

# More Tax Savings for S Corporations: Bypassing the Personal SALT \$10,000 Deduction Limit

BY ROBERT W. OLSON, JR.

## State and Local Tax (SALT) Deduction

Starting in 1954, Internal Revenue Code section 164 permitted full deduction of state and local taxes (“SALT”) on personal federal income tax returns.<sup>1</sup> SALT includes state income, real property, personal property, foreign taxes, and sales taxes. This deduction is extremely valuable to Californians, given our combination of higher income, high income tax rates, and increasing property values.

## SALT Deduction Limited Since 2018

However, the federal Tax Cuts and Jobs Act of 2017 (“TCJA”) imposed a \$10,000 limit on SALT deductions.<sup>2</sup> This change put a significant tax burden on Californians that relied heavily on SALT deductions to lower their federal taxes. For example, a married California couple that earned \$250,000 as S corporation business owners, are making mortgage payments on a home assessed at \$1,000,000, and bought a car for \$50,000, paid an additional \$6,540 in 2018 federal income tax due to the \$10,000 SALT deduction limit.<sup>3</sup>

## Failed State Attempts to Avoid SALT Deduction Limit

High-tax states were outraged by this aspect of the TCJA. In response, many high-tax states attempted to recast various personal SALT payments as deductible “charity” donations, but that approach was shut down by Internal Revenue Service (“IRS”) Notice 2018-54. A few high-tax states then sued the federal government for removal of the SALT deduction limit but were recently rebuffed by the United States Court of Appeals for the Second Circuit.<sup>4</sup> Repeal of the SALT deduction limit has been forcefully pushed by many blue-state Democrats in Congress as necessary to their support of the Build Back Better Act, currently under consideration with the House of Representatives, but to date those efforts have been unsuccessful.<sup>5</sup>

## An Entity-Specific Solution: IRS Notice 2020-75

Issued on November 9, 2020, IRS Notice 2020-75 (“Notice 2020-75”) announced proposed regulations “that State and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction ...” This Notice extended



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to partnerships and S corporations the right to deduct all SALT paid by their business for federal income tax purposes. Nice, but partnerships do not pay any SALT, and the franchise tax payable by California corporations is minimal: 1.5% on corporate income with a minimum tax of \$800.

However, Notice 2020-75 goes on to approve a state-level solution: “Certain jurisdictions described in section 164(b) (2) have enacted, or are contemplating the enactment of, tax laws that impose either a mandatory or elective entity-level income tax on partnerships and S corporations ... [with a] corresponding or offsetting, owner-level tax benefit, such as a full or partial credit, deduction, or exclusion [emphasis added].”

## Small Business Relief Act

Through September 1, 2021, nineteen states have taken advantage of the “owner-level tax benefit” affirmed by Notice 2020-75. Included in that number is California’s Small Business Relief Act.<sup>6</sup> This article focuses on only one of those owner-level categories: California business owners that operate through “pass-through entities” like S corporations and partnerships (“PTE”). For PTE owners, the effect is to partially nullify the personal SALT deduction limit! This is how it works:

**Elective Payment.** The PTE must pay an additional entity-level elective tax (“ELET”), amounting to 9.3% of the PTE owner’s “distributive share” of “qualified net income” (i.e., S corporation and partnership distributions).<sup>7</sup> The Franchise Tax Board has confirmed that proceeds from asset sales (but NOT of interest in the entity itself) are “qualified net income.”<sup>8</sup>

**Timely Payment.** For 2021 tax returns, the PTE must pay the entire ELET on or before the due date of its 2021 tax return (March 15, 2022, for a calendar year PTE). For 2022-2026 tax returns, the ELET must be paid in two installments:

the greater of \$1,000 or 50% of the PTE's prior tax year's ELET payment, on or before June 15 of the then-current tax year; and the balance on or before the due date of the then-current tax year's tax return.<sup>9</sup>

**Timely Election.** The PTE must make its election to pay the ELET on an original (not amended) and timely filed (not on extension) tax return and must be made annually. For tax years after 2021, that means the PTE must pay some of its ELET before it makes the formal election!

**Tax Credit.** Only if the PTE made both timely election and timely payment of its ELET, California grants a tax credit of 9.3% of the PTE owner's percentage share of the PTE's "qualified net income" (i.e., S corporation and partnership profit distributions).<sup>10</sup>

**Excess or Prepaid ELET.** If the PTE does not make the annual election on its original and timely filed entity return, or overpays on ELET for the applicable tax year, the prepaid ELET is not refundable but may be carried forward on tax returns due and filed on or before April 30, 2027.<sup>11</sup>

Using our earlier example of a married California couple earning \$250,000 as PTE owners, let us assume that they paid themselves \$85,000 wages and \$165,000 as distributions (profit) in 2021.<sup>12</sup> If this couple's PTE pays 9.3% of those distributions as an ELET (\$15,345), and complies with election and payment timing rules, that ELET becomes a 2021 tax deduction on the PTE federal S corporation tax return, reducing the couple's reported distributions (and personal federal taxable income) by the same \$15,345. At an assumed 24% marginal federal tax rate, they just saved an additional \$3,376 on their personal federal income tax while their overall personal and PTE California income tax remains the same as before.

This is not a complete solution to the \$10,000 SALT deduction limit, but for the couple in our example, it effectively increased their SALT deduction limit from \$10,000 to \$25,345. Your results may vary, so contact your CPA for details. ■

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#### ENDNOTES

- 1 Internal Revenue Code of 1954, 26 USC §164(a); and Internal Revenue Code of 1986, 26 USC §164(b)(1).
- 2 26 USC §164(b)(6)(B).

- 3 Assuming a marginal federal income tax rate of 24%, California marginal income tax rate of 9.3%, no deductions other than SALT and \$30,000 of mortgage interest, property tax of 1% without bond measures, and a local 8% sales tax, the pre-TCJA SALT deduction would be \$37,250. The TCJA also cut marginal tax rates for this couple from 28% to 24%, reducing their federal tax by \$10,000 in 2018. Overall, this couple paid \$3,460 less in federal income tax despite reduction of its SALT deduction.
- 4 *New York v. Yellen*, No. 19-3962 (2d Cir. 2021).
- 5 Build Back Better Act, H.R. 5376, 117th Cong. (2021); Ferris, Sarah (March 30, 2021); "Blue-state Democrats demand SALT relief in Biden's next big bill." Retrieved from <<https://www.politico.com/news/2021/03/30/blue-state-democrats-salt-taxes-478556>>
- 6 Chapter 82, Statutes of 2021.
- 7 Cal. Rev. & Tax. Code §§ 17052.10(b)(2), 17053.71(h)(1), and 19900(a)(1).
- 8 Franchise Tax Board (October 1, 2021). "Help with pass-through entity elective tax." <<https://www.ftb.ca.gov/file/business/credits/pass-through-entity-elective-tax/help.html>>
- 9 Cal. Rev. & Tax. Code § 19904(a).
- 10 Cal. Rev. & Tax. Code §§ 17052.10(b)(2), 17053.71(h)(1), and 19900(a)(1).
- 11 Cal. Rev. & Tax. Code § 17059.2(e).
- 12 See Olson, Huge Tax Savings for S Corporations (May 2018) *Santa Barbara Lawyer*.

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