state may decline to provide a resident tax credit for the CA PET because the pass-through entity tax is not imposed on the individual taxpayer but on the qualified entity.

Factors such as a qualified taxpayer's state of residence and the fact that the CA PET may be carried over, whereas unused other state tax credit is lost, should be taken into consideration when analyzing the pros and cons of consenting to the CA PET.

Other state tax credits. California specifies the order that credits need to be utilized.[40] As noted above, when California originally implemented its pass-through entity tax, credit for taxes paid to other states (OSTC) was to be utilized after CA PET credit.[41] This caused a negative impact for certain taxpayers given the fact that OSTC is not refundable and may not be carried forward. To the extent CA PET credit eliminated or reduced net income tax so that OSTC was not able to be fully utilized, the credit would have been lost. Senate Bill 113 (2022) fixed this ordering issue but not for the 2021 tax year.[42] To illustrate the potential loss of OSTC and reduction of the federal benefit for the 2021 tax year, let's looks at an example of an owner that has OSTC and CA PET.

This example illustrates the importance of modeling at the individual taxpayer level where taxpayers with OSTC run the risk of losing the credit for tax year 2021. The owner in our example loses $4,754 in OSTC. As noted above, Senate Bill 113 changed the usage order of credits for January 1, 2022, and before January 1, 2026, thus reducing the risk of a qualified taxpayer losing their other state tax credit; however, modeling specific results is recommended to make sure the taxpayer can anticipate their ability to use the credit carryover within the five-year period.

	California Entity Tax 2021	California Entity Tax 2022	Lost credits
Consent to CA PET	Yes	Yes	
CA PET (based on $1,000,000 PET tax base)	$93,000	$93,000	
California tax before credits (based on $1,000,000 California taxable income at 12.3%)	$93,246	$93,246	
OSTC for tax years 2022–2025	$0	$5,000	
CA PET credit used	$93,000	$88,246	
OSTC for tax year 2021	$5,000		
Lost OSTC	$4,754	-	$4,754
CA PET credit carryover - 5 years			
2021	$0	-	-
2022		$4,754	
Total	**$0**	**$4,754**	**$4,754**

Nonresident withholding. A qualified entity that also has nonresident withholding obligations may not use the CA PET in its nonresident withholding calculation.[43] To the extent the qualified entity does overpay CA PET, it can use the overpaid amount to offset current year liabilities at its level or have the amount refunded.[44] Overpayment of CA PET may not be carried forward.[45] Overpaid amounts may not be credited to the qualified entity's owners. Qualified entities electing into the CA PET will still be responsible for remitting withholding on behalf of their nonresident partners where applicable. Nonresident owners that consent to inclusion in the CA PET should consider applying for a nonresident withholding waiver exemption to reduce this double remittance.[46]

Tax credits limited to $5 million. In June 2020, Assembly Bill 85 (AB85) was signed into law in California. AB85 puts a $5 million limit on the use of business tax credits that may reduce a taxpayer's California income tax liability. This limitation is applicable through tax year 2021.[47] The $5 million limit

applies to the sum of all business credits available in a particular year and, as such, includes the CA PET credit. Taxpayers with business credits expected to exceed $5 million for the 2021 tax year should model their specific facts.

Prior to Senate Bill 113, the $5 million credit limit was set to apply to the 2022 tax year as well, but the legislature updated the law to sunset beginning January 1, 2022.[48]

CA PET credit is nonrefundable but may be carried over for up to five years. To the extent a taxpayer cannot utilize the entire amount of CA PET credit in a given year, they may carry the excess credit forward for five years after which point it will expire. A taxpayer may consider not consenting in a particular year in order to ensure full utilization of available CA PET credits before they expire. Again, modeling at the individual owner level is helpful in determining whether a qualified taxpayer's particular facts run the risk of having credits expire unused.

Guaranteed payments are includable in the CA PET tax base. Per the technical corrections made as part of Senate Bill 113 (2022) guaranteed payments are included in the CA PET tax base.[49] There was some question whether guaranteed payments would be treated as distributable income because when determining California source income for nonresident partners, guaranteed payments are sourced as if they were a distributive share of partnership income, and the FTB originally issued guidance stating that guaranteed payments are excluded from the CA PET base and computation of the CA PET credit. The legislature cleared up this issue by specifically providing for inclusion of guaranteed payments of qualified taxpayers in the CA PET tax base.[50]

Nonresident group return filing implications. Taxpayers that previously elected to file as part of a California Nonresident Group Return will need to file separate returns in California to utilize the CA PET credit. The FTB has indicated that the CA PET credit may not be taken on a nonresident group return.

S corporation election. S corporations may only have one class of stock based upon binding governing documents. In general, an S corporation is presumed to have one class of stock when all outstanding shares of stock have identical rights to distribution and liquidation proceeds. As such, S corporations cannot specially allocate expenses and cannot make disproportionate distributions.

For CA PET, only shareholders that consent to inclusion in the CA PET will receive their share of the PET credit. Further, the CA PET is computed on pre-apportioned pro rata or distributive share of qualified net income of a consenting California resident and post-apportioned pro rata or distributive share of qualified net income of a consenting nonresident. Making the CA PET election could change the economics to the owners and unlike a partnership, the S corporation cannot change the distributions or specially allocate the expense to correct the economics. S corporations that are considering making the CA PET election could potentially violate their S election if they change their distributions to fix the economics caused by some of their shareholders not consenting to inclusion and/or the consenting shareholders are composed of California residents and nonresidents.

The AICPA has asked the IRS Chief Council's Office of Passthroughs to issue guidance on the possible second class of stock issue.[51]

Qualified taxpayer excludes disregarded entities. The definition of qualified taxpayer specifically excludes business entities that are disregarded for federal purposes unless the disregarded entity is a single member limited liability company owned by an individual, fiduciary, estate or trust subject to tax under CRTC Section 17004.[52] While having a disregarded entity as a partner or member does not disqualify a pass-through from qualified entity status and making the CA PET election, a business entity that is disregarded is not eligible to receive CA PET credit. Entities that are disregarded under California Revenue and Taxation Code 23038 are considered disregarded for purposes of eligible taxpayer status.[53] As discussed above, the FTB has confirmed that grantor trusts could be qualified taxpayers.

Tiered partnerships. California's original PET legislation specifically excluded pass-through entities that have partnerships as partners from making the election. With the passage of Senate Bill 113 (2022), taxpayers with tiered partnership structures that want

to participate in California's pass-through elective tax regime are no longer excluded from participating.54 It is important to note that while having a partnership as an owner will not preclude an entity from being a qualified entity, a partnership cannot be a qualified taxpayer.55 That is, an upper tier partnership's share of income may not be included in the qualified entity tax base and the upper tier partnership owner will not receive any CA PET credit.

General partnerships. There was some early concern that general partnerships would not be eligible to make the CA PET election based on the definition of a qualified entity. Specifically, the language in California Revenue and Taxation Code Section 19902 defining a qualified entity as an "entity that is taxed as a partnership or 'S' corporation" raised the question whether a general partnership is taxed.[56] The FTB has stated that general partnerships are eligible to make the CA PET election so long as they otherwise meet the definition of a qualified entity set forth in California Revenue and Taxation Code Section 19902.[57]

Election timing and payment considerations. For tax year 2021, the election must be made on an original, timely filed return including extensions.[58] As the CA PET election will be made after calendar year 2021, this raises questions around the deductibility of the CA PET expense for tax year 2021. These issues and questions should be discussed with a tax adviser when considering the timing of the CA PET payments and the deductibility of the expense for both a cash basis and an accrual basis taxpayer.

Takeaways

While California's PET regime appears straightforward at first glance, the details are complicated and require a deeper analysis. The analysis is heavily weighted at the owner level, and pass-through entities should encourage their owners to consult with individual tax advisers to determine whether to consent to inclusion in California's PET regime.

Endnotes

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2. 2021 Bill Text CA A.B. 150; Senate Bill 113 (2022).
3. *See* generally I.R.C. § 164(a).
4. *See* I.R.C. § 56(b)(1)(A)(ii). Note, however, that the deduction will not be considered for purposes of determining an individual's alternative minimum tax unless the SALT deduction is allowable in computing adjusted gross income under I.R.C. § 62.
5. *See* § 164(b)(6)(B) ("[T]he aggregate amount of taxes taken into account … for any taxable year shall not exceed $10,000 ($5,000 in the case of a married individual filing a separate return)").
6. *See* § 164(b)(6)(B) (referring to taxes described in § 164(a)(1) (real property taxes) and (a)(2) (personal property taxes)).
7. *See* generally I.R.S. Notice 2020-75, 2020-49 I.R.B. 1453.
8. These include Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Georgia, Idaho, Illinois, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, New Jersey, New York, North Carolina, Oklahoma, Oregon, Rhode Island, South Carolina, and Wisconsin. As of the same date, Ohio and Pennsylvania have proposed PET legislation. This is in addition to jurisdictions that already impose entity-level taxes, such as the District of Columbia, New Hampshire, New York City, Tennessee, and Texas.
9. *See* Cal Rev. & Tax. Code §§ 17052.10(a) - (b), 19900, 19902. Qualified entity generally includes partnerships, limited liability companies treated as partnerships, and S corporations.
10. *See* Rev. & Tax. § 17052.10(a).
11. *See* Rev. & Tax. § 19902(a).
12. *See* Assembly Bill 150 (2021).
13. *See* Senate Bill 113 (2022); REV. & Tax. § 19902(a).

Endnotes

14. *See id*. § 19902.
15. State of California Franchise Tax Board (FTB), "Help with pass-through entity elective tax," accessed Jan. 27, 2022.
16. Ibid.
17. *See id*. § 17052.10(b)(3)(A).
18. *See* Senate Bill 113 (2022); Rev. & Tax. § 17004.
19. *See id*.
20. *See* Franchise Tax Board, supra note 15.
21. *See id*. § 17052.10.
22. *See id*.
23. *See id*. § 19900(d).
24. *See id*. § 19900(c).
25. *See id*. § 19904(a)(1).
26. *See id*. § 19904(a)(2)(A).
27. *See id*. § 19904(a)(2)(B).
28. *See* Rev. & Tax. § 19904 (a)(2).
29. *See* Rev. & Tax. § 17951-4, Franchise Tax Board, supra note 15.
30. FTB Form 3893.
31. *See* Rev. & Tax. §§ 17052.10(b)(2), 19900(a)(2).
32. *See* Rev. & Tax. §§ 17052.10(b)(3)(A), 17004.
33. *See* Rev. & Tax. § 17052.10(b)(3)(B).
34. *See* Senate Bill 113 (2022).
35. *See* Franchise Tax Board, supra note 15.
36. *See* Senate Bill 113 (2022); Rev. & Tax. § 17951-4.
37. Ibid.
38. *See id*. § 17052.10(a).
39. *See id*. § 17052.10(a).
40. *See* Rev. & Tax. § 17039.
41. *See* Assembly Bill 150 (2021); Franchise Tax Board, supra note 15.
42. *See* Senate Bill 113 (2022).
43. *See* Franchise Tax Board, supra note 15; Senate Bill 113 (2022).
44. Ibid.
45. *See* Franchise Tax Board, supra note 15.
46. *See* Franchise Tax Board Form 588.
47. *See* Senate Bill 113 (2022).
48. *See id*.
49. *See* Senate Bill 113 (2022).
50. Ibid.
51. *See* AICPA Offers Comments on Future Proposed SALT Regs, 2021 TAX NOTES TODAY (Oct. 26, 2021).
52. *See* Senate Bill 113 (2022); Rev. & Tax. § 17004.
53. *See id*.
54. *See* Senate Bill 113 (2022).
55. *See* Rev. & Tax. § 17052.10(b)(3)(A).
56. *See* Franchise Tax Board, supra note 15.
57. Ibid.
58. *See* Rev. & Tax. § 19001(d).

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