

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Lieber and Umberg Analyst: John Pavalasky Bill Number: AB 2982

Related Bills: See Legislative History Telephone: 845-4335 Introduced Date: February 24, 2006

Attorney: Patrick Kusiak Sponsor: _____

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

SUMMARY

This bill would retroactively allow certain S corporations to use suspended credits and NOLs created prior to 2002.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to provide tax relief to corporations that were required under AB 1122 (Stats. 2002, Ch. 35) to be an S corporation for state purposes.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately. The provision relating to net operating loss (NOL) carryovers from a C year to an S year would retroactively apply to taxable years beginning on or after January 1, 2004. The provision affecting credit carryovers from a C year to an S year would retroactively apply to taxable years beginning on or after January 1, 2003.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENTS

Department staff is available to assist with amendments to resolve the implementation concerns discussed in this analysis.

ANALYSIS

FEDERAL/STATE LAW

Current Federal Law

General Rules

Under the federal Internal Revenue Code (IRC), a business entity formed by filing articles of incorporation under a foreign or U.S. state law is classified as a general corporation under subchapter C of the IRC (commonly known as a "C" corporation). A C corporation's income and deductions are reported on the corporation's tax return and included in determining the net income of that corporation subject to the federal tax on corporations. Dividends paid by a

Board Position:

_____ S _____ NA _____ NP
_____ SA _____ O _____ NAR
_____ N _____ OUA X PENDING

Department Director

Date

S. Stanislaus

4/12/06

C corporation to its shareholders are not deductible by the corporation in computing the corporation's net income subject to tax but are taxable when received by the shareholders, i.e., two levels of taxation. Dividends received by shareholders are treated as intangible income arising from the ownership of stock in the corporation and do not retain the character of the income when originally earned by the corporation.

Certain small business corporations with less than 100 shareholders may elect to be taxed under subchapter S of the IRC (commonly known as "S" corporations) rather than under subchapter C. That election means that the S corporation's income is not taxed at the entity level to the corporation itself, but instead it "passes through" to its shareholders any profits, losses, and separately stated items in the same manner as a partnership, regardless of whether such income is actually distributed, i.e., one level of taxation. Each item of income, deduction, or separately stated item is "passed through" to the shareholders and retains its character in the hands of the shareholder, i.e., whether it constitutes ordinary income, capital gain, depreciation, and whether it constitutes personal property income or deduction, real property income or deduction, intangible property income or deduction, as well as the source of that income or deduction.

Conversion from C corporation to S corporation status

Under federal law, the following special rules, which take into account the change from two levels of taxation to one, apply when an existing C corporation elects S corporation status:

1. A tax is imposed at the entity level at the federal corporation tax rate on the amount of the built-in-gain (BIG) on each asset owned on the last day of its last C corporation taxable year that is sold within 10 years of the date of the S election. The amount of the BIG for each asset is the difference between the fair-market-value of that asset reduced by the adjusted basis of that asset, both determined as of the last day of the C corporation taxable year prior to conversion to S corporation status.
2. No carryover between C and S years is allowed. Net operating losses (NOL) and credits arising in a taxable year in which a corporation is a C corporation may not be carried over to a taxable year in which a corporation is an S corporation (and vice versa). These suspended NOL and credit carryovers will be allowed only to offset the BIG tax or utilized when the corporation is once again liable for the C corporation tax and no longer treated as an S corporation. Note that S years do reduce the total number of years to which a C year NOL may be carried, so in effect the C year carryover period is tolled during S years.
3. Retained earnings of the corporation on the last day of its last C corporation taxable year remain taxable to the shareholders as dividends when they are actually distributed. The taxable dividend amount is computed in the following manner:
 - A. An accumulated adjustments account (AAA) is required to be established with a beginning balance of zero as of the date of the S election.
 - B. Actual distributions to shareholders are required to be offset first against the amount of S corporation undistributed earnings that are "passed through" and previously taxed to the shareholders and accounted for in the AAA.

- C. Actual distributions that exceed the balance in the AAA at the end of each S year are next treated as dividends taxable to the shareholders until all of the retained earnings on the last day of its last C corporation taxable year are exhausted.
- D. Actual distributions that exceed those taxable retained earnings are next treated as a nontaxable return of basis in the corporation to the extent the distribution does not exceed the shareholder's adjusted basis in the stock of the corporation.
- E. Any actual distributions that exceed the shareholder's adjusted basis in the stock of the corporation are taxed as gain from the sale or exchange of property, i.e. capital gain.

Current California Law

Under California law, a federal C corporation that is doing business or qualified to conduct business in California is subject to the California franchise tax. The franchise tax is a tax imposed on the privilege of exercising the entity's corporate franchise within California at a rate of 8.84% of the net income for the taxable year, but not less than the minimum franchise tax (currently \$800). The rate of tax for financial corporations is 10.84%. Corporations not subject to the franchise tax are subject to the corporate income tax at a rate of 8.84% of the net income for the taxable year, but are not subject to the \$800 minimum franchise tax.

For taxable years beginning on or after January 1, 1987, California conforms to the federal S corporation provisions, including the retention of the character of the income or deduction in the hands of the shareholder and special rules for conversions from C to S, with specified exceptions.

1. One important difference from federal law is that in addition to treating an S corporation as a "pass through" entity, California continues to impose the corporate level franchise tax on an S corporation, but at the rate of 1.5% (versus 8.84% for a C corporation) on its net income, or the minimum franchise tax of \$800, if greater. The rate of tax for financial S corporations is 3.5% (versus 10.84% for a financial C corporation), while S corporations subject to the corporate income tax continue to be subject to the corporate income tax, but at the rate of 1.5%, (versus 8.84%) on its net income, or the minimum tax of \$800, if greater.

To accommodate this continued corporate level tax on California S corporations, the federal special rules for conversions from C to S are modified by California to allow credit carryovers from C years to be carried over to S years, unlike under federal law. The amount that can offset the 1.5% corporate level tax on a California S corporation is one-third of the amount of the credit carryover from the last C corporation taxable year to the first S corporation taxable year. As under federal law, credits earned during a C year are prohibited from passing through to an S corporation shareholder. Additionally, as under federal law, NOL carryovers from C years to S years are not allowed and NOLs arising during a C year are prohibited from passing through to an S corporation shareholder. NOLs arising during S years are allowed to be fully "passed through" to shareholders and also to be used to offset the net income for the taxable year that is subject to the 1.5% corporate level tax.

2. California conforms to the BIG tax, with modifications. As under federal law, this corporate-level tax only applies to S corporations that were formerly C corporations. The BIG tax is imposed on each asset owned on the last day of its last C corporation taxable year that is sold

within 10 years of the date of the S election. The amount of the BIG for each asset is the difference between the fair-market-value of that asset reduced by the adjusted basis of that asset. Under California law, the BIG tax is imposed at the rate applicable to C corporations (8.84%).

3. For taxable years beginning on or after January 1, 1987, and before January 1, 2002, a period of 15 years, special California rules provided that a federal S corporation could elect to be a C corporation for California purposes. AB 1122 (Corbett, Stats. 2002, Ch. 35) provided that for taxable years beginning on or after January 1, 2002, federal S corporations will always be treated as S corporations for California purposes. AB 1122 designated the S election date for California purposes as the first day the corporation was an S corporation for California purposes. The election date determines the beginning of the 10-year period when the S corporation will be subject to the BIG tax. AB 2328 (Stats. 2004, Ch. 782) changed the designated election date to the date the corporation elected to be an S corporation for federal purposes, thus retroactively eliminating the BIG tax for most S corporations affected by AB 1122.

THIS BILL

For a C corporation required to be an S corporation for state purposes under the provisions of AB 1122 (Corbett, Stats. 2002, Ch. 35), this bill would make the following changes:

- Allow NOLs generated in a C corporation taxable year to be carried forward to an S corporation taxable 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 taken in 2004.¹ The provision permits the NOL to reduce taxable income for purposes of the 1.5% corporate level tax imposed on an S corporation and attempts to permit the NOL to also be passed through to the shareholder's individual tax return without any reduction. The provision does not alter current law with respect to the application of C corporation NOLs to reduce the BIG.
- Allow 100% (versus one-third) of credits generated in a C corporation tax year to be applied against the 1.5% corporate level tax imposed on an S corporation. The amount of the credit available for taxable years beginning on or after January 1, 2003, would be the credit carry forward amount as of the last day the corporation was a C corporation, minus the amount of the credit used after being reduced by two-thirds in the S corporation's 2002 tax year. The balance of credits generated in a C year on the first day of the corporation's 2003 S taxable year would be grossed back up to 100% by multiplying the balance by three. The individual credit's rules in effect in the year the credit was generated would apply.

IMPLEMENTATION CONSIDERATIONS

The intent of the bill appears to be to permit the C year NOL to also be passed through to the shareholder's individual tax return without any reduction. The bill adds a reference on page 9, line 5, in the present law paragraph limiting the pass through of C items to S shareholders. The

¹ California suspended NOLS for tax years 2002 and 2003.

reference that is being added describes NOLs for the S corporation, not the shareholder. Therefore, the bill does not actually permit the pass through to the shareholder's individual return. If the author intends to allow the pass through to the shareholder's individual return, it is suggested that the intent be clarified.

LEGISLATIVE HISTORY

AB 2668 (Canciamilla, 2005/2006) is substantially the same as this bill and would allow corporations that became S corporations under AB 1122 (Stats. 2002, Ch. 35), 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. That bill is currently in the Assembly Revenue and Taxation Committee.

SB 259 (Campbell, 2005/2006) was substantially the same as this bill and would have allowed corporations that became S corporations under AB 1122 (Stats. 2002, Ch. 35), 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. SB 259 was held in the Senate Revenue and Taxation Committee.

AB 2328 (Wyland, Stats. 2004, Ch. 782) changed the designated election date to the date the corporation elected to be an S corporation for federal purposes. Thus, this eliminated the BIG tax for most corporations required to be S corporations under AB 1122 (Stats. 2002, Ch. 35).

SB 1237 (Hollingsworth, 2003/2004) would have exempted corporations required to be S corporations under AB 1122 (Stats. 2002, Ch. 35) from the BIG tax for assets sold or under contract of sale before May 8, 2002 (the enactment date of AB 1122). SB 1237 was held in the Senate Appropriations Committee.

AB 1622 (Wyland, 2003/2004) would have allowed corporations that became S corporations under AB 1122 (Stats. 2002, Ch. 35), 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. AB 1622 was held in the Assembly Appropriations Committee.

SB 219 (Scott, Stats. 2002, Ch. 807) was a technical clean-up bill to AB 1122 and other bills enacted in the 2002 legislative session.

AB 1122 (Corbett, Stats. 2002, Ch. 35) was identical to SB 657 (Scott, Stats. 2002, Ch. 34) but was chaptered after SB 657. Both bills provided that a corporation that is a valid federal S corporation is an S corporation for California purposes.

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, NOLs and credit treatment has been the same as federal for the above states 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 does not permit NOL or credit carryovers from C to S years.

FISCAL IMPACT

The bill would require the department to process an unknown number of amended returns as claims for refund. Although the number of these anticipated amended returns is unknown, department staff estimates that the cost associated with processing these amended returns would be insignificant.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this provision would result in the following revenue losses.

Estimated Revenue Impact of AB 2982 Effective for Tax Years BOA 1/1/2003 Assumed Enactment Date After 6/30/06 (Millions)		
2005/06	2006/07	2008/09
-\$10	-\$10	-\$10

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The revenue impact of this bill is dependent on the number of corporations that converted from a C corporation to an S corporation for taxable year 2002 and the NOLs and credits available for use versus the amount used.

Based on the NOL model, the amount of stock NOL carryover for 2001 C corporations that converted into an S corporation for 2002 totals \$863 million. Applying an average marginal tax rate of 7.0% (6.0% individual and 1.0% S Corp rate) losses of approximately \$60 million divided over 7 years would result in annual losses of \$8.5 million (\$863 million x .07 / 7 years).

The two most frequently reported credits are the manufacturers' investment credit and the research credit. It is estimated that converted S corporations average usage rate of these credits would approximate \$500,000 annually. Note that the available credits for carryover from previous years for both credits approximate \$60 million.

However, these amounts do not result in a direct revenue impact because even though the credits are available for use to the extent that NOL deductions are available, credits will continue to be carried forward.

ARGUMENTS/POLICY CONCERNS

1. AB 1122 (Corbett, Stats. 2002, Ch. 35) provided that federal S corporations will always be treated as S corporations for California purposes. The April 27, 2005, Senate Revenue and Taxation Committee analysis of SB 259 (Campbell, 2005/2006), which was substantially the same as this bill, states that:

“The thought behind this reform was that corporations electing to be C corporations for state purposes but S corporations for federal purposes were taking advantage of federal - state differences to reduce their tax liability, and that this change would generate some \$20 million of additional revenue for "budget-balancing" purposes for the 2002 budget. This bill would back away from this reform, and allow those who chose to retain California C corporation status while continuing as federal S corporations to retain the tax advantages of the federal / state differences in elective S corporation status.”

2. The provision allowing NOLs generated in C corporation years to offset income earned in S years does not prevent those NOLs from being used to offset BIG tax. Thus, it appears that an NOL may be used twice: once against net income for the 1.5% tax and once against BIG tax for the 8.84% tax.

LEGISLATIVE STAFF CONTACT

John Pavalasky
Franchise Tax Board
845-4335

John.Pavalasky@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333

brian.putler@ftb.ca.gov