

Lucas Horsfall Presents

AB150 – California's SALT Limitation Workaround

Tuesday, September 21 | 11:00 - 12:00 AM PT



Michael Rodgers
Tax Director
mrodgers@LHMP.com



Kenneth Woerner
Tax Director
kwoerner@LHMP.com

Background

- Prior to 2018, taxpayers were able to deduct state and local taxes paid as part of their itemized deductions against their Federal income to decrease their Federal liability.
- The *Tax Cuts & Jobs Act* (TCJA) signed by President Trump in late 2017 capped the state and local tax (SALT) deduction at \$10,000 per taxpayer.
- Consequently, many high taxed states including California have sought workarounds to lessen the negative effects felt by their taxpayers.

The Workaround at a Glance

- Eligible flow-through entities (Partnerships & S-Corporations) are able to pay a portion of the partners/shareholders state income tax on their behalf.
- Partners/shareholders Federal income is reduced by the amount of the payment.
- Partners/shareholders receive a state tax credit equal to the amount of the payment to offset their state liability.
- The IRS has given the green light to this approach per Notice 2020-75

Eligibility

- Entities taxed as Partnerships & S-Corporations are eligible.
- Only individuals, estates, and trusts are eligible partners/shareholders for purposes of receiving the credit.
- Entities with other Partnerships as owners are not eligible whatsoever and negate the availability of the benefit to all other owners.
- Entities that are permitted or required to be in a combined reporting group are not eligible.
- Disregarded entities/single member LLC's are not eligible. (We are hopeful this will change otherwise there are potential workarounds to this situation).

Finer Details

- The rate the entity pays on behalf of the partners/shareholders is a flat 9.3% on all income subject to tax.
- The credit each partner/shareholder receives for their share of the tax paid on their behalf is non-refundable.
- If a partner/shareholder has losses from other income or is at a lower marginal tax rate such that the credit cannot be fully utilized, it can be carried over up to five years.
- Not all partners/shareholders have to be on-board and consent, but this can create some issues.
- The election to participate by the entity and their partners/shareholder is an annual election which is irrevocable once made for that tax year.

Potential Federal Savings

- While the ultimate savings amount will vary for each individual taxpayer, there are two easy percentages to keep in the back of your mind depending upon the character/classification of the business income:
 - QBI [A] Business Income = 2.75% of net income
 - Non-QBI (SSTB) [B] Business Income = 3.44% of net income
- [A] – QBI businesses include construction, manufacturing, distribution, food service, insurance agencies among others
- [B] – Non-QBI/SSTB businesses include attorneys, doctors, and accountants among other professional services

Numerical Example

	Without AB150	With AB150
Wages	200,000	200,000
Flow-Through Income	1,000,000	907,000
QBI Deduction	(200,000)	(181,400)
Itemized Deductions	<u>(35,000)</u>	<u>(35,000)</u>
Taxable Income	965,000	890,600
Federal Tax Liability	321,477	293,949
California Tax Liability	133,218	133,218
Federal Savings		27,528

Tax Payment Due Dates

- For the 2021 tax year, the passthrough entity tax is due March 15th, 2022 (assumes a calendar year taxpayer).
- For the 2022-2025 tax years, the greater of \$1,000 or 50% of the prior year tax is due on June 15th of the taxable year and the remaining is due by the entity's original filing deadline (March 15th).
- You are not able to pay late! Failure to pay the greater of \$1,000 or 50% of the prior year tax by June 15th eliminates the entity's ability to make the election for that tax year.
- Presently, there is no safe-harbor based on current year income should current year income be anticipated to drop.

Tax Payment Timing for Deduction

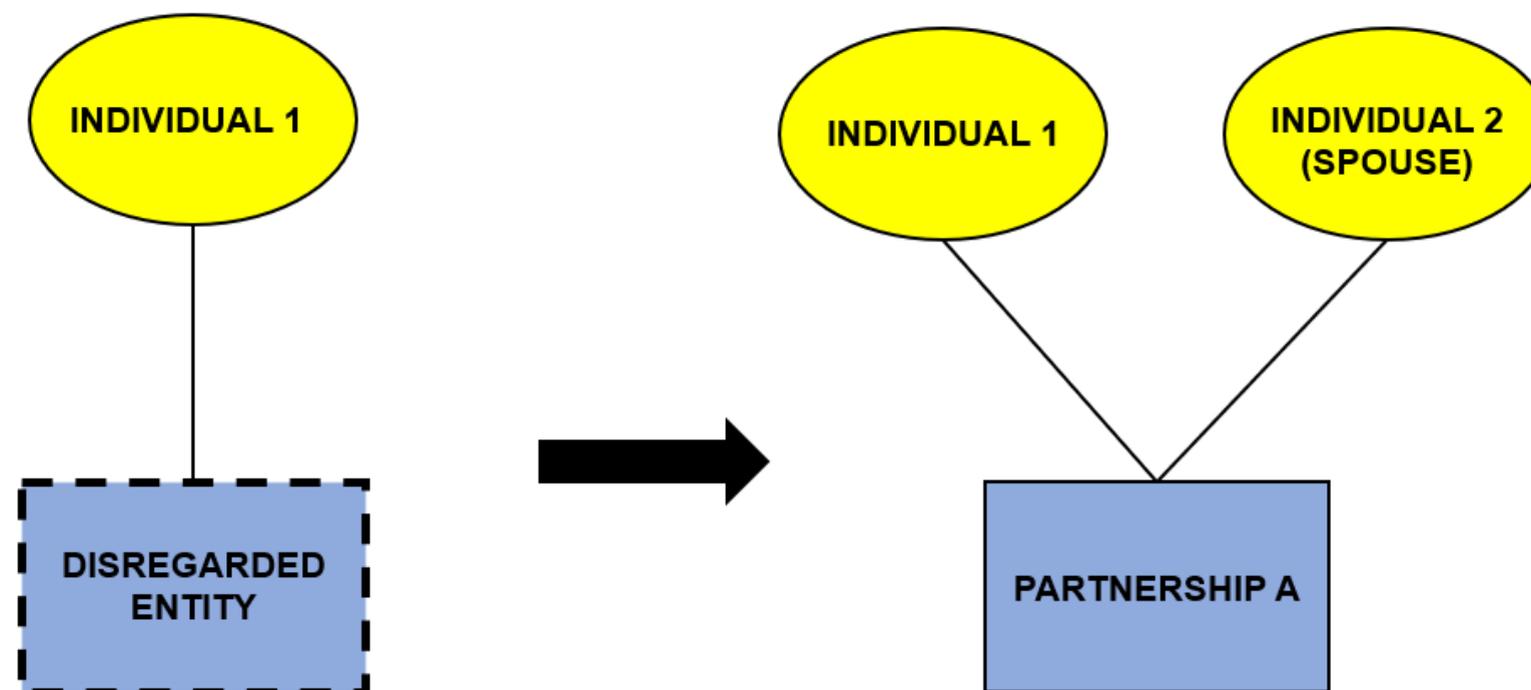
- Cash basis taxpayers receive a deduction when the payments are made.
- For 2021, the payment will need to be made by December 31, 2021
- Accrual basis taxpayers may have some leeway
- Typical accrual basis rules would allow for a deduction in 2021 if the payment is made by March 15, 2022
- IRS Notice 2020-75 specifically states that the entity is allowed a deduction “in computing its taxable income for the taxable year in which the payment is made.”

Potential Pitfalls

- The 9.3% rate is not the rate applicable to your ultimate liability on the flow-through income. If your marginal rate is higher, you are liable for the spread via separate estimate payments.
- Failing to timely make the safe harbor payments for the 2022 and future tax years eliminates the potential to take the benefit for that year.
- S-Corporation's require deductions be allocated pro-rata, therefore all owners need to take part in order to avoid having an economic imbalance amongst owners
- Partnerships allow for special allocations if not all partners take part. However, partnership agreements will likely not have language to reflect specific allocations for this type of payment if not all participate. Amended agreements may be necessary.

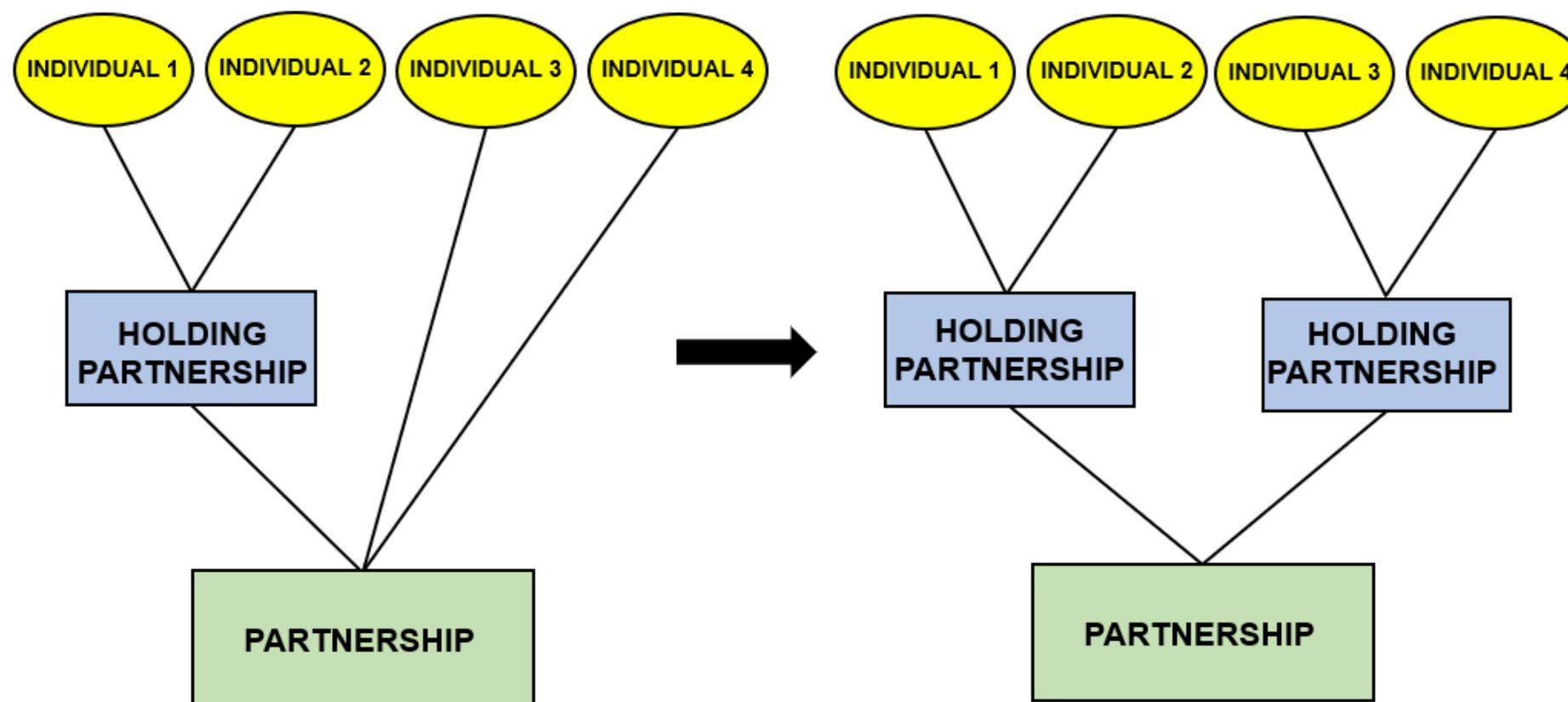
Planning Opportunities

- Do we need to restructure the entity in some form or fashion?
 - Disregarded entities adding members to become multi-member partnerships



Planning Opportunities

- Do we need to restructure the entity in some form or fashion?
 - Entities with partnership owners having the non-partnership owners form their own separate holding vehicle



Planning Opportunities

- Cash flow:
 - Do we need to forgo or limit future 2021 distributions?
 - Do we need to reverse previously made distributions?
- Selling a business/flow-through entity?
 - Structuring the sale as an “asset sale” will allow you to take advantage of AB150 on the associated gain from the sale

Outstanding Questions

- Will the Federal deduction be treated as an AMT preference item like the standard SALT deduction (itemized)?
- Are guaranteed payments paid by partnerships to partners eligible to be included for purposes of calculating the pass-through entity tax?
- How are overpayments/underpayments treated when it comes to the timing of the deduction? Will we recognize income in the subsequent year on overpayments?

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