

AB 150 - What Is It and What Does It Do?



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California Assembly Bill 150 ("AB 150") is the long awaited California "work around" to the federal income tax deduction limitation on state and local income taxes. The \$10,000 federal deduction limitation applies until 2026, when it sunsets. California has provided some relief to S corporations, limited liability companies ("LLCs") and partnerships (collectively, "Pass-through Entities") by allowing them to elect to pay an entity level tax of 9.3% of their California taxable income for the 2021 through 2025 tax years.

Why would anyone want to pay an "elective tax"? For two reasons: i) the individual owners of the Pass-through Entities receive a corresponding credit for their share of the elective tax on their individual California tax returns, and ii) the state tax is deductible at the Pass-through Entity level. The deduction thus reduces the amount of income subject to federal income tax. The federal tax savings are equal to each taxpayer's share of the elective tax, multiplied by that taxpayer's effective federal tax rate.

This new relief does not apply to sole proprietorships or any LLCs that are treated as a disregarded entity. If you have any such entities, you should consider converting them to tax partnerships, or incorporating sole proprietorships as S corporations, to obtain AB 150 relief. For such entities, the relief will only apply prospectively - from the time their status converts. A Pass-through Entity in existence on January 1, 2021 gets a full year of benefit.

Is the elective tax a no-brainer? Absolutely not. For example, lowering the federal taxable income from a Pass-through Entity may reduce qualified business income ("QBI") deductions. AB 150 planning also affects other decisions as well. For example, should salaries in S corporations be reduced to maximize their taxable income, thus increasing deductible state income taxes? Remember that the IRS frequently challenges salaries paid by corporations - trying to reduce salaries with C corporations, but trying to increase salaries with S corporations. Deciding on the right course of action can be complicated.

The AB 150 benefit may not be as great as it appears. Assume an S corporation is owned 50-50 by two individuals and has \$1,000,000 of taxable income. If the entity level tax is elected, the S corporation can deduct \$93,000 more state tax. If each shareholder has an effective federal tax rate of 35%, each can lower their federal income tax by \$16,275. Thus, the federal income tax savings is less than 3.3% of federal taxable income at a 35% effective rate. These savings must be balanced against possible losses in the QBI deduction and possible reductions in allowable pension plan deductions if salaries are reduced to maximize the AB 150 benefit. The only way to be sure is to have your CPA run projections exploring the impact of the AB 150 deduction to make sure the benefit isn't outweighed by other costs.

Ideally, the analysis should be done and the decisions made before the end of the year, while there is still time to adjust salaries if warranted. Although the 2021 election is made when the Pass-through Entity tax return is filed, i) the actual tax must be paid by the original, un-extended due date for the return, and ii) certain decisions, such as the correct salary level, must be made before year end.