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California's Pass Through Entity Tax – Summary, Examples, and Frequently Asked Questions (FAQs)

What are the effective dates of the new tax?

The elective pass through entity tax (PTE) is effective for tax years beginning 1/1/2021 and before 1/1/2026. The California PTE will terminate prior to 1/1/2026 upon termination of the current federal $10,000 limitation rule, should that occur.

What is the basis of the tax?

The tax is on "qualified net income" will be paid on all income reported on the K-1 including interest, dividends, and capital gains.

Are items of income such as proceeds from an asset sale included?

Per FTB, if an entity is sold in an asset sale, then the gain from that asset sale would be entity-level income which would be subject to the tax. However, sale of stock or ownership interests would generate owner-level income, and that income is not subject to the tax.

What members of a pass-through entity are considered "qualified members", for purposes of allowing the pass-through entity to make the election?

The law states that an entity may only make the election if all the owners of the entity are corporations, as defined in R&TC §23038 (this includes S corporations), or taxpayers as defined in R&TC §17004 (individuals, fiduciaries, estates, or trusts), ***but partnership owners are specifically excluded***.

The FTB has confirmed that a living trust whose income is reported on the grantor's return is considered a taxpayer under §17004 and does not disqualify an entity.

When must the PTE tax be paid?

The tax must be paid by the original due date of the entity's return.

The entity has until the extended due date of the return to make the election. This means entities must estimate their liability by the due date of the return and pay that amount. The owners' credits will be limited to the amount paid in by this date.

Must all qualifying partners / members make the election for the pass-through entity to pay the tax on their behalf?

No. Each qualifying taxpayer may separately elect to be subject to the tax If qualifying taxpayers choose not to make the election, other eligible partners / members may still make the election.

Is the PTE tax rate bracketed or a flat rate?

The PTE tax is calculated on the qualified net income of the entity making the election, computed at a flat rate of 9.3%.

Is the calculation different for California and non-California partners / members?

Yes. For California taxpayers, this would include all distributive income from the pass through entity. For nonresident taxpayers, this would include only California-source income.

When must a qualified entity make the election?

A qualified entity makes the election on its original, timely filed return, and the election is irrevocable.

Does an "original, timely filed" return, include returns filed on extension?

Yes. FTB has confirmed the election may be made on an extended return (assuming the extended return is timely). Note that ***payment*** of the tax must still be made by the original due date, not the extended due date.

Must electing taxpayers (pass-through entities) make an estimated payment or payments during the tax year?

Yes, for tax years <u>beginning after 1/1/2022 and before 1/1/2026. Note that for tax years beginning on or after 1/1/2021 and before 1/1/2022</u> – one (1) payment is required (the elective PTE tax is due and payable on or before the filing due date of the original return (regardless of extension)). For example, this would be March 15 for calendar year taxpayers.

For tax years beginning <u>on or after 1/1/2022 and before 1/1/2026</u>, two payments are required: for calendar year taxpayers, the greater of 50% of the PTE tax paid in the prior year or $1,000 (whichever is greater) must be paid by June 15. For a calendar year taxpayer, the second payment (balance of tax due), is due on or before the original due date of the return (March 15).

For partners / members that elect to have the pass-through entity pay the 9.3% tax on their behalf, does that satisfy the partners' / members' California tax liability?

No. The PTE tax is *in addition to* any other required personal or corporate income tax. For example, for an individual, if a partner in a partnership is subject to a California personal income tax bracket greater than 9.3%, and elects to have the partnership pay 9.3% on her distributive share, she will also owe tax on the amount not subject to the partnership's 9.3% payment.

California allows partners / members to take a credit on their California return for the tax paid on their behalf by the pass-through entity. What if the allowable credit exceeds the taxpayer's net tax due?

Where the allowable credit for a taxpayer exceeds the taxpayer's net tax due, the excess credit is allowed as a carryforward to the following 5 years.

Will the California FTB create new forms for the net PTE tax?

Yes. The FTB will create four new forms for the new tax.

- The first form will be used to allow taxpayers to pay by the due date of the business entity tax return if the return is filed by the extended due date.
- The second form is a payment voucher that will be used to make the prepayment that is due June 15 of the taxable year beginning in 2022.
- The third form is to be completed and filed by the business entity, and used to calculate the elective tax amount and show the allocation to the participating partners, shareholders, or members.
- The last form is to be filed by the partners, shareholders, or members to report the tax credit allocated to them.

Can taxpayers elect to pay the PTE before the end of 2021?

Yes. For entities who are looking to pay the PTE now because they are filing a short year return for 2021 → while the FTB is still developing the PTE elective tax payment vouchers, FTB has indicated that taxpayers may make payments using the Pending Audit Tax Deposit Vouchers.

- S corporations may use form FTB 3577, LLCs may use form FTB 3578, and partnerships may use form FTB 3579 to make the PTE elective tax payment in 2021.
- On these Pending Audit Tax Deposit Vouchers, enter the tax year as "2021" and check the "Other" box when making the payment. Note that for federal purposes the entities will only benefit from the reduction of net income on the 2021 K-1s if the payment is made before the end of the entity's 2021 taxable year.

Has the FTB provided guidance for taxpayers making third and / or fourth quarter estimated tax payments?

Yes. According to the FTB:

- R&TC §19136(c)(2) provides that the underpayment of estimated tax penalty is based on the tax imposed under R&TC §§17041, 17048, and 17062, less credits against tax provided by Part 10 (commencing with §17001).
- The newly-enacted credit is R&TC §17052.10, is included in Part 10 and therefore it is one of the credits that reduce the computation of estimated payments.
- This means that those taxpayers eligible to claim the credit may reduce their third and/or fourth quarter estimated tax payment to account for additional amounts that will be paid in through the new PET for 2021.
- Note that the PET credit that is passed to owners will reduce their 2021 California income tax liability, so long as the payment is made by the original due date of the passthrough entity's 2021 California tax return. [8/27/2021]

Are prepayments of the credit amount considered estimated tax payments?

No. Per FTB (8/31/2021):

Qualified taxpayers reduce the amount of their overall tax due by the amount of Passthrough Entity Tax Credit that they claim for purposes of determining any underpayment of estimated tax penalties. (R&TC §19136(c)(2)) However, prepayments of the credit amount are not considered estimated tax payments.

When projecting third and fourth quarter estimated tax payments, practitioners should not consider the credit amount as an estimated tax payment. Instead, reduce projected tax liability by the credit amount, and use that reduced amount to calculate third and fourth quarter estimate payments.

Has FTB provided guidance related to the interplay of the PTE and California AMT?

Yes. Based on guidance provided by the FTB on 8/31/2021:

The credit does not reduce a taxpayer's California Tentative Minimum Tax. (R&TC §17039) This means the benefits of the Passthrough Entity Tax Credit may be limited for those taxpayers who are subject to California Alternative Minimum Tax (AMT) (e.g., those with large amounts of incentive stock options, property taxes, medical and dental expenses, and/or miscellaneous itemized deductions).

However, these taxpayers may qualify for the AMT business income exclusion. A "qualified taxpayer" may exclude from alternative minimum taxable income (AMTI) the income, positive and negative adjustments, and preference items attributable to any trade or business. (R&TC §17062(b)(4)).

Only individuals and trusts that meet the following criteria qualify:

- They own or have an ownership interest in a trade or business; and

- They have aggregate gross receipts, less returns and allowances, during the taxable year of less than $1 million from all trades or businesses for which the individual or trust is the owner or has an ownership interest.

Gross receipts may include, but are not limited to, items reported on federal Schedules C, D, E (other than income from a trust), or F and from federal Form 4797, Sales of Business Property, (figured in accordance with California law) or California Schedule D-1 (if required to complete it) that are associated with a trade or business.

In the case of an ownership interest, you include only the proportional share of gross receipts of any trade or business from a partnership, LLC, or S corporation regulated investment company (RIC), a real estate investment trust (REIT), or real estate mortgage investment conduit (REMIC) in accordance with your ownership interest in the enterprise. Apply the $1,000,000 test to the return regardless of filing status. The threshold does not become $2,000,000 for married filing joint taxpayers.

What can single-member LLC (SMLLCs) do to become qualified to make the election to pay the PTE tax?

Per FTB (8/31/2021): A single member (SMLLC) cannot make the election to pay the passthrough entity tax. To be eligible, they must add a member or elect to be treated as an S corporation. However, an SMLLC owned by a husband and wife can elect to be taxed as a partnership and can qualify to pay the passthrough entity tax. (Rev. Proc. 2002-69)

Per Spidell (8/31/2021): A husband and wife that elect mid-year to have their LLC treated as a partnership rather than an SMLLC will have to file two short year Forms 568, Limited Liability Company Return of Income and pay the $800 annual tax for each short year. Married couples should evaluate whether it makes sense for them to wait until the end of the year to make this election to avoid having to pay the $800 annual tax twice.

Taxpayer Examples (per FTB Guidance to Spidell on 8/31/2021)

Example 1. Example of estimated tax/credit interplay for a taxpayer with AGI over $1 million
For 2021, Paul is a single California resident taxpayer who estimates he will have the following:

- AGI of $1.8 million;
- California taxable income of $1.5 million;
- California tax liability of approximately $169,049; and
- 2021 required estimated tax of $152,144 ($169,049 × 90%).

Without considering any Passthrough Entity Tax Credit, his 2021 estimated tax payments would be calculated as follows:

- 2021 estimated California tax liability $169,049
- 2021 liability × 90% $152,144
- Q1 estimate $45,643
- Q2 estimate $60,858
- Q3 estimate $0
- Q4 estimate $45,643

Paul timely paid a total of $106,501 in his first and second quarter estimates. However, his income includes $500,000 of passthrough income from an S corporation. The S corporation makes an election to pay the passthrough entity tax, and Paul opts to have tax paid on his behalf. The S corporation will pay $46,500 ($500,000 × 9.3%) on his behalf. This $46,500 does not satisfy his fourth quarter estimated tax payment requirement.

The FTB bases the estimated tax underpayment penalty on the amount of tax owed after reducing the tax due for the Passthrough Entity Tax Credit, but the Pass through Entity Tax Credit is not considered an estimated tax payment. Considering his first two estimated tax payments, and his Passthrough Entity Tax Credit amount, Paul's fourth quarter estimated tax payment will be reduced to $3,793, calculated as follows:

- 2021 estimated California tax liability $169,049
- Less credit (46,500)
- Remaining tax due $122,549
- Times 90% $110,294
- Less Q1 and Q2 estimates (106,501)
- Remaining estimates required $ 3,793

Unless Paul is annualizing his income, he may make a fourth quarter estimate payment of

$3,793 since he has more than 70% of the required amount paid with his first and second quarter payments. If he is annualizing his installments, he must compute his required payment for the third and fourth quarters, based on the remaining $3,793 due.

Example 2. Example of estimated tax/credit interplay for a taxpayer with AGI between $150,000 and $1 million

For 2021, Paul is a single California resident taxpayer who estimates he will have the following:

- AGI of $700,000;
- California taxable income of $500,000;
- California tax liability of approximately $47,039;
- 2020 California tax liability of $40,000; and
- 2021 required estimated tax of $44,000 ($40,000 2020 liability × 110%).

Without considering any Passthrough Entity Tax Credit, his 2021 estimated tax payments would be calculated as follows:

- 2020 California tax liability $40,000
- 2020 liability × 110% $44,000
- Q1 estimate $13,200
- Q2 estimate $17,600
- Q3 estimate $0
- Q4 estimate $13,200

Paul timely paid a total of $30,800 in his first and second quarter estimates. However, his income includes $200,000 of passthrough income from an S corporation. The S corporation makes an election to pay the passthrough entity tax, and Paul opts to have tax paid on his behalf. The S corporation will pay $18,600 ($200,000 × 9.3%) on his behalf.

The FTB bases the underpayment penalty on the amount of tax owed after reducing the liability for the Passthrough Entity Tax Credit, but the credit is not considered an estimated tax payment. Considering his first two estimated tax payments, Paul is not required to make any additional estimate payments:

- 2021 estimated California tax liability $47,039
- Less credit (18,600)
- Remaining liability $28,439
- Less Q1 and Q2 estimates (30,800)
- Remaining estimates required ($ 2,361)

Example 3 - Example of estimated tax/credit interplay for a taxpayer with AGI between $150,000 and $1 million

If Paul's 2020 tax due was only $30,000, the larger increase in 2021 income would result in additional estimated tax payments. Without considering any Passthrough Entity Tax Credit, his 2021 estimated tax payments would be calculated as follows:

- 2020 California tax liability $30,000
- 2020 liability × 110% $33,000
- Q1 estimate $9,900
- Q2 estimate $13,200
- Q3 estimate $0
- Q4 estimate $9,900

Paul timely paid a total of $23,100 in his first and second quarter estimates, and the S corporation will still pay $18,600 ($200,000 × 9.3%) on his behalf.

Because the Passthrough Entity Tax Credit does not eliminate Paul's tax liability, he must pay the lesser of an amount to satisfy his 90% of current year tax liability, or his previously calculated fourth quarter estimate payment.

- 2021 estimated California tax liability $47,039
- Less credit (18,600)
- Remaining liability $28,439
- Times 90% $25,595
- Less Q1 and Q2 estimates (23,100)
- Remaining estimates required $ 2,495

Paul is now required to make additional estimate payments of $2,495. If he is annualizing his installments, he must compute his required payment for the third and fourth quarters, based on the addition $2,495 due.

Open Questions (Questions Posed by Spidell to the California FTB for Clarification)

- (8/27/2021). While the FTB has confirmed that a living trust whose income is reported on the grantor's return is considered a taxpayer under §17004 and does not disqualify an entity, additional guidance has been requested from FTB to determine whether the same reasoning would apply to a single member LLC owner, as well as whether an intentionally defective grantor trust owner would disqualify an entity.

- (8/27/2021). Guidance has been requested from FTB as to whether guaranteed payments to partners reported on the K-1 are included.

- (8/27/2021). Cash-basis taxpayer issues (per FTB / Spidell):

    - For cash basis taxpayers, it appears that the tax must be paid by December 31, 2021 to reduce the owner's federal income for 2021.
    - The FTB anticipates releasing the new elective tax voucher before December 2021. The FTB anticipates releasing the new PTE elective tax voucher before December 2021 and that voucher will provide instructions on how to make the PTE elective tax payment going forward.
    - Note that for federal purposes the entities will only benefit from the reduction of net income on the 2021 K-1s if the payment is made before the end of the entity's 2021 taxable year.

- (8/27/2021). Because the credit is nonrefundable, but overpayments of estimated tax are refundable, in what order will these payments be credited for taxpayers who have made estimated tax payments based on income that now qualifies for the tax?

    - Based on responses received so far, we (Spidell) believe the credit is applied first, and excess amounts would be refundable as excess estimates, but we are confirming this with the FTB.

- (8/27/2021). How will these payments be credited for purposes of meeting nonresident withholding requirements?

- (8/27/2021). What will happen when taxpayers underestimate or overestimate their tax liability? *It seems that they would be limited to the amount paid for underpayments and would likely be entitled to refunds of overpayments, but Spidell is confirming this with the FTB.*

- (8/27/2021). What happens if a return is later audited or amended and the taxable income amount is reduced? How will the tax be paid for owners of multistate entities? *This is an issue because California resident owners will be subject to California income* *tax on all of the entity's income, while nonresident owners are only subject to California income tax on the amount apportioned to California*.

- (8/27/2021). Will there be any exceptions to the 50% of prior year tax requirement for June 15 payments?
    - For example, if an entity has a one-time sale that increases their income subject to the tax to a total of $2 million of income for 2021, and they pay $186,000 in PET tax.
    - However, their projected 2022 income is approximately $500,000. Are they required to pay the full $93,000 on June 15, or will there be some sort of exception that applies?