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Passthrough entity elective tax

There are special considerations for higher income taxpayers.

While much of the focus on the Passthrough Entity Elective Tax Credit has been on the tentative minimum tax limitation, there are some other important considerations higher income taxpayers should be aware of. This article addresses three of those key issues:

- The NOL suspension;
- The $5 million business credit limitation; and
- The Other State Tax Credit.

It should be noted, however, that the Governor is proposing retroactive changes to the Passthrough Entity Elective Tax Credit including eliminating the TMT limitation and repealing the business credit limitation and NOL suspension for 2022. If enacted, these changes will undoubtedly factor into a taxpayer's decision as to whether to make the election.

NOL suspension

California NOLs are suspended for taxable years beginning on or after January 1, 2020, and before January 1, 2023, for businesses that are:[1]

- Subject to the personal income tax if they have net business income **and** modified adjusted gross income of $1 million or more; and
- Subject to the corporation income or franchise tax if their business income subject to California taxation is $1 million or more.

"Modified adjusted gross income" for purposes of the $1 million threshold is the taxpayer's federal AGI without regard to the NOL deduction.

One benefit of making the passthrough entity elective tax election is it may allow the individual partner/shareholder/member to avoid the NOL suspension. Payment of the tax does not decrease an S corporation's income subject to California's corporate income tax because the passthrough entity elective tax is added back in the computation of the S corporation's California net income.

However, because modified adjusted gross income is based on the partners'/shareholders'/members' federal adjusted gross income, payment of the tax may reduce their modified AGI below the $1 million threshold, making them eligible to claim their NOL or NOL carryover.

Example of passthrough entity elective tax and NOL suspension interplay: Al is one of the members of the A&C, LLC, which is taxed as a partnership and which elects to pay the passthrough entity elective tax on behalf of its consenting members.

Al has $1.1 million in modified adjusted gross income. A&C pays the passthrough entity elective tax in 2021 on behalf of all of its consenting members, $200,000 of which is allocated to Al. The $200,000 tax payment that flows through to Al reduces his modified AGI to $900,000, which allows him to claim unused NOL carryovers from prior years.

Business credit limitation

Under current California law, businesses may not claim more than $5 million in business credits annually during the 2020 through 2022 tax years, including the Passthrough Entity Elective Tax Credit.[2] This means that the Passthrough Entity Elective Tax Credit for taxpayers with more than $5 million in business credits may be limited. Business credits disallowed due to the limitation may be carried over, and the carryover period for disallowed credits is extended by the number of taxable years the credit was not allowed. Unused Passthrough Entity Elective Tax Credits may normally be carried over for five years.

Taxpayers are generally not able to pick and choose which credits are claimed first to strategize how to maximize the credits. Taxpayers must follow the credit ordering rules specified in R&TC §§17039(a) and 23036(c). The Schedule P form and instructions specify what credits are assigned to which tier and the ordering rules for the different tiers. For instance the Passthrough Entity Elective Tax Credit is applied prior to the Research Credit and the Other State Tax Credit. However, taxpayers may choose the order of the credits within any given tier. For example, because the Main Street Hiring Credit and Passthrough Entity Elective Tax Credit are in the same tier in the ordering rules, taxpayers may choose which of these two credits may be claimed first.

This means that if a taxpayer has $4 million in Passthrough Entity Elective Tax and Main Street Hiring Credits, and $2 million in Research Credits during the 2021 tax year, the taxpayer must claim the $4 million of the first two credits but may only claim $1 million of the Research Credit. The remaining $1 million will be carried over.

Other State Tax Credit

The ordering of credits has also been an issue for taxpayers who claim an Other State Tax Credit on their California return. Practitioners working with California residents with passthrough income from other states are finding that the Other State Tax Credit, which is claimed after the Passthrough Entity Elective Tax Credit, is substantially reduced, if not completely eliminated, as a result of claiming the Passthrough Entity Elective Tax Credit. This is because by applying the Passthrough Entity Elective Tax Credit first, the California tax liability amount used to compute the Other State Tax Credit on Schedule S is dramatically reduced.

Example of interplay between PEET and OSTC credits: Terry is a California resident, and his only source of income is from Ruhl Partnership. Terry’s flowthrough income from Ruhl is $300,000 ($200,000 sourced to California and $100,000 sourced to New York).

Ruhl elected to make a California passthrough entity tax payment and made a payment to the state of California on Terry's behalf of $18,600 ($200,000 California income × 9.3%). Here is a side-by-side comparison of Terry's federal and California returns with and without the Passthrough Entity Elective Tax (PEET) Credit.

	With AB 150	**Without AB 150**
Federal AGI (after factoring in PEET payment and other Schedule 1 deductions, such as one-half of SE tax, SE health insurance, and retirement contributions)	$261,094	$279,445*
California adjustment (PEET payment)	$ 18,600	$ 0
California AGI	$279,694	$279,445
Itemized deductions (property tax, mortgage interest, charitable contributions)	($42,000)	($ 42,000)
Disallowed itemized deductions due to AGI limitations	$ 3,465	$ 4,566
Taxable income	$241,159	$242,011
Tax	$ 19,556	$ 19,636
PEET credit	$ 18,600	$ 0
Other State Tax Credit	**$ 272**	**$ 4,761**
Total tax	$ 684	$ 14,875
*Without PEET payment, federal SE tax is increased, so the difference between federal AGI with and without PEET is not exactly $18,600 (the amount of the PEET payment)		

The reason for the large drop in Terry's Other State Tax Credit when the Passthrough Entity Elective Tax Credit is utilized is because the Passthrough Entity Elective Tax Credit reduces the California tax liability used to compute his Other State Tax Credit (Schedule S, line 2) as follows:

	With AB150	**Without AB150**
California tax (previous calculation)	$ 19,556	$19,636
PEET credit	($18,600)	$ 0
Schedule S, line 2 (California tax liability used to calculate the Other State Tax Credit)	$ 956	$19,636

Governor's proposed budget

On January 10, 2022, California Governor Newsom unveiled his proposed 2022-23 budget. His budget proposes:

- Expanding the Passthrough Entity Elective Tax Credit by eliminating the tentative minimum tax limitation and allowing disregarded entities, including single member LLCs, to claim the credit. The Governor is requesting that this be enacted by March 15, 2022; and
- Eliminating the NOL suspension and $5 million business credit limitation for the 2022 taxable year.

Should this be enacted, the passthrough entity elective tax becomes much more attractive to most taxpayers, who will no longer be subject to the tentative minimum tax limitation. This means they will be much more likely to be able to utilize the full amount of the credit. If the $5 million business credit limitation and the NOL suspension are repealed beginning with the 2022 tax year, these issues will only be of concern for the 2021 tax year.

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[1] R&TC §§17276.23, 24416.23
[2] R&TC §17039.3

Impact of corporate reorganizations on credit assignments

The type of reorganization/restructuring determines whether a credit may be assigned or not.

The FTB has adopted a new regulation[1] to assist corporate taxpayers in determining whether a credit may still be assigned after a corporate reorganization or restructuring.

California allows affiliated members of the same combined reporting group to assign eligible credits (defined below) earned by one member to another member of the group, as long as the assignee is an “eligible assignee.”[2]

An eligible assignee is generally any affiliated corporation that is properly treated as a member of the same combined reporting group as the assignor in both the taxable year the credits were earned and the taxable year the credits are assigned to the assignee.

It’s important to note that the combined reporting groups do not have to be composed of all the same members at the time the credit at issue is earned and the time it is assigned, as long as the assignor and assignee are part of the same group for both of these events.

Since the credit assignment law was adopted in 2008, tax professionals have raised numerous questions such as whether an assignment can be made:

- If, as a result of a corporate merger, the assignor was not the entity that actually earned the credit;

- When an assignor and its subsidiaries have been acquired by an unrelated combined reporting group after the credits were earned; and
- When the assignor and/or the assignee have participated in a corporate merger or reorganization.

The regulations clarify that:

- If a taxpayer and its subsidiary are acquired by another entity in a tax-free “B” reorganization, the taxpayer may assign a credit earned pre-acquisition, but only to the subsidiary that was also purchased. This is because the assignor and subsidiary were part of the same reporting group at the time the credit was earned and at the time it was assigned;
- A credit cannot be assigned to a new organization created in either a corporate spin-off or corporate split-off after the credit was earned because the new organization was not part of the assignor’s combined reporting group at the time the credit was earned;
- An assignor can assign a credit to an assignee following a corporate split-up as long as the assignor and assignee were in the same combined reporting group at the time the credit was earned and at the time the credit was assigned;
- Credits earned by a taxpayer (merged entity) prior to the taxpayer’s merger into another corporate taxpayer (the surviving entity) in a tax-free “A” reorganization can be assigned by the surviving entity, but only to eligible assignees in the post-merger combined reporting group that were in the merged entity’s combined reporting group at the time the credit was earned; and
- Credits earned by one taxpayer that reincorporates as another taxpayer in an “F” reorganization can be assigned by the new corporation to any member of the original corporation’s combined reporting group as long as the new corporation and the eligible assignees are still part of that original corporation’s combined reporting group.

The regulation provides numerous examples to illustrate these different types of scenarios.

Ineligible assignee

The regulations also clarify that a taxpayer is not an eligible assignee if:

- The taxpayer is the surviving entity in a corporate reorganization/restructuring with an entity that was not a member of the combined reporting group when the assignor’s credit was earned; and
- In the reorganization/restructuring, the taxpayer acquired assets used in conducting its trade or business, with an aggregate fair market value (FMV) that exceeds 80% of the aggregate FMV of the total assets of the trade or business being conducted by the member immediately after the acquisition.

> **Example of ineligible assignee:** X, Y, and Z Corporations are in one combined reporting group, with X owning 100% of Y, and Y owning 100% of Z. Z Corp. is an operating business with minimal business assets. In 2010, Y Corp. earns $10,000 in credits, which it has yet to use or assign.

In 2012, Y Corp. acquires Mega Corp., which has significant business assets, by having Mega Corp. merge into Z Corp., with Z Corp. as the surviving corporation in an "A" reorganization. The FMV of Z Corp.'s assets immediately before the merger are less than 20% of the FMV of Z Corp.'s total business assets immediately after the merger.

Therefore, even though Z Corp. was in the same combined reporting group as Y Corp. when the credit was earned, Z Corp. is not an eligible assignee because the FMV of Z Corp.'s assets immediately prior to the merger with Mega Corp. was less than 20% of the FMV of Z Corp.'s assets immediately after the acquisition.

What is an eligible credit?

An "eligible credit" is:[3]

- Any credit earned by the taxpayer in a taxable year beginning on or after July 1, 2008; or
- Any credit earned in any taxable year beginning before July 1, 2008, that is eligible to be carried forward to the taxpayer's first taxable year beginning on or after July 1, 2008.

The regulation clarifies that a credit that is assigned to or purchased by a taxpayer is not an eligible credit because it was not "earned" by the taxpayer.[4]

Limitations transferred along with credit

Any limitation on the allowance of any credit that applies to the assignor also applies to the same extent to the assignee. For instance, an assignor claiming an enterprise zone Credit may only claim the credit against income attributable to an enterprise zone. If the assignor transfers the credit to an eligible assignee, the assignee is also limited to claiming the credit against income attributable to an enterprise zone.

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[1] 18 Cal. Code Regs. §23663-6
[2] R&TC §23633
[3] R&TC §23633(b)(2)
[4] 18 Cal. Code Regs. §23663-6(b)

Who pays the tax: marketplace facilitators or drop shippers?

The CDTFA amends the drop shipment rule to clarify who is liable for tax.

When a purchaser buys an item directly from a California retailer, it is clear that the retailer is required to collect and remit the sales tax on the transaction. If the retailer is not engaged in business in California, then the purchaser is generally required to pay use tax on the purchase.

But not all transactions are that simple. In today's e-commerce economy, frequently retailers:

- Don't keep items in stock and have their suppliers ship these items directly to the ultimate customer (a drop shipment sale); or
- Sell their items over an internet marketplace such as Amazon or e-Bay and have the marketplace facilitator ship the item directly to the ultimate customers (a marketplace facilitator sale).

Who is responsible for collecting and remitting the tax in these situations? California law and regulations hold the supplier liable for drop shipment transactions and most marketplace facilitators liable for transactions made via the marketplace.[1]

But who is liable when a drop shipment transaction is facilitated over the marketplace? A recent amendment to the CDTFA's drop shipment regulation clarifies that in most situations it is the marketplace facilitator.[2]

Drop shipments

As discussed above, in a drop shipment scenario, an out-of-state retailer will sell an item to a California purchaser, and then purchase the item from a California supplier and have the supplier ship the item directly to the California consumer on behalf of the out-of-state retailer (referred to as the "true retailer"). Generally, in this type of scenario, the California seller/supplier is considered the retailer and is required to collect and remit the tax. This approach ensures that the tax is actually paid on the transaction because the CDTFA has a California seller it can hold liable for the tax.

There are two exceptions to the drop shipment rule. These involve out-of-state sellers that either have a:

- California seller's permit; or
- California Certificate of Registration – Use Tax.

In these scenarios, the out-of-state seller is liable for the tax because the CDTFA can pursue collections from them.

Marketplace sales

In 2019, California enacted the Marketplace Facilitators Act.[3] The act treats marketplace facilitators with economic nexus in California (more than $500,000 in California sales of tangible personal property) as the California retailer for sales made to California purchasers over the marketplace. The amended drop shipment regulation makes clear that even if an out-of-state marketplace seller contracts with a California supplier to ship the item purchased over the marketplace, the California retailer liable for collecting the tax on the marketplace transaction remains the marketplace facilitator.[4] The supplier is not considered a drop shipper and is not required to collect the tax.

> **Example of drop shipment/marketplace facilitator transaction**: Free Sails, Inc. sells sails to its customers over Amazon. Free Sails is located in Arizona and is not engaged in business in California; however, its supplier is located in Long Beach, California. Skip purchases a sail from Free Sails over Amazon, and Free Sails has its supplier ship the item directly to Skip. Amazon is considered the California retailer and must collect sales tax on the purchase.

[1] 18 Cal. Code Regs. §1706; R&TC §6040 et seq.
[2] 18 Cal. Code Regs. §1706
[3] AB 147 (Ch. 19-5)
[4] 18 Cal. Code Regs. §1706

IRS adopts, proposes regulations impacting foreign taxation

Practitioners whose clients have foreign operations or investments should familiarize themselves with this latest round of regulations.

Since the TCJA dramatically changed how the U.S. taxes foreign income and corporations, the IRS has issued almost annual regulatory changes concerning the Foreign Tax Credit, the Global Intangible Low Taxed Income (GILTI) tax, the new IRC §250 deduction for GILTI and foreign-derived intangible income, and a new 100% dividends received deduction for the foreign source portion of dividends paid by certain foreign corporations to qualified domestic corporations.

This article provides a bird's-eye view of recent regulatory activity concerning some of these international tax provisions.

Foreign Tax Credit

The IRS has issued their latest round of final regulations[1] (totaling over 100 pages in regulations and commentary), which finalizes the IRS's 2020 proposed regulations[2] and addresses various issues, including, but not limited to:

- The Foreign Tax Credit, including the disallowance of a credit or deduction for foreign income taxes with respect to the dividends eligible for a dividends received deduction;
- The allocation and apportionment of interest expense, foreign income tax expense, and certain deductions of life insurance companies;
- The definition of a foreign income tax and a tax in lieu of an income tax;
- The definition of foreign branch category income;
- The time at which foreign taxes accrue and can be claimed as a Foreign Tax Credit; and
- Rules related to foreign-derived intangible income.

Domestic partnerships with foreign corporation investments

The IRS has also adopted final regulations providing guidance on the treatment of domestic partnerships for purposes of determining amounts included in the gross income of their partners with respect to foreign corporations.[3] These regulations affect U.S. persons who own stock of foreign corporations through domestic partnerships and domestic partnerships that are U.S. shareholders (10% owners) of foreign corporations.

The final regulations treat domestic partnerships as aggregates of their partners for purposes of determining income inclusions under the IRC §951 GILTI provisions and IRC §956(a), which taxes certain U.S. shareholders' earnings from controlled foreign corporation investments in U.S. property.

Passive foreign investment companies

The IRS has also issued proposed regulations[4] regarding the treatment of domestic partnerships and S corporations that own stock of passive foreign investment companies and their domestic partners and shareholders. These regulations provide guidance regarding:

- The determination of the controlling domestic shareholders of foreign corporations;
- The owner of a controlled foreign corporation or qualified electing fund that makes an election under IRC §1411, Net Investment Income Tax;
- The treatment of S corporations with accumulated earnings and profits for Subpart F purposes; and
- The determination and inclusion of related person insurance income under IRC §953(c).

These proposed regulations affect U.S. persons who own, directly or indirectly, stock in certain foreign corporations.

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[1] TD 9959, available at: www.federalregister.gov/documents/2022/01/04/2021-27887/guidance-related-to-the-foreign-tax-credit-clarification-of-foreign-derived-intangible-income
[2] REG-101657-20, available at: www.irs.gov/pub/irs-drop/reg-101657-20.pdf
[3] TD 9960
[4] Proposed REG-118250-20

About the Author

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