

# ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Campbell Analyst: Jeff Garnier Bill Number: SB 259

Related Bills: See Legislative History Telephone: 845-5322 Introduced Date: Feb. 15, 2005

Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** S Corporations/Carryforward of Net Operating Loss and Tax Credits

## SUMMARY

This bill would allow corporations, required in 2002 to be "S" corporations, to use "C" corporation tax attributes-created prior to 2002.

## PURPOSE OF THE BILL

The author's staff has indicated that the purpose of the bill is to provide tax benefits to corporations that were required under AB 1122 (Stats. 2002, Ch. 35) to be an "S" corporation for state purposes.

## EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately. The provision relating to net operating loss (NOL) carryovers from a "C" year to an "S" year apply to taxable years beginning on or after January 1, 2004. The provision affecting credit carryovers from a "C" year to an "S" year apply to taxable years beginning on or after January 1, 2003.

## POSITION

Pending.

## SUMMARY OF SUGGESTED AMENDMENTS

Department staff is available to assist with amendments to resolve the implementation, technical, and policy concerns discussed in this analysis.

## ANALYSIS

### FEDERAL/STATE LAW

Corporations are either classified as a general "C" or a small business "S" corporation. A "C" corporation income is taxed first at the corporation level, and another level of tax is imposed when corporate profits are distributed in the form of a dividend to the shareholder. Generally, the taxable income of an "S" corporation is taxed only at the shareholder level, rather than at the corporation level, regardless of whether such income is actually distributed.

For taxable years beginning on or after January 1, 1987, California conformed to the federal "S" corporation provisions, with specified exceptions. One important difference from federal law is that California still subjects the income of an "S" corporation to a 1.5% corporate level tax. For taxable years beginning before January 1, 2002, a federal "S" corporation could elect to be a "C" corporation for California purposes. However, due to state income tax gaming, beginning in 2002, AB 1122

Board Position:

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Department Director

Date

Gerald H. Goldberg

4/18/05

required all federal "S" corporations to be an "S" corporation for California purposes. AB 1122 designated the election date for California purposes as the first day the corporation was an "S" corporation for California purposes. The election date determines when the "S" corporation will be subject to the built-in gains (BIG) tax. AB 2328 (Stats. 2004, Ch. 782) changed the designated election date to the date the corporation elected to be an "S" corporation for federal purposes, thus eliminating the BIG tax for most "S" corporations affected by AB 1122.

As stated above, California law, in addition to the pass through of the "S" corporation's income, deductions, and credits to its shareholders, specifies that an "S" corporation continues to be subject to the franchise tax, in an amount equal to the greater of the minimum tax (\$800) or 1.5% of its net income for the taxable year.

Federal and state laws provide for various credits that can be carried over to later tax years. Credits generated in a "C" corporation tax year and carried over to an "S" corporation tax year receive different treatment under federal and state law. Under federal law, credits from a "C" year can only be used to reduce an "S" corporation's BIG tax. Under state law, credits from a "C" year carried over to an "S" year are reduced to one-third of the original carried over amount and applied against the state's "S" corporation's measured tax rate of 1.5%. Under federal and state law, credits earned during a "C" year are prohibited from passing through to an "S" corporation shareholder.

"S" corporations are allowed NOL treatment at the entity level, which can be carried forward as deductions against the income subject to the 1.5% "S" corporation tax.

Federal and state law does not permit an NOL generated in a "C" corporation tax year to be carried over to an "S" corporation tax year. Any NOL generated in a "C" year is applied against and reduces the BIG, thus reducing the BIG tax.

Under federal and state law, "S" corporations are subject to the BIG tax. This corporate-level tax only applies to "S" corporations that were formerly "C" corporations. The BIG tax is assessed on recognized gain from the disposition by an "S" corporation of an asset that can be attributed to the period when the corporation was a "C" corporation. Under California law, these taxes are assessed at the rate applicable to "C" corporations (8.84%).

The BIG tax is designed to apply the "C" corporation tax rate to tax benefits (e.g., depreciation) and appreciation properly belonging to the corporation's "C" years.

### THIS BILL

For "C" corporations required to be an "S" corporation for state purposes under the provisions of AB 1122, this bill would make the following changes:

- Allow NOLs generated in a "C" corporation tax year to be carried forward to an "S" corporation tax year under the NOL provisions in effect for the year the NOL was generated. For example, 55% of an NOL generated in 2001 would be allowed to be taken in 2004. The provision permits the NOL to reduce taxable income for purposes of the 1.5% "S" corporation tax. The provision does not alter current law with respect to the application of "C" corporation NOLs to reduce the BIG.

- Allow 100% of credits generated in a “C” corporation tax year to be applied against the “S” corporation measured tax of 1.5%. The amount of the credit available for taxable years beginning on or after January 1, 2003, would be the credit carry forward amount as of the last day the corporation was a “C” corporation, minus the amount of the credit used after being reduced by two-thirds in the “S” corporation’s 2002 tax year. The balance of credits generated in a “C” year on the first day of the corporation’s 2003 “S” tax year would be grossed back up to 100% by multiplying the balance by three. The individual credit’s rules in effect the year the credit was generated would apply.

### IMPLEMENTATION CONSIDERATIONS

The bill attempts to permit the “C” year NOL to also be passed through to the shareholder’s individual tax return without any reduction. The bill adds a reference on page 9, line 5, in the present law paragraph limiting the pass through of “C” items to “S” shareholders. The reference that is being added describes NOLs for the “S” corporation, not the shareholder. Therefore, the bill does not actually permit the pass through to the shareholder’s individual return. If the author intends to allow the pass through to the shareholder’s individual return, it should be clearly stated.

### **LEGISLATIVE HISTORY**

AB 1122 (Corbett, Stats. 2002, Ch. 35) provided that a corporation that is a valid federal “S” corporation is an “S” corporation for California purposes.

SB 219 (Scott, Stats. 2002, Chap.807) was a technical clean-up bill to AB 1122 and other bills enacted in the 2002 legislative session.

AB 1622 (Wyland, 2003) would have allowed corporations that became “S” corporations under AB 1122, and its shareholders, to use any previously incurred NOLs or tax credits that the former “C” corporation had generated prior to the forced conversion into an “S” corporation. AB 1622 was held in the Assembly Appropriations Committee.

SB 1237 (Hollingsworth, 2004) would have exempted corporations required to be “S” corporations under AB 1122 from the BIG tax for assets sold or under contract of sale before May 8, 2002 (the enactment date of AB 1122). SB 1237 was held in the Senate Appropriations Committee.

AB 2328 (Wyland, Stats. 2004, Ch. 782) changed the designated election date to the date the corporation elected to be an “S” corporation for federal purposes. Thus, this eliminated the BIGs tax for most corporations required to be “S” corporation under AB 1122.

### **OTHER STATES’ INFORMATION**

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California’s economy, business entity types, and tax laws.

Based on a limited review, *Florida, Illinois, Massachusetts, and Minnesota* have not allowed separate “S” corporation elections for at least 20 years. Accordingly, NOLs, and credit treatment has been the same as federal for the above states for at least 20 years.

*Michigan* treats “S” corporations as any other business entity for purposes of imposing the “single business tax,” which is Michigan’s version of a business income tax. Consequently, Michigan’s tax law is not comparable to California tax law as it relates to “S” corporation elections.

*New York* allows a separate election for “S” corporation status. New York does not permit NOL or credit carryovers from “C” to “S” years.

A cursory review was done of all other states. In addition to New York, only Arkansas allows separate “S” corporation elections. Various information readily available to the public was reviewed, including individual state tax forms and websites. Arkansas does not permit NOL or credit carryovers from “C” to “S” years.

## **FISCAL IMPACT**

The bill would require the department to process an unknown number of amended returns as claims for refund. Although the number of these anticipated amended returns is unknown, department staff estimates that the cost associated with processing these amended returns would be insignificant. .

## **ECONOMIC IMPACT**

### Revenue Estimate

Based on the discussion below, the revenue loss from this bill is as follows:

Estimated Revenue Impact of SB 259		
Effective Tax Years BOA 1/1/04		
Assumed Enactment Date After 6/30/05		
<b>2005/06</b>	<b>2006/07</b>	<b>2007/08</b>
-\$10	-\$10	-\$10

### Revenue Discussion

The revenue impact of this proposal is dependent on the number of corporations that converted from a “C” corporation to an “S” corporation for taxable year 2002 and the amount of stock NOL and credits available for use versus the amount used.

Based on the NOL model, the amount of stock NOL carryover for 2001 “C” corporations that converted into an “S” corporation for 2002 totals \$863 million. Applying an average marginal tax rate of 7.0% (6.0% individual and 1.0% “S” corporation rate) losses of approximately \$60 million divided over seven years would result in annual losses of \$8.5 million (\$863 million x .07 / 7 years).

The two most frequently reported credits are the manufacturers’ investment credit and the research credit. Based on historical credit usage trends, it is estimated that the recently converted “S” corporations average usage rate of these credits would approximate \$500,000 annually. Note that the available credits for carryover from previous years for both credits approximate \$60 million. However, these amounts do not result in a direct revenue impact because even though the credits are available for use to the extent that NOL deductions are available, credits will continue to be carried forward.

## **POLICY CONCERNS**

The bill would allow tax relief for certain taxpayers for prior tax years. Typically a bill of this nature includes a public purpose statement because it retroactively reducing taxes.

The provision allowing NOLs generated in "C" years to offset income earned in "S" years does not prevent NOLs being used to offset BIG tax. Thus, it appears that an NOL may be used twice: once against ordinary income for the 1.5% tax and once against BIGs for the 8.84% tax.

## **LEGISLATIVE STAFF CONTACT**

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