

Avoid Costly Mistakes with Pass-Through Entity Tax Payments

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If you use the State of California’s Franchise Tax Board (FTB) website to make an electronic payment for an *elective pass-through entity*, you should know ahead of time that it’s easy to make a mistake and get mixed up over personal and business payments.

Here at SWC, a San Diego-based tax planning and financial strategy firm for entrepreneurs and small business owners, real estate investors, and high-net-worth individuals, we see this happening all too often. And that’s why in this singlette, we explain how California’s version of the elective pass-through entity tax works and provide guidance on how to avoid making costly mistakes when paying your elective tax.

To start us off, if you’re unfamiliar with the *elective pass-through entity tax*, here’s what we want you to know.



Understanding the Elective Pass-Through Entity Tax

The Tax Cuts and Jobs Act (TCJA), which some have described as “the most sweeping tax overhaul in decades,” was signed into law on Dec. 22, 2017, just 50 days after it was first introduced in the U.S. House of Representative. Once enacted on Jan. 1, 2018, the TCJA limited the amount of state and local taxes (income taxes, sales taxes, and property taxes) that taxpayers are allowed to deduct when filing their federal income tax returns. This resulted in the cap being \$10,000 for married couples and \$5,000 for individuals (or married individuals who choose to file separately).

For example, suppose you're a married couple living in California, and you paid \$7,000 in state income taxes and \$6,000 in property taxes. That's \$13,000 total. Under the TCJA, when you're filing your federal income tax return, you would be able to deduct only \$10,000 from your taxable income, not the full \$13,000.

Understanding that this cap could be especially burdensome for taxpayers in states with high income taxes and/or high property taxes, some states, such as California, enacted an *elective pass-through entity tax* as a workaround. In California, this workaround is detailed in California Assembly Bill 150 – the *Sales and Use Tax Law: Personal Income Tax Law: Corporation Tax Law: Budget Act of 2021*.

A *pass-through entity (PTE)* is a legal business structure wherein income flows through to the business entity's owners and investors, rendering the income of the entity as the income of the owners or investors. Pass-through entities include sole-proprietorships, limited liability companies (LLCs), partnerships, and S-corporations.

How California Elective Pass-Through Entity (PTE) Tax Works

California's elective pass-through entity (PTE) tax isn't very complicated, and here's how it works:

1. A qualifying elective PTE pays 9.3 percent of qualified net income – the taxpayer's share of income (including interest, dividends, and capital gains) from the PTE – to the California Franchise Tax Board (FTB).
2. At year's end, the PTE issues a federal Schedule K-1 (Form 1065) showing the taxpayer's income from the PTE as 9.3 percent less than what the taxpayer received. This lowers the taxpayer's federally reported income from the PTE by 9.3 percent.
3. The taxpayer claims a credit on his or her state tax return equal to the PTE tax paid to the FTB.

Note: The pass-through entity tax reduces only the federally reported income, not state reported income. The PTE files a separate state K1 reporting 100 percent of what it paid the owner.

Here's an example:

- A partnership has qualified net income of \$200,000
- It pays \$18,600 to the FTB ($\$200,000 \times .093$)
- The federal K1 reports taxpayer income of \$181,400 ($\$200,000 - \$18,600$)
- The California K1 reports taxpayer income of \$200,000
- The taxpayer receives a California tax credit of \$18,600

Bottom line? Instead of paying federal income tax on \$200,000, the taxpayer pays federal income tax on only \$181,400 from the partnership. The reduction in reported income on the taxpayer's federal income tax return may also result in the taxpayer qualifying for a lower tax bracket – an additional savings.

If federal legislation ever repeals the state and local tax (SALT) deduction limitation, California's passthrough entity elective tax will be repealed automatically.

Understanding the Rules

To take advantage of the pass-through entity (PTE) elective tax, you need to follow the rules:

- California's Budget Act of 2021 (AB 150) is effective for tax years beginning on or after Jan. 1, 2021, and before Jan. 1, 2026. In other words, AB 150 is scheduled to expire after tax year 2025.
- The pass-through entity must be an S corporation, partnership, or LLC taxed as an S corporation or partnership. And the pass-through entity must be "doing business" in California and be required to file a California return. That means out-of-state entities not doing business in California cannot make the election, even if their owners are California residents. Qualifying entities do not include publicly traded partnerships or entities permitted or required to be included in a California combined reporting group.
- Single Member LLCs (SMLLCs) are eligible only if they elect to be taxed as an S corporation, add a member, or, in the case of married taxpayers in a community property state like California, elect to be treated as a partnership. The SMLLC must make the election by filing IRS Form 2553, the *Election by a Small Business Corporation* form, within two months and 15 days after the beginning of the tax year the election is to take effect.
- The election to pay the tax must be made on the entity's original, timely-filed tax return, including extensions. The entity must attach California's Form 3804, the *Pass-Through Entity Elective Tax Calculation* form, to its return, listing all the consenting owners and the amount of tax paid on their behalf.
- The election is annual and irrevocable – it may not be changed.
- The pass-through entity elective tax may be paid only on behalf of a *qualified taxpayer* – an individual, estate, or trust or an SMLLC owned by an individual, estate, or trust. A corporation is not considered a qualified taxpayer. Trusts are qualified taxpayers and may pass along the PTE elective tax credit through to beneficiaries. Not all partners / shareholders / members / beneficiaries need to consent, but the tax can only be paid on behalf of consenting "qualified taxpayer" owner(s).
- For tax years beginning on or after Jan. 1, 2022, the pass-through entity tax is due in the following increments:
 - The first installment is due on or before June 15 of the taxable year of the annual election, which is to be the greater of either 50 percent of the elective tax paid the prior taxable year or \$1,000. If the June prepayment is underpaid, the taxpayer is ineligible to make the election.
 - The second installment (the remaining amount) is due by the entity's original filing date deadline. If amounts paid by the original filing date deadline are less than 9.3 percent of the entity's qualified net income, the remainder will be due with the return, and the entity will be subject to penalties and interest. Any overpayment will be refunded to the entity subject to any outstanding tax liabilities or offsets, once it files its return.
- If the entity files for an extension, it has until the extended due date to make the election, but the tax must be paid by the original due date.

Note: If an entity is sold in an asset sale, the gain from that asset sale is considered entity-level income, but sale of stock or ownership interests generates owner-level income *not* subject to the elective PTE tax.

New Forms

California's FTB provides three forms for the elective pass-through entity tax:

- The Pass-Through Entity Elective Tax Calculation form (FTB 3804), which is used by the business entity to calculate the elective tax amount and show the allocation to the participating partners, shareholders, or members.
- The Pass-Through Entity Elective Tax Payment Voucher (FTB 3893) is used by the business entity to make an elective tax payment on or before June 15 during the taxable year of the election and pay the remaining amount on or before the due date of the original return that the qualified PTE is required to file.
- The Pass-Through Entity Elective Tax Credit (FTB 3804-CR) is used by the partners, shareholders, or members to report their elective PTE tax credit.

Making Payments

Pass-through entity elective tax payments can only be made:

- By check with Form FTB 3893, the Pass-Through Entity Elective Tax Payment Voucher
- With Web Pay
- By electronic funds withdrawal (EFW)

If your S corporation is required to make payments electronically, it must also remit the elective tax payment electronically. S corporations required to remit payments electronically must use Web Pay or EFW. The e-pay mandate does not apply to partnerships or LLCs taxed as partnerships.

The pass-through entity tax payment cannot be combined with other payments, nor can overpayments of the PTE elective tax or other entity taxes be applied to pay future payments of the PTE elective tax.

Avoiding Potentially Costly Mistakes

Be careful when making electronic payments on the FTB website. It's easy to make a mistake and get mixed up over personal and business payments. Such mistakes can be costly if not corrected in a timely manner.

A recent ruling from California's Office of Tax Appeals (OTA) highlights the pitfalls taxpayers can encounter when making PTE elective tax payments electronically on FTB's website.

In this case, Sea Turtle, Inc. mistakenly applied a \$56,000 payment through Web Pay to its S corporation tax rather than the intended PTE elective tax. Upon realizing the error (before the payment deadline), the company immediately requested a stop payment through its bank and tried to correct the application of the funds.

However, the correction process went awry. The stop payment request was incorrectly set up as a recurring cancellation, rather than as a one-time stop. As a result, the company's second attempt to pay the PTE elective tax was also rejected. Unfortunately, the company's bookkeeper failed to inform the taxpayer that the payment was not processed, and Sea Turtle, Inc. did not discover the nonpayment until seven months later.

The OTA concluded that the taxpayer had a nondelegable responsibility to ensure the timely payment of taxes and upheld over \$5,000 in penalties and interest for late payment.

Correcting Payment Errors

The FTB has a process in place for correcting payment errors such as those in the Sea Turtle, Inc. case. According to the FTB, “In the event that the business representative inadvertently directs the application of a payment to be applied as an estimate payment, S corporation tax, LLC tax, or LLC fee, FTB can accommodate a request to correct the error in order to apply the payment as intended.”

If you make a mistake, contact the FTB to transfer the S corporation tax payment to the passthrough entity tax to avoid penalties and interest. Submit your request in writing, signed by an officer or owner of the entity or a representative with a valid Power of Attorney (POA) on file. You can submit your request through the S corporation’s MyFTB account. The request must include acknowledgment that reapplying the payment to another liability may result in penalties and interest in the tax year when the payment was originally applied.

Don’t Let the Complexities Dissuade You from Pursuing an Aggressive Tax-Saving Strategy

California’s Budget Act of 2021 (AB 150) elective pass-through entity tax can be a great way to reduce your federal income tax legally, so we strongly encourage any California taxpayer with ownership in a qualifying entity to look into the potential tax savings.

If you’re unsure whether a PTE you own in part or total qualifies, you have any questions about AB 150, or you need help making your election, calculating your PTE elective tax, making payments, or correcting mistaken payments, [contact us](#). We can help you minimize your tax burden, avoid costly mistakes, and build wealth.

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