

# For Business Owners and Investors: California AB 150 — Pay More Taxes Now in Order to Pay Less in Taxes Later

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**In** December 2017, the Tax Cuts and Jobs Act (TCJA) became law, representing the most significant federal tax code overhaul in the United States in more than three decades. In part, the TCJA limited the state and local tax (SALT) deduction on federal tax returns to \$10,000. In response, several states have enacted an *elective pass-through entity tax* as a workaround.

On July 16, 2021, California joined the group when its governor signed into law California Assembly Bill 150 (AB 150).



## ***How California Assembly Bill 150 Works***

A pass-through entity (PTE), which is also known as a flow-through entity or fiscally transparent entity, is a legal business structure wherein income flows through to the business entity's owners and investors, rendering the income of the entity as the income of the owners or investors.

Here's how California's elective pass-through entity (PTE) tax works:

1. A qualifying elective PTE pays 9.3 percent of qualified net income — the taxpayer's

share of income (including interest, dividends, and capital gains) from the PTE – to the California Franchise Tax Board (FTB).

2. At year's end, the PTE issues a federal K1 showing the taxpayer's income from the PTE as 9.3 percent less than what the taxpayer received. This lowers the taxpayer's federally reported income from the PTE by 9.3 percent.
3. The taxpayer claims a credit on his or her state tax return equal to the PTE tax paid to the FTB.

**Note:** The pass-through entity tax reduces *only* the federally reported income, not state reported income. The PTE files a separate state K1 reporting 100 percent of what it paid the owner.

Here's an example:

- A partnership has qualified net income of \$100,000
- It pays \$9,300 to the FTB ( $\$100,000 \times .093$ )
- The federal K1 reports taxpayer income of \$90,700 ( $\$100,000 - \$9,300$ )
- The California K1 reports taxpayer income of \$100,000
- The taxpayer receives a California tax credit of \$9,300

Bottom line, instead of paying federal income tax on \$100,000, the taxpayer pays federal income tax on only \$90,700 from the partnership. The reduction in reported income may also result in the taxpayer qualifying for a lower tax bracket.

**Note:** If federal legislation ever repeals the SALT deduction limitation, California's elective passthrough entity tax will be repealed automatically.

### ***Understanding the Rules***

The IRS gave its "stamp of approval" to these elective passthrough entity workarounds in IRS Notice 2020-75 and plans to clarify how these workarounds will be implemented on entity and taxpayer federal returns.

Although additional clarification is yet to come, these are the current guidelines:

- AB 150 is effective for tax years beginning on or after Jan. 1, 2021, and before Jan. 1, 2026.
- The passthrough entity must be a partnership or S corporation with partners, shareholders, or members that are exclusively corporations, individuals, fiduciaries, estates, or trusts subject to California tax. (*Whether a single-owner LLC qualifies has yet to be determined.*)
- Qualifying entities do *not* include the following:
  - PTEs whose partners are partnerships
  - Publicly traded partnerships

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- Entities required to be included in a California combined reporting group
- The election is annual and irrevocable
- The election is made on filing
- For tax years beginning on or after Jan. 1, 2021, and before Jan. 1, 2022, the PTE tax must be paid by the original due date of the entity's return. The owners' credits are limited to the amount paid in by that date. For tax years beginning on or after Jan. 1, 2022, the PTE tax is due in the following increments:
  - The first installment is due on or before June 15 of the taxable year of the annual election, which is to be the greater of either 50 percent of the elective tax paid the prior taxable year or \$1,000.
  - The second installment is due on or before the due date of the original return for the qualified entity.
- If the entity files for an extension, it has until the extended due date to make the election, but the tax must be paid by the original due date.
- Each owner of the entity can choose to opt out.

**Note:** If an entity is sold in an asset sale, the gain from that asset sale is considered entity-level income, but sale of stock or ownership interests generates owner-level income not subject to the elective PTE tax.

### ***New Forms***

The FTB will create four new forms for the elective PTE tax:

- The first form allows taxpayers to pay by the due date of the business entity tax return.
- The second form is a payment voucher for making a prepayment due June 15 of the taxable year starting in 2022.
- The third form is used by the business entity to calculate the elective tax amount and show the allocation to the participating partners, shareholders, or members.
- The fourth form is used by the partners, shareholders, or members to report their elective PTE tax credit

### ***Fuzzy Areas***

AB 150 is fuzzy about several issues, including the following:

- Whether a single-member LLC qualifies.
- Whether an intentionally defective grantor trust owner would disqualify an entity.
- Whether guaranteed payments to partners reported on the K-1 are considered income (interest, dividends, and capital gains are all considered income).
- Whether vouchers will be available for cash basis taxpayers to pay by Dec. 31,

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2021, to reduce the owner's federal income for 2021.

- How elective PTE tax payments will be credited for purposes of meeting estimated tax and nonresident withholding requirements.
- Because the PTE tax credit is nonrefundable, but overpayments of estimated tax are refundable, the order in which payments will be credited for taxpayers that have made estimated tax payments based on income that now qualifies for the elective PTE tax.
- How payments will be handled if an audited or amended return results in a reduction of reported income from the PTE.

AB 150's elective PTE tax is a great way to reduce your federal income tax legally, so we strongly encourage any California taxpayer with ownership in a qualifying entity to take advantage of it.

If you're unsure whether a PTE you own in part or total qualifies, or if you have any other questions about AB 150, [contact us](#) for additional information and guidance.

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