

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Hollingsworth Analyst: Jeff Garnier Bill Number: SB 1237

Related Bills: See Legislative History Telephone: 845-5322 Introduced Date: Feb. 12, 2004

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: S Corporation Built-in Gains Tax Transitional Exclusion

SUMMARY

This bill would provide limited transitional tax relief for corporations that were required by 2002 legislation to be "S" corporations.

PURPOSE OF THE BILL

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

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy. Thus, it would be effective immediately, and is specified to be operative with respect to property sold or otherwise disposed of by a corporation required to be an "S" corporation if the property was sold or entered into contract for sale by May 8, 2002.

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. "C" corporation income is taxed at the corporation level and again when the income is distributed as a dividend to the shareholder. Generally, the taxable income of an "S" corporation is taxed only at the corporation's shareholder level, rather than at the corporation level, regardless of whether such income is actually distributed.

Board Position:

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Department Director

Date

Gerald Goldberg

March 22, 2004

For taxable years beginning on or after January 1, 1987, California conformed to the federal "S" corporation provisions, with specified exceptions. California still subjects the income of an "S" corporation to 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. Beginning in 2002, AB 1122 (Stats. 2002, Ch. 35) requires a corporation with a valid "S" corporation election for federal income tax purposes to be an "S" corporation for California income tax purposes. AB 1122 designated the election date for California purposes as the first day the corporation was required to be an "S" corporation for California purposes.

Under federal and state law, "S" corporations are subject to the "built-in gains" (BIG) tax on certain assets. This corporate level tax only applies to "S" corporations that were formerly "C" corporations. Gain is built-in to the extent appreciation of an asset belongs to a corporation's "C" years. Taxable income allocated to shareholders is reduced by BIG tax paid by the "S" corporation for the year. Under California law, the BIG tax is 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. The BIG tax applies for ten years after the "C" corporation becomes an "S" corporation. For California purposes the ten-year period begins on the date of the corporation's election to be an "S" corporation for California purposes or the first day of the taxable year the corporation becomes an "S" corporation under the provisions of AB 1122 discussed above. Because prior to AB 1122 a corporation could be a federal "S" corporation and a California "C" corporation, the ten-year period may be different for federal and state purposes.

THIS BILL

The bill would grant transitional relief for corporate taxpayers selling appreciated property that were required to switch from a "C" corporation to an "S" corporation under AB 1122. The transitional relief that would be granted would exempt from the BIG tax any sale or disposition of property occurring on or before May 8, 2002 (AB 1122's enactment date). Additionally, transitional relief would be provided for property under contract or option to sell, under certain conditions, on or before May 8, 2002.

IMPLEMENTATION CONSIDERATIONS

This bill would not significantly impact the department's costs

TECHNICAL CONSIDERATIONS

Section 1 of the bill would amend Section 76 of AB 1122 as it was chaptered. Section 76 of AB 1122 was amended by Section 20 of SB 219 (Stats. 2002, Ch. 807). Section 1 amends the language as it originally appeared in AB 1122 when it should instead start with the language in SB 219. Section 1 also contains a typographical error in the heading.

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 2002 Legislative Session.

SB 227 (Hollingsworth, 2003) contained the same provisions as this bill. SB 227 did not move out of the Senate Revenue and Taxation Committee.

AB 2328 (Wyland, 2004) would allow corporations, that became "S" corporations under AB 1122, and its shareholders to use any previously incurred net operating losses or tax credits that the former "C" corporation had generated prior to the forced conversion into an "S" corporation. AB 2328 is presently at the Assembly Desk.

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, transitional relief from requiring certain corporations to be "S" corporations is not applicable.

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 status.

New York allows a separate election for "S" corporation status. New York uses the date of the New York election; however, New York does not impose a BIG tax.

A cursory review was done of all other states. In addition to New York, only Arkansas allows separate "S" corporation elections. Information readily available to the public was reviewed, including individual state tax forms and websites. Arkansas uses the date of the Arkansas election for purposes of the BIG tax.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

SB 1237			
As Introduced February 12, 2004			
	2004/2005	2005/2006	2006/2007
Built in Gains Tax	-\$450,000	-\$150,000	-\$150,000

Revenue Discussion

This bill would exempt from BIG's tax, appreciated property sold between January 1, 2002, and May 8, 2002, by an "S" corporation required to convert from a "C" corporation for its first taxable year beginning on or after January 1, 2002. This is projected to create a one-time revenue loss of \$300,000. Based on historical information for "S" corporations paying the BIG's tax, the number with gains on property sold between January 1, 2002, and May 8, 2002, is projected to be quite low (fewer than ten) at an average tax of \$50,000.

This bill would also exempt from BIG's tax appreciated property that was under a contract or option to sell prior to May 8, 2002, by an "S" corporation that was required to convert. This provision is projected to create a revenue loss of less than \$150,000 annually.

POLICY CONCERN

The bill would allow tax relief for prior tax years. Although Section 2 appears to give a public purpose for the gift of public funds, the language does not specifically state the bill serves a public purpose. The author may wish to amend Section 2 to clearly state the public purpose.

LEGISLATIVE STAFF CONTACT

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