SENATE COMMITTEE ON GOVERNANCE AND FINANCE

Senator Mike McGuire, Chair

2021 - 2022 Regular

Bill No:	SB 104	**Hearing Date:**	3/25/21
Author:	McGuire	**Tax Levy:**	No
Version:	3/9/21 Amended	**Fiscal:**	Yes
Consultant:	Deitchman		

ELECTIVE TAX: LIMITED PARTNERSHIP: LIMITED LIABILITY PARTNERSHIP: LIMITED LIABILITY COMPANY: "S" CORPORATION: CREDIT

Creates an elective tax that allows pass-through entities to pay tax on behalf of their owners and allows a credit to the owners of those pass-through entities.

Background

Pass-Through Entities. S-corporations, Limited Liability Companies (LLC), Limited Liability Partnerships (LLP) and Limited Partnerships (LP) are business entities set up to distribute net income generated from the business to its owners (called shareholders, members, or owners). The owners report the income on their personal income tax returns and pay appropriate tax. This "pass-through" is meant to prevent double taxation of the same income, which can occur with C-corporations, who pay an entity level tax and whose owners pay tax on dividend income or capital gains from the sale of stock. As with any other business entity, pass-through entities can deduct state and local taxes paid as a business expense on their federal tax return.

Corporation Tax Rate and Minimum Franchise Tax. State law imposes a tax on all corporations doing business in California equal to 8.84 percent of the corporation's taxable income attributable to California. State law also imposes a Minimum Franchise Tax (MFT) of $800 on all corporations that incorporate under the laws of the state, or are doing business in the state. Corporations must pay either the regular franchise tax or the MFT, whichever is greater. The MFT ensures businesses that do not show a profit in a taxable year bear some of the cost of public services. Generally, corporations that have net income of less than $9,050 pay the MFT since their measured franchise tax would be less than $800.

Pass-through Entity Tax Rates and Annual Tax. The treatment of state taxes for pass-through entities varies by type.

- All S-corporations doing business in California pay a tax equal to 1.5 percent of the S-corporations income attributable to California and are subject to the annual tax.
- LLPs and LPs are only subject to the annual tax in California.
- LLCs pay a flat fee, in addition to the annual tax, based on the amount of California income as follows:

California Income	Fee
$250,000 - $499,999	$900
$500,000 - $999,999	$2,500

$1,000,000- $4,999999	$6,000
$5,000,000 or more	$11,790

State law imposes an annual tax on LLCs not classified as corporations, LPs, LLPs, and qualified Subchapter S subsidiaries (QSubs) that are either organized or doing business in California. The annual tax is currently set at $800 by reference to the minimum franchise tax.

State and Local Tax Deduction. Federal law generally allows individuals to deduct their state and local income taxes, sales and property taxes (SALT) on their federal income tax return. Beginning in 2018, the Federal Tax Cuts and Jobs Act (TCJA), changed several itemized deductions, including limiting the total deduction for SALT to $10,000 ($5,000 if married filing separate) for personal income taxpayers. The SALT limitation placed on individuals is set to expire after the 2025 taxable year. The SALT cap only affects individuals, not business entities.

In November 2020, the Internal Revenue Service (IRS) notified taxpayers that it intends to issue regulations clarifying that tax payments made at the entity level are not subject to the SALT deduction limitation applicable to partners and shareholders. Specifically, the announcement said the proposed regulations would: "…clarify that State and local income taxes imposed on and paid by a partnership or an S-corporation on its income are allowed as a deduction by the partnership or S-corporation in computing its non-separately stated taxable income or loss for the taxable year of payment, and therefore are not subject to the state and local tax deduction limitation for partners and shareholders who itemize deductions." The Notice provides that pass-through entities can pay SALT at the entity level, and the tax deduction that flows through to the individual partners and shareholders will not be subject to the individual SALT limitation for itemized deduction purposes.

The author wants to allow pass-through entities to pay the tax on behalf of their owners, and allow a tax credit to the owners equal to 94.9 percent of the tax paid by the pass-through entity.

Proposed Law

Senate Bill 104 creates a 9.3 percent elective tax that pass-through entities could elect to pay on behalf of their owners. All flow-through entities can elect to pay this tax (S-corporation, LLC, LLP, or LP) as long as the entity is exclusively owned by individuals, fiduciaries, estates or trusts and is not part of a combined reporting group for corporation tax purposes. The bill applies beginning in the 2021 taxable year, and ends after the 2025 taxable year.

The bill provides that the entity's election to pay the tax is irrevocable and can only be made on an original, timely filed return for the taxable year in a form and manner as prescribed by the Franchise Tax Board.

If the entity elects to pay this tax, the measure states that it is paid on behalf of their owners. In return, SB 104 allows all owners of the pass-through entity a tax credit equal to 94.9 percent of the "qualified amount," defined as an amount equal to 9.3 percent of the owner's pro rata share of income subject to the election made by a pass-through entity. The measure allows owners to carry forward the credit up to two subsequent years after the tax year in which the tax is paid.

SB 104 additionally provides:

- The elective tax is in addition to, and not in place of, any other tax or fee that applies to the entity.
- FTB may enforce and collect the tax in the same way as other tax obligations.
- All of the entity's partners, shareholders, and owners are bound by the entity's election.
- The due date for the elective tax is the same as due dates for other taxes that apply to that entity.
- That FTB may issue regulations necessary and appropriate to implement the bill.
- The Administrative Procedures Act does not apply to any regulation, rule, guideline, or procedure prescribed by the Franchise Tax Board.

State Revenue Impact

According to the FTB, this bill would result in a revenue gain of $420 million in the 2021-22 fiscal year and $55 million in the 2022-23 fiscal year and a revenue loss of -$26 million in the 2023-24 fiscal year, -$60 million in the fiscal year 2024-25 and -$370 million in the fiscal year 2025-26.

Comments

1. Purpose of the bill. According to the author, "SB 104 helps owners of pass-through entities limited by the SALT cap by allowing the entity that generates the pass-through income to pay the tax on their behalf. Owners must report their share of the income from their pass-through entity and are then made whole by claiming a 94.9 percent tax credit for the taxes paid on their behalf. Under SB 104, the state receives the same amount in California taxes, but by shifting the tax obligation to the pass-through entity, owners save in federal taxes and have more room under the SALT cap to deduct any other California taxes they pay."

2. How does this work? Under SB 104, owners of a pass-through entity can elect to have the entity they own pay their portion of individual tax owed on the business tax return on their behalf and the business will be able to deduct the taxes paid on their federal return. For example, two friends own a restaurant. The restaurant makes $400,000 in net income this year, distributing $200,000 in income to each partner, both of whom then include this income on their personal income tax returns. At a personal income tax rate of 9.3%, each owner would pay roughly $18,600 in state taxes. However, each partner can only deduct $10,000 in state personal income taxes from their federal income taxes because of the SALT cap. Using the above example, under SB 104, the restaurant would pay the state the same $37,200 in tax ($18,600 x 2) as its partners would have, but can then deduct this amount on its federal income tax return as a business expense, reducing its income subject to federal taxes. Additionally, the state income tax credit allowed to the owners reduces the owners' state personal income tax, because the restaurant paid the tax on their behalf. Under SB 104, the state receives the same $18,600 in California taxes, but by shifting the tax obligation to the pass-through entity, both owners save roughly $3,790 in federal taxes because the income distributed to them will be less after the entity deducts all state taxes paid. The owners would also have more room under the SALT cap to deduct any other California taxes they pay.

3. Prior Legislation. In 2018, SB 227 (De León) and AB 2217 (Burke) attempted to help those Californians that were limited by the new SALT deduction limitation enacted by the TCJA. These bills would have allowed taxpayers to donate to a state income tax fund, in the form of a charitable donation, instead of paying their taxes on their state tax return. In exchange for

making a donation to the fund in the amount of taxes owed by the individual, the state would offer a tax credit to the individual to claim when they filed their state tax return. Because charitable donations were not limited under the TCJA, those individuals that made a donation to the state income tax fund would have been able to deduct the entire donation amount from their federal tax return. As these bills moved through the legislative process, it became unclear whether the IRS would not allow this type of a donation. Generally, charitable contributions are only deductible to the extent that the donor received nothing in return for the donation. The IRS affirmatively disallowed these types of transactions in August 2018. SB 104 differs from the approach used in SB 227 and AB 2217 because the IRS notice that is applicable for SB 104 interprets whether elective state pass through entity taxes are ordinary and necessary business expense deductions, a much different issue than. Not whether mandatory tax payments can be converted to charitable contributions, as was the case with SB 227 and AB 2217.

4. Stay tuned. IRS issued Notice 2020-75, in November 2020, stating its intention to issue regulations clarifying that tax payments made at the entity level would not be subject to the SALT deduction limitation. While the final regulations are forthcoming, the method SB 104 advances appears to be blessed by the IRS. However, these regulations may provide further guidance for states considering adopting elective pass through entity taxes.

5. Governor's proposal. As part of the Governor's proposed budget, the Governor proposed language to "mitigate the federal $10,000 SALT deduction limitation for S-corporation shareholders by allowing the S-corporation to pay tax at a rate of 13.3%, thereby reducing the amount of income passed to shareholders and subject to federal income tax."

6. Gains early, losses later. The bill permits owners of a pass-through entity to elect to have their tax paid at the entity level, and then offers a credit in return for that payment. All of its owners are bound by the entity's choice to pay the tax or not. However, some owners will have losses from other pass-through entities they own interest in that could have been used to offset the income generated from the pass-through that elected to pay the tax, and would not have paid any tax as a result of those losses. As a result, some owners of pass-through entities will not be able to use some or all of the credit allowed to them in the year it's generated and will have to carryover the credit allowed to future tax years. As a result, SB 104 generates revenue gains in the first two fiscal years, which are then offset by revenue losses in the later years as these owners a claim credits generated in prior years.

7. Other states. To date, nine other states (Alabama, Arkansas, Connecticut, Louisiana, Maryland, New Jersey, Oklahoma, Rhode Island, and Wisconsin) have passed legislation to allow pass-through entities to pay taxes on behalf of their shareholders. The structures of these bills vary. Some of the varying items included are: allowing an income exclusion or a credit (either 100 percent or something less) requiring an elective or mandatory tax, and whether individual shareholders or the entity itself makes the election.

8. Technical amendments. Committee staff recommends the following technical amendments:

- An amendment to expand the definition of "pro-rata" to also include "distributive share" when appropriate for that entity type.
- Two amendments to clarify that the amount of tax charged on the pass-through entity should equal the amount of tax allowed to the shareholders or owners.

- Three amendments to clarify terms (one for net income and two for the definition of qualified entity) within the bill.

Support and Opposition (3/22/21)

Support: Allegis Redwood Maxim Public Affairs; California Chamber of Commerce; Coalition for Small and Disabled Veteran Businesses; National Federation of Independent Business- CA; S Corp Association.

Opposition: None listed

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