

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Chavez Analyst: Jeff Garnier Bill Number: AB 967
Related Bills: See Legislative History Telephone: 845-5322 Introduced Date: February 20, 2003
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Binding Federal S Corporation Clean-up/ Estimated Tax Payments to Include Alternative Minimum Tax

SUMMARY

This bill would clarify the intentions of AB 1122 (Stats. 2002, Ch. 35) relating to S corporation status and estimated tax payments.

PURPOSE OF THE BILL

The author's staff has indicated the purpose of the bill is to ensure that all corporations with valid federal S elections are S corporations for state purposes and to correct AB 1122's (Stats. 2002, Ch. 35) unintentional omission of AMT from computation of an individual's estimated tax payment.

EFFECTIVE/OPERATIVE DATE

The S corporation provisions of this bill would be effective and operative for taxable years beginning on or after January 1, 2004. The provision relating to AMT included in the computation of estimated tax payments would be effective January 1, 2004, and operative for taxable years beginning on or after January 1, 2005.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

For income years beginning on or after January 1, 1987, California conformed to the federal S corporation provisions, with specified exceptions. For federal purposes, the taxable income or loss of an S corporation is taken into account by the corporation's shareholders, rather than by the entity, regardless of whether such income is actually distributed. The shareholders of a small business C corporation may elect to have the corporation be treated as an S corporation.

Under California law, in addition to the pass-through of the S corporation's income and deductions to its shareholders, an S corporation continues to be subject to the franchise tax, in an amount equal to the greater of the minimum tax or 1.5% of its net income for the taxable year. Unlike other corporations, however, an S corporation is allowed to compute depreciation under the modified cost recovery system (MACRS) and is subject to the same at-risk and passive activity loss rules as an individual. An S corporation is not subject to the alternative minimum tax. Credits are allowed against this corporate level tax in an amount equal to one-third of the amount otherwise allowable.

Board Position:

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Department Director
Gerald H. Goldberg

Date
03/28/03

Prior to AB 1122, a corporation that had in effect a valid federal election to be an S corporation was an S corporation for California purposes unless the corporation elected to remain a C corporation. AB 1122 removed a corporation's ability to elect to remain a C corporation for state purposes. Therefore, AB 1122 generally provided that a corporation with a valid federal S election is a California S corporation. AB 1122 did not alter two rules that either terminated or prohibited the S election for California purposes, thus still permitting separate federal/state S corporation treatment.

Under federal and state law, if passive investment income exceeds 25% of gross receipts for 3 consecutive taxable years and the corporation has accumulated earnings and profits from C corporation tax years, the S election is terminated and the corporation reverts back to being a C corporation. Because of other differences between state and federal laws (e.g., C corporation depreciation), a corporation's election could be terminated under state law and not under federal law. This result conflicts with the purpose of AB 1122.

Under federal and state law a bank that uses the reserve method to account for its bad debts cannot be an S corporation. Prior to 2002, federal and state law differed in the types of banks that could use the reserve method. Because of this difference, California S corporation law, not permitting banks and financials using the reserve method to be S corporations, was "stand alone" language similar to the federal language. AB 2065 (Stats. 2002, Ch. 488) effectively conformed California law to the federal bad debt deduction rules for banks. Revenue and Taxation Code Section 24348 allows the reserve method computed under IRC 585 for financials/banks defined in IRC 581. The reserve method is elective, therefore, a federal S corporation bank could elect to use the reserve method for state purposes only and, thus, would not be allowed to be an S corporation for state purposes. This result conflicts with the purpose of AB 1122.

Under federal law, an individual taxpayer generally is subject to an addition to tax (a penalty) for any underpayment of estimated tax (including AMT). Income tax withholding from wages is considered to be a payment of estimated taxes. An individual generally does not have an underpayment of estimated tax if the required estimated tax for the year is less than \$1,000 or if he or she makes timely estimated tax payments (required payments) at least equal to:

- 1) 90% of the tax shown on the return for the current year, or
- 2) 100% of the tax shown on the return of the individual for the preceding year. A special rule affecting high-income taxpayers with AGI over \$150,000 (\$75,000 if married filing a separate return) applies. For 2003 and thereafter, the percentage is 110%.

For estimated tax purposes, some trusts and estates are treated as individuals.

Current California law conforms, in general, with federal rules relating to the payment of estimated tax by individuals with the following exceptions:

- The "required payment" does not include alternative minimum tax.
- Estimated payments are required, unless the tax due for the year is less than \$200 as opposed to the federal \$1,000.

AB 1122 eliminated several material differences between federal and state estimate tax payment rules. AB 1122 intended to conform to the federal inclusion of AMT in the estimate tax payment computation, however, it did not.

THIS BILL

This bill would, in regard to:

S Corporations:

- Provide that the termination of S corporation status resulting from having passive investment income exceeding 25% of gross receipts only applies at the state level if it applied at the federal level and the federal S status was terminated.
- Remove the state language prohibiting a financial S corporation from using the reserve method for bad debts (thus, conforming to the federal rule by reference) and add language prohibiting an S corporation from using the reserve method for bad debts. (Thus, not permitting a separate reserve method election at the state level that would trigger a state only termination of S status.)
- Make numerous amendments removing obsolete language, mostly transitional or effective date language going back as far as when California first recognized S corporations in 1987 and make clerical adjustments, such as inserting "income tax" into the phrase "federal purposes."

Estimated Tax Payments:

- Require that AMT be included in the computation of the required estimated tax payments in order to meet a safe harbor from the underpayment of estimated tax penalty.

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 and conformed to the federal estimate tax computation with exceptions.

AB 1622 (Wyland, 2003) appears to be a spot bill related to S corporations. AB 1622 is presently at the Assembly Desk.

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 at Senate Rules.

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

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.

Florida, Illinois, Massachusetts, and Minnesota do not allow separate S corporation elections.

Michigan treats S corporations as any other business entity for purposes of imposing the "single business tax," which is Michigan's version of income tax. Therefore, 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.

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.

All the above states, except Florida, which does not have a personal income tax, generally conform to the federal estimate tax payment rules. However, Minnesota and New York are the only states that have an AMT and the AMT is included in the computation of the estimated tax payment.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

This bill would have no impact on PIT and Corporation tax revenues. This bill's clarification represents provisions that were previously accounted for in AB 1122.

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