

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Wyland Analyst: Jeff Garnier Bill Number: AB 1622

Related Bills: See Legislative History Telephone: 845-5322 Amended Date: 2-21, 5-6, & 5-8-03

Attorney: Patrick Kusiak Sponsor: _____

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

SUMMARY

This bill would provide limited tax relief for corporations required to be S corporations due to the passage of AB 1122 (Stats. 2002, Ch.35).

SUMMARY OF AMENDMENTS

The bill as introduced on February 21, 2003, made non-substantive technical changes to an S corporation provision.

The May 6, 2003, amendments removed the technical changes and inserted the S corporation NOL and credit carryover provisions.

The May 8, 2003, amendment made the bill a tax levy going into effect immediately.

PURPOSE OF THE BILL

The author's staff has indicated that the purpose of the bill is to allow a new S corporation 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.

EFFECTIVE/OPERATIVE DATE

This bill would be effective immediately and apply to taxable years beginning on or after January 1, 2003.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Federal law provides, in general, that an NOL can be carried back two years and forward 20 years. An NOL is defined as the excess of allowable deductions (as specifically modified) over gross income computed under the law in effect for the loss year.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ <u>X</u> PENDING

Department Director

Date

Gerald H. Goldberg

5/28/03

Existing state law conforms to the federal computation of an NOL, except for the following modifications: California does not allow NOL carrybacks. In addition, depending on the type of taxpayer or amount of a taxpayer's income, the percentage of the NOL that is eligible to be carried forward and the number of years it can be carried forward varies.

Existing state law provides for seven different types of NOLs:

Type of NOL	Allowable Carryover	Taxable Years	Carryover Period
General NOL	55% 60% 100%	2000 & 2001 2002 & 2003 2004 - on	10 Years
New Business Year 1 Year 2 Year 3	100% 100% 100%		10 Years
Eligible Small Business	100%		10 Years
Specified Disaster Loss Any remaining excess	100% 55% 60% 100%	2000 & 2001 2002 & 2003 2004 - on	5 Years 10 Years
Economic Development Areas	100%		15 Years

Note: NOL deductions have been suspended for the 2002 and 2003 taxable years.

Federal and state law does not permit a NOL generated in a C corporation tax year to be carried over to an S corporation tax year. Instead, the NOL is utilized in the computation of a built-in gains (BIGs) tax. A BIGs tax is assessed on an S corporation that disposes of assets that appreciated in value during the years when the corporation was a C corporation. Thus, the BIGs tax only applies to S corporations that were originally a C corporation. The tax on the BIG is computed at the C corporation tax rate (California's current rate is 8.84%). Any NOL generated in a "C" year is applied against the BIG, reducing the BIG, and thus reducing the BIGs tax.

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 carried over to an "S" year can only be used to reduce the BIGs tax. Under state law, credits from a "C" year carried over to an "S" year are reduced to 1/3 of the original carried over amount and applied against the state's S corporation's measured tax rate of 1.5%.

For taxable years beginning on or after January 1, 2002, AB 1122 (Stats. 2002, Ch. 35) provided that a corporation with a valid S corporation election for federal law is an S corporation for California law.

THIS BILL

For corporations required to become a California S corporation in the 2002 tax year under AB 1122, this bill would 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 utilized in 2004. This bill also provides that the NOL could not be used to offset a BIG.
- 100% of credits generated in a C corporation tax year would be applied against the S corporation measured tax. The balance of credits generated in a “C” year on the first day of the corporation’s 2003 tax year would be grossed back up to 100% by multiplying the balance by three. The individual credit’s rules in affect the year the credit was generated would apply.

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.

AB 967 (Chavez, 2003) is a technical correction bill for AB 1122. AB 967 clarifies that a corporation with a valid federal S corporation is an S corporation for California purposes and removes obsolete language from S corporation tax law. AB 967 is presently at the third reading in the Assembly.

SB 227 (Hollingsworth, 2003) would, for C corporations required to be S corporations beginning in 2002 (AB 1122), make the effective date of the S corporation election for state purposes the same date as the federal election to be an S corporation. SB 227 is presently in the Senate Revenue and Taxation Committee.

SB 516 (Speier, 2003) would prohibit corporations with gross receipts in excess \$20 million from being an S corporation. SB 516 is presently in the Senate Revenue and Taxation Committee.

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* do not allow separate federal/state S corporation elections. Only *New York* allows a separate election.

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 corporations.

Florida and Illinois do not have a measured tax on S corporations. Therefore, coupled with no separate federal/state elections, the provisions of this bill do not apply to these two states.

Massachusetts assesses a measured tax on an S corporation's net income. The tax rate is based on the S corporation's total receipts ranging from 3% on \$6 million to 4.5% on \$9 million in total receipts. *Massachusetts* does not allow "C" NOLs and credits to offset the measured tax.

New York assesses a measured tax on an S corporation's net income. The effective tax rate for 2003 is approximately 0.36%. *New York* does not allow "C" NOLs to offset the measured tax. *New York* allows a limited credit carryover.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue losses:

Fiscal Year	2003-2004	2004-2005	2005-2006
NOL Carryover from C Corp to S Corp	Losses less than \$500,000	\$1 million loss	\$1 million loss
Credit Carryover from C Corp to S Corp	Losses less than \$250,000	Losses less than \$250,000	Losses less than \$250,000

Revenue Discussion

NOL Carryover from C Corp to S Corp -- Based on available department data, it is estimated that the utilization of NOL carryovers from the C Corporation to the S Corporation is expected to result in a revenue loss of approximately \$1 million annually over a period of five years. Approximately 2500 corporations were required to become S corporations for California purposes by the enactment of AB 1122.

Credit Carryover from C Corp to S Corp -- Available information indicates that a vast majority of the credits are utilized in the current year, resulting in a negligible carryover balance. Therefore, allowing 100% of the carryover credits from the C Corporation to be used by the S Corporation is expected to result in negligible revenue losses, less than \$250,000 annually.

LEGISLATIVE STAFF CONTACT

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