ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Assembly Rev & Tax Committee	Analyst:	Norman Catelli	Bill Number:	AB 3073
Related Bills:	See Legislative History	Telephone:	845-5117	Introduced Date:	03/11/2004
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Exclude LIFO Recapture Tax from Estimated Tax Underpayment for a C Corporation Electing S Corporation Treatment

SUMMARY

This bill would eliminate inconsistent payment due dates between two sections of California tax law.

PURPOSE OF THE BILL

This bill is intended to clarify tax law and ease taxpayer compliance and administrative burdens regarding last-in, first-out (LIFO) recapture provisions and estimated tax payments.

EFFECTIVE/OPERATIVE DATE

This bill would become effective January 1, 2005, and would apply to taxable years beginning on or after that date.

POSITION

Support.

On November 26, 2002, the Franchise Tax Board voted 2-0 to sponsor the language included in this bill.

ANALYSIS

BACKGROUND

LIFO is an inventory method of accounting for determining the value of opening and closing inventories where the most recently purchased or produced goods are deemed to be the first sold. Using LIFO in a period of rising prices results in a higher cost of goods sold and a lower taxable income than using other inventory valuation methods (e.g., first-in, first-out (FIFO) and cost-averaging methods).

FEDERAL/STATE LAW

Under existing federal law, and subject to certain restrictions, an eligible C corporation may elect to be taxed as a Subchapter S corporation. A C corporation is an ordinary corporation taxed under Subchapter C of the Internal Revenue Code (IRC) where it is recognized as a taxpaying entity. A corporation that makes the election to be subject to Subchapter S of the IRC is known as an S corporation. An S corporation passes items of income, loss, deductions, and credits through to the shareholders to be reflected on the individual shareholder's tax return.

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP		
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If a C corporation uses the LIFO method of accounting for its inventory for the tax year before an S election becomes effective, it must add to income an amount called the LIFO recapture amount. The LIFO recapture amount is the difference between inventory valued using FIFO and LIFO. The additional tax due on this recaptured income is payable over four equal annual installments. The installments are due by the corporation's tax return due date (without extension) for the next four taxable years. For federal purposes, pursuant to Internal Revenue Service (IRS) Revenue Procedure 94-61 as required by Internal Revenue Code Section 1363, the amount of tax imposed by reason of the LIFO recapture is not included in the amount of quarterly estimated tax payments a corporation is required to make for any of the taxable years for which a LIFO tax installment is due.

A C corporation with a valid federal S corporation election automatically becomes a California S corporation.

California law conforms to the federal LIFO recapture rules, including the benefit of allowing the tax to be paid in four equal annual installments due by the tax return due dates.

The LIFO recapture tax is contained within a portion of the Revenue and Taxation Code (R&TC) that technically requires the LIFO recapture tax to be included in estimated quarterly tax payments. However, inclusion of the LIFO recapture tax in quarterly payments conflicts with the federal annual installment provisions to which California conforms.

THIS BILL

This bill specifically excludes the annual payments of the LIFO recapture tax from being included in the definition of "estimated tax" and therefore subject to an underpayment penalty based on the estimated tax rules.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs and operations.

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.

Minnesota recognizes the federal relief provision and allows the LIFO recapture tax to be paid in four equal annual installments.

Florida, Illinois, Massachusetts, Michigan, and *New York* do not conform to the federal LIFO recapture relief provisions.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Revenue Impact ($ Millions)			
Fiscal Year	2004-05	2005-06	2006-07
Revenue loss	Insignificant loss	Insignificant loss	Insignificant loss

An insignificant loss does not exceed $150,000.

Revenue Discussion

For purposes of this analysis, it is assumed that enactment will not occur until after June 30, 2004. It is also assumed that corporations are in fact including LIFO recapture tax in their estimated tax payments as required under current law.

Based on available data, the total LIFO recapture tax is not expected to exceed an average of $300,000 annually. This proposal merely provides for a postponement of tax due to the due date of the returns rather than through quarterly estimate payments. The result is an insignificant initial cash flow loss (not exceeding $150,000) for fiscal year 2004-05. Offsetting cash flow gains and losses will occur for fiscal years 2005-06, 2006-07 and thereafter; however, the gain or loss is also expected to be insignificant.

ARGUMENTS/POLICY CONCERNS

This change would eliminate the imposition of an underpayment penalty that would arise from inconsistencies in California tax law.

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