California's Passthrough Entity Elective Tax FAQs		
Question	**Response**	**More information available**
Who can make the election?	Qualified entities are S corporations, partnerships, and LLCs taxed as S corporations or partnerships. (R&TC §19902) As originally enacted, a partnership or an LLC with a partnership partner was not a qualified entity, but SB 113 repealed this restriction retroactively. SMLLCs are not eligible to make the election unless they elect to be taxed as an S corporation, add a member, or in the case of married taxpayers in a community property state, they elect to be treated as a partnership. Remember that making these elections midyear will result in two short-year California returns and two $800 annual/minimum franchise tax payments. To make the passthrough entity elective tax election, the entity must be "doing business" in California and required to file a California return, so out-of-state entities that are not doing business in California cannot make the election, even if their owners are California residents. Publicly traded partnerships and entities permitted or required to be included in a combined report are also ineligible to make the election.	See "New passthrough entity law saves federal taxes" and "Big changes to California's passthrough entity tax" in the August 2021 and March 2022 issues, respectively, of *Spidell's California Taxletter®*
Can SMLLCs make a late S election to be eligible?	To elect S corporation status to be eligible to make the passthrough entity elective tax election, S corporations must make the election by filing Form 2553, Election by a Small Business Corporation. This election must be made within two months and 15 days after the beginning of the tax year the election is to take effect.	
How is the election made?	The passthrough entity elective tax election is made on the entity's timely filed, original return, including extensions. (R&TC §19900) Not all partners/shareholders/members have to consent, but the tax can only be paid on behalf of consenting "qualified taxpayer" owners. The entity must attach Form 3804, Pass-Through Entity Elective Tax Calculation, to its return, listing all the consenting owners and the amount of tax paid on their behalf. The election is made annually and is irrevocable.	See "New passthrough entity law saves federal taxes" in the August 2021 issue of *Spidell's California Taxletter®*

Who is a qualified taxpayer?	Tax may only be paid on behalf of "qualified taxpayer" owners. A qualified taxpayer is an individual, estate, or trust or SMLLC owned by an individual, estate, or trust. (R&TC §§17052.10, 19900; FTB's webpage "Help with pass-through elective tax", supra) A corporation is not considered a qualified taxpayer, so the tax cannot be paid on its behalf. Disregarded business entities, other than SMLLCs listed above, are not considered qualified taxpayers. Trusts are qualified taxpayers and may pass along the Passthrough Entity Elective Tax Credit through to beneficiaries. This includes grantor trusts and intentionally defective grantor trusts, which may pass through the credit to their grantor.	See "Passthrough entity elective tax: payment, calculation, and eligibility" and "Big changes to California's passthrough entity tax" in the August 2021 and March 2022 issues, respectively, issue of *Spidell's California Taxletter®*
What is the tax rate?	The tax is 9.3% of the entity's qualified net income. (R&TC §19900) Entities cannot choose to pay a lower rate.	See "More passthrough entity elective tax news" in the December 2021 issue of *Spidell's California Taxletter®*
What is qualified net income?	Qualified net income is the sum of the consenting owners' pro rata or distributive share of income subject to California personal income tax. (R&TC §19900) Only "qualified taxpayers" may consent to have their pro rata/distributive share of income subject to tax. For entities with both California resident and nonresident consenting owners, the entity includes all of the California resident's share of the entity's income, but only the California-source income of the nonresident's share of income. According to the FTB, in general, for an S corporation this will be the sum of lines 1–10 minus the sum of lines 11 and 12 on the K-1 (100S), and for a partnership this will be the sum of lines 1–11 minus the sum of lines 12 and 13 on the K-1 (565/568). In general terms, this means the partner's/shareholder's share of the entity's rental income, interest income, dividends, royalties, and capital and IRC §1231 gains is included, less IRC §179 deductions, charitable contributions, and investment interest expense. Originally, the FTB took the position that guaranteed payments are not included in qualified net income, but SB 113 clarified that guaranteed payments are included, retroactive to the 2021 taxable year. IRC §743(b) adjustments are also included in qualified net income.	See "Passthrough entity elective tax: payment, calculation, and eligibility" and "Big changes to California's passthrough entity tax" in the August 2021 and March 2022 issues, respectively, of *Spidell's California Taxletter®*

How is the credit claimed?	The credit is claimed in the tax year for which the qualified net income is earned. (R&TC §19900) So even if an entity pays the 2021 tax on March 15, 2022, the partner/shareholder/member may claim the credit on their 2021 return. However, as stated above, federal taxable income is reduced in the year the payment is actually made. The credit is equal to 9.3% of the consenting owner's share of the entity's qualified net income. If the entity overpays the tax, the taxpayer may only claim the credit for the actual amount due. The credit is claimed on FTB Form 3804-CR, Pass-Through Entity Elective Tax Credit.	
When can the entity claim the deduction?	According to IRS Notice 2020-75, the entity will claim the deduction in the year the tax is paid. **Open questions:** The IRS has not specifically addressed whether different rules apply to accrual-based taxpayers Nor has the IRS addressed whether a taxpayer that overpays the tax in 2021 is limited to deducting the amount of tax that will actually be due, or whether they may claim the deduction for the amount paid in 2021, and then include in their 2022 taxable income any amount actually refunded.	
How is the tax allocated to owners for deduction purposes?	For federal purposes, these payments are treated as an expense of the passthrough entity at the entity level. Absent different guidance from the IRS, this would mean that the payments would be equally allocated to all owners based on their ownership percentage, even if they did not elect to have a payment made on their behalf. Partnerships may be able to address this issue by amending their partnership agreement to allow special allocations (although it's unclear whether this will pass the "substantial economic effect" test). However, for S corporations special allocations run afoul of the disproportionate distribution prohibition. We are currently awaiting additional guidance from the IRS on this issue.	

How is the payment made?	For the 2021 tax year, the payment must be made by the original filing deadline for the entity return. (R&TC §19904) Similar to income tax extension payments, the full amount of the tax must be paid with the return. Payments made after the original filing deadline will be subject to penalties and interest. For the 2022 through 2025 tax years, the entity must make two payments. The first payment is due by June 15 of the year of the election. The amount due is the greater of: • 50% of the elective tax paid for the prior year; or • $1,000. The remaining amount is due by the entity's original filing date deadline. Currently, the FTB has no mechanism to apply overpayments of a prior year's passthrough entity elective tax to the June 15 prepayment for the following year. See discussion below regarding overpayments. The payment may be made electronically or by check. If paid by check, taxpayers must file Form FTB 3893, Pass-Through Entity Elective Tax Payment Voucher. These payments are posted in a taxpayer's MyFTB account.	See "New passthrough entity law saves federal taxes" in the August 2021 issue of *Spidell's California Taxletter®*
What if the tax is underpaid?	For 2022 through 2025, if the June prepayment is underpaid, then the taxpayer is ineligible to make the election. (R&TC §19904) For all years, if amounts paid by the original due date of the return are less than 9.3% of the entity's qualified net income calculated when the return is filed, the remainder will be due with the return, and the entity will be subject to penalties and interest. (FTB's webpage "Help with pass-through elective tax", supra)	
What if the tax is overpaid?	The entity will be refunded the overpaid amount, subject to any outstanding tax liabilities or offsets, once it files its return. (FTB's webpage "Help with pass-through elective tax", supra)	
Are these payments subject to California's e-pay mandate?	Partnerships are not subject to the electronic payment mandate. S corporations already required to make payments electronically must also pay the passthrough entity elective tax electronically. (R&TC §19011.5) S corporations not previously subject to the e-pay requirement must make all future tax payments electronically if their passthrough entity elective tax is over $80,000.	See "Passthrough entity elective tax: payment, calculation, and eligibility" in the January 2022 issue of *Spidell's California Taxletter®*

Is the tax treated as an estimated tax payment on behalf of the owner?	No, the tax is not an estimated tax payment on behalf of the owner. However, it may decrease the owner's ultimate tax liability, which results in reduced estimated tax payment amounts. The credit is applied before estimated tax payments, so taxpayers that overpay their estimated taxes as a result of the passthrough entity elective tax being paid on their behalf will have their estimated tax overpayments refunded.	See "More passthrough entity elective tax news" in the December 2021 issue of *Spidell's California Taxletter®*
What is the interplay with nonresident withholding?	According to the FTB, payment of the passthrough entity elective tax does not relieve the entity from paying nonresident withholding.	See "More AB 150 information" in the October 2021 issue of *Spidell's California Taxletter®*
Who can claim the credit?	Individual, estate, or trust owners who consent to have the passthrough entity pay the tax on their behalf may claim up to 100% of the tax paid on their behalf, subject to the limitations discussed below. (R&TC §17052.10)	
Are there credit limitations?	As originally enacted by AB 150, the credit could not reduce a taxpayer's tentative minimum tax, which could drastically limit the amount of credit a taxpayer can claim. This limitation was retroactively repealed by SB 113, effective beginning with the 2021 tax year. The tax is considered a business credit and therefore is subject to the $5 million business credit limitation in effect for the 2021 tax year.	See "Passthrough entity elective tax: payment, calculation, and eligibility" and "Big changes to California's passthrough entity tax" in the August 2021 and March 2022 issues, respectively, of *Spidell's California Taxletter®*
Can the credit be carried over?	Yes. Unused credit may be carried over for up to five years. (R&TC §17052.10)	

What is the interplay with other credits?	The Passthrough Entity Elective Tax Credit is claimed after any credit that does not contain carryover or refundable provisions, but is claimed before refundable credits and, for the 2021 tax year only, the Other State Tax Credit (OSTC). Beginning with the 2022 tax year, the Passthrough Entity Elective Tax Credit is claimed after the Other State Tax Credit but before refundable tax credits. (R&TC §17039)	See "Passthrough entity elective tax: payment, calculation, and eligibility" and "Big changes to California's passthrough entity tax" in the August 2021 and March 2022 issues, respectively, of *Spidell's California Taxletter®*
How do other states' passthrough entity elective tax regimes impact California's Other State Tax Credit?	Taxpayers may claim the OSTC for passthrough entity elective taxes paid to other states as long as the other state tax is a tax on net income for a partnership and net or gross income for an S corporation. The amount of tax paid to the other state for purposes of calculating California's OSTC is not reduced by any exclusion, credit, or deduction made available to the taxpayer in the other state (e.g., New York's passthrough entity elective tax credit).	See "More passthrough entity elective tax news" in the December 2021 issue of *Spidell's California Taxletter®*