

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Hollingsworth Analyst: Jeff Garnier Bill Number: SB 227

Related Bills: See Legislative History Telephone: 845-5322 Introduced Date: February 13, 2003

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: S Corporation Election Date Same as Federal Election

SUMMARY

This bill would require that the California S corporation election date be the same date the corporation elected to be a federal S corporation.

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 unless otherwise specified, it would apply to taxable years beginning on or after January 1, 2003. The author's staff stated that the bill would be amended to make the effective and operative date of the provision for taxable years beginning on or after January 1, 2002.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

For federal purposes, the taxable income or loss and credits of an S corporation are 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 corporation may elect to have the corporation treated as an S corporation.

For taxable years beginning on or after January 1, 1987, California conformed to the federal S corporation provisions, with specified exceptions. 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 as 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.

Board Position:

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Department Director
Gerald H. Goldberg

Date
03/25/03

Under California law, in addition to the pass-through of the S corporation's income, deductions, and credits 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 (\$800) or 1.5% of its net income for the taxable year. Credits are allowed against this corporate level tax in an amount equal to one-third of the amount otherwise allowable under the Corporation Tax Law. An S corporation is not subject to the alternative minimum tax. S corporations are allowed, "net operating losses" at the entity level, which can be carried forward as deductions against the income subject to the 1.5% S corporation tax.

Under federal and state law S corporations are subject to the "built-in gains" (BIG) tax and the "last-in, first-out" (LIFO) recapture tax. These corporate level taxes only apply to S corporations that were formerly C corporations. BIG tax is assessed on recognized gain from the disposition by an S corporation of an asset that can be attributed to the corporation's "C" period. Distributable taxable income to shareholders is reduced by any BIG tax paid by the S corporation for the year. Distributable taxable income is not reduced by any LIFO recapture tax paid by the S corporation because the amount of LIFO recapture is not passed through to shareholders. Under California law, these taxes are assessed at the rate applicable to C corporations (8.84%).

The BIG tax is designed to tax gains on the disposition of assets by an S corporation where tax benefits (e.g., depreciation) or appreciation occurred during the corporation's "C" years, therefore, properly taxing the gain at the C corporation tax rate to preserve the second layer of taxation under Subchapter C of the Internal Revenue Code. 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.

The LIFO recapture tax applies to corporations that used the LIFO method of inventory the last day of its C corporation tax year (and, therefore, before its first S corporation year). The tax is assessed on the difference between the basis of the inventory computed under the LIFO method and the "first-in, first-out" (FIFO) method of inventory on the last day of the corporation's last "C" year. This difference represents "book" or "paper" deductions taken during C corporation tax years. The tax is paid in four equal annual installments. For federal purposes the LIFO recapture tax generally applies to corporations electing to become an S corporation after December 17, 1987. For California purposes the LIFO recapture applies to corporations that become an S corporation on or after January 1, 1989.

THIS BILL

This bill would change the S election date designated by AB 1122 from the first day of the corporation's taxable year beginning in 2002, to the same date as the federal S election date. Therefore, for purposes of applying the BIG and LIFO recapture tax, the federal election date would be used for corporations required to be an S corporation under AB 1122. This bill does not affect the election date of other California C corporations electing to be California S corporations prior to January 1, 2002.

In regard to the BIG tax, this bill would affect the sale of assets for taxable years beginning on or after January 1, 2003.

Since this bill has a 2003 effective and operative date, it would not generally impact corporations otherwise subject to the LIFO recapture tax.

IMPLEMENTATION CONSIDERATIONS

This bill, as introduced February 13, 2003, would not materially affect the department's costs and operations. If this bill were amended to be effective and operative in 2002, the department would be required to process an unknown number of claims for refund.

TECHNICAL CONSIDERATIONS

This 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). This bill amends the language as it originally appeared in AB 1122 when it should instead start with the language in SB 219.

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 an AB 1122 clean-up bill. 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 Assembly Desk.

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

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.

Based on a limited review, *Florida, Illinois, Massachusetts, and Minnesota* have not allowed separate S corporation elections for at least 20 years. Accordingly, the election date has been the same for at least 20 years.

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 elections.

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 or LIFO recapture tax.

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. Arkansas uses the date of the Arkansas election for purposes of the BIG and LIFO recapture tax.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Annual revenue losses for this proposal are expected to be minor, not exceeding \$500,000.

Revenue Discussion

For purposes of this analysis, it is projected that approximately 1300 relevant S Corporations will own appreciated property upon conversion to an S corporation. If 1% become subject to the BIG tax annually over the next 10 years, this would impact around 15 corporations each year. Assuming an average BIG tax of \$26,000 and average built-in gains of \$294,000, the elimination of the BIG tax for those corporations would result in minor (under \$500,000) revenue losses annually, beginning in 2003-04.

Currently only 0.3% of all S Corporations report BIG tax with an average BIG tax liability of approximately \$26,000. This equates to approximately \$294,000 of built-in gains per corporation.

ARGUMENTS/POLICY CONCERNS

This bill does not change the S corporation election date for state elections made prior to January 1, 2002.

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