How to Deduct 100% of Your State Taxes

In 2017, the Tax Cuts and Jobs Act (TCJA) was passed, becoming the largest tax overhaul in modern history. One controversial aspect of the TCJA was the capping of the State and Local Tax (SALT) deduction at $10,000. Additionally, the standard deduction doubled. In 2024, for example, it's $14,600 for individuals and $29,200 for joint filers. This means that even if you have $10,000 in state and local taxes, you cannot deduct them unless you itemize your returns.

Historically, state and local taxes were a significant deduction for reducing federal tax liability, especially in high-tax states. However, now, this option is limited unless you itemize, which the majority of taxpayers don't. And even if you do itemize, you're restricted to a $10,000 deduction.

The Workaround: Introducing the Pass-Through Entity Tax Election (PTET)

If you're a business owner, you're in luck. Through the Pass-Through Entity Tax Election, you can deduct all your state taxes on your federal tax return. If you're not a business owner, skip to page 4 for "10 Creative Ways W-2 Earners Can Save on Taxes". But if you are, keep reading about PTET.

What is PTET?

When the TCJA imposed the 10k SALT deduction limit, states with high taxes, like California, were outraged. Their taxpayers faced significantly higher federal tax bills. As a workaround, the Pass-Through Entity Tax Election was created. PTET is an elective tax that business owners pay at the entity level. Instead of business income passing through to their individual return, they pay a separate state tax on their business income. This pass-through entity tax is 100% deductible at the federal level, and generally, you receive a dollar-for-dollar credit on your personal state tax return.

For example, if you elect PTET and the tax is $20,000, that amount is fully deductible on your federal return. It is not capped at $10,000, and you can still take the standard deduction. This $20,000 PTET then reduces any state tax you owe. If your state tax liability is $20,000, it would be eliminated since you've already paid $20,000 through PTET.

Considerations:

- Not all states offer PTET, and each state's rules vary. For example, in Arizona, the PTET tax is 2.5%, the same as the personal income tax rate. In California, it's a flat 9.3%. You'll need to work with your tax planner to see if the PTET is worth it.
- PTET reduces your Qualified Business Income (QBI), which may affect your QBI deduction. This is important to consider, especially if you are an non-SSB or have a high income.
- PTET taxes must be paid separately, often through state online portals. These taxes cannot be deferred until the tax filing deadline of the following year and are not covered by quarterly tax payments or withholdings.

California Case Study:

We examine a solo business owner with a joint return and $900,000 in net income. Without the PTET, their total tax liability is higher. However, by electing to pay California's 9.3% PTET on their net profits, they incur more state taxes but significantly reduce their federal taxable income, which drives down their overall tax liability. In this example, the business owner saves $25,702 in taxes.

2024 MFJ	No PTET Election	PTET
Net Income	$900,000	$900,000
State Tax	$78,432 CA state tax	$83,700 PTET Tax
Effective State Rate	8.71%	9.3%
2024 Fed Standard Deduction	$29,200	$29,200
Deductible State Tax	**SALT Cap of $10,000 -Tax payer will take standard deduction so the amount is $0**	**$83,700 (PTET is a deductible business expense)**
Fed Tax	$248,322	$217,352
Total State and Fed Tax	$326,754	$301,052
TOTAL TAX SAVED		**$25,702**

Bottom Line

If you're a business owner, even with a side hustle, this is something to consider. It's a complex topic requiring advanced tax planning, so consult with your trusted financial and tax planner. If you don't have one, set up a complimentary discovery call with us using this link: https://calendly.com/mdrnwealth-johnboyd/discovery. If you aren't a business owner, check out our guide **10 Creative Ways W-2 Earners Can Save on Taxes,** on the next page!

10 Creative Ways W-2 Earners Can **Save on Taxes**

1.**HSA Contributions**: A Health Savings Account (HSA) is a tax-advantaged medical savings account for individuals enrolled in a high-deductible health plan (HDHP). Contributions, investment growth, and withdrawals for eligible medical expenses are all tax-free. What many people aren't aware of is that after turning 65, the penalty for distributions that are not medically related goes away. Your HSA effectively turns into another retirement account! Coupled with the fact that you can deduct nearly $8,000 in taxes using a family plan, this becomes an underappreciated tool for tax savings and wealth accumulation.

2. **Real Estate Loopholes**: Real estate investment offers numerous tax advantages, including deductions for mortgage interest, property taxes, and maintenance expenses. Loopholes such as the Short-Term Rental (STR) and Real Estate Professional Status allow you to deduct "losses" from real estate directly from your 1040, thus reducing your W-2 income. When these loopholes are used in conjunction with strategies like bonus depreciation and 1031 exchanges, you can truly maximize your real estate tax benefits.

3. **Tax Loss Harvesting**: This strategy involves selling off investments that have lost value, absorbing the losses for tax purposes, and replacing them with something that could potentially appreciate. It can help reduce your tax liability and effectively manage your investment portfolio. If done properly, you can use up to $3,000 in annual losses to reduce your income on your personal tax return, while potentially generating positive returns in your portfolio.

4. **Take Advantage of a DAF**: A Donor-Advised Fund (DAF) allows donors to make a charitable contribution, receive an immediate tax deduction, and then recommend grants from the fund over time. Not only is it a cost-effective way to donate to charity, but it also allows you to accumulate deductions and avoid paying taxes on profitable investments.

5. **Utilizing a QOZ**: Qualified Opportunity Zones (QOZs) are areas designated as economically distressed. Investing in a QOZ can provide significant tax benefits, including deferral and reduction of capital gains taxes and potential tax-free growth within the QOZ. This strategy is particularly effective for those with highly appreciated assets. For example, if your investment in the QOZ fund is held for at least 10 years, you could potentially be eligible for an increase in basis equal to the fair market value of the investment on the date the QOZ investment is sold or exchanged. In effect, you would not pay capital gains tax on any appreciation of the QOZ investment itself.

6. **Bunch Deductions**: Bunching deductions means consolidating your tax deductions into one year instead of spreading them out over several years. This strategy can be beneficial if your itemized deductions are close to the standard deduction limit. It works well for individuals who anticipate being in a high tax bracket for multiple years and then transitioning to a mid-tier bracket due to accepting a lower income, less stressful job, or having a spouse become a full-time, stay-at-home parent.

7. **Backdoor 529 Plan**: 529 plans are savings plans that offer tax advantages for education costs. Under the new Secure Act 2.0, you can transfer up to $35,000 to a Roth from 529 dollars. The Backdoor 529 plan works by setting up a 529 IN YOUR NAME, contributing to it, and allowing it to grow for at least 15 years. After this period, if you still have earned income, you can transfer money to a Roth in your name. Depending on your state, this could provide state tax credits or deductions and allow another tax-free growth bucket.

8. **Alternative Savings Accounts**: Most people leave their cash in a traditional savings account. Interest in a savings account is completely taxable at the federal or state level. By exploring alternative saving account vehicles, such as treasuries and municipal-based money market funds, you can potentially generate much higher after-tax income and avoid paying taxes on interest at the state and/or federal level.

9. **Mega Backdoor Roth**: A mega backdoor Roth allows individuals to contribute after-tax dollars to their 401(k), then roll those contributions over into a Roth. This is a great way to boost retirement savings with money that will grow tax-free, bypassing income phase limits associated with Roth IRAs.

10. **Max Out Tax-Deferred Options**: Maxing out contributions to tax-deferred retirement accounts like 401(k)s and IRAs can provide immediate tax deductions. Additionally, the money grows tax-deferred until retirement. Depending on your employer-sponsored plan, you may have other tax-deferred options such as deferred comp plans and 457 plans available. These could potentially allow for nearly six figures in tax-deferred savings.

It's time to simplify tax planning and start making your wealth work for you.

Take the first step today by scheduling your complimentary one-hour discovery call at www.MDRNwealth.com