Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Gatto	Analyst:	David Scott	Bill Number:	AB 2540
Related Bills:	See Legislative History	Telephone:	845-5806	Introduced Date:	February 24, 2012
				Amended Date:	March 7, 2012
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Gross Income Exclusion/ Sales Tax for Specified Services

SUMMARY

This bill would do the following:

- Impose a sales tax on specified services; and
- For personal income taxpayers, exclude the lesser of 20 percent or $10,000 of business income from a trade or business conducted by a taxpayer or pass-thru entity.

This analysis will not address the changes to the sales and use tax laws, except for the above listing that the bill will impose a sales tax on specified services.

RECOMMENDATION

No position.

Summary of Amendments

This bill, as introduced on February 24, 2012, would: (1) impose a sales tax on specified services, and (2) exclude the lesser of 20 percent or $10,000 of business income from a trade or business from gross income for California income tax purposes.

The March 7, 2012, amendments made changes to the sales and use tax sections of the Revenue and Taxation Code.

This is the department's first analysis of the bill. This analysis only addresses the provisions of this bill that impact the department's programs and operations.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to bring much needed tax relief to California's entrepreneurs, helping to jump-start our economy and help the state's biggest job creators: California's Small Businesses.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2012.

Board Position:			Executive Officer	Date
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ANALYSIS

FEDERAL/STATE LAW

The Internal Revenue Code (IRC) defines "gross income" as all income from whatever source derived, including gross income from trade or business activities. California conforms to the federal definition, with modifications. The trade or business income reported by an individual taxpayer received from a pass-thru entity is the taxpayer's distributive or pro rata share of the income from the trade or business conducted by the pass-thru entity.

THIS BILL

This bill would exclude 20 percent of business income from a trade or business conducted by a taxpayer or a pass-thru entity in which the taxpayer is a partner or shareholder. The maximum aggregate amount of business income, from activities directly conducted by the taxpayer and/or a taxpayer's distributive or pro rata share of business income from pass-thru entities, that may be excluded would be $10,000. If a husband and wife file separate returns (spouses and registered domestic partners), the $10,000 maximum exclusion may be taken by either spouse or divided equally between the two spouses. The total aggregate exclusion taken on the two separate returns cannot exceed $10,000. The exclusion is for personal income tax purposes only. Business income is defined as income from a trade or business conducted by the taxpayer or by a pass-thru entity (a partnership or "S" corporation).

In addition, the bill specifies that the exclusion amount is to be treated as a "separately stated item"[1] where the amount is passing through from a partnership or S corporation.

This bill is silent as to whether or not the gross income excluded would be a tax preference item for alternative minimum tax purposes, therefore, it would not be a tax preference item.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

- The Revenue and Taxation Code's definition of "taxpayer"[2] includes any individual, fiduciary, estate, or trust subject to tax imposed by this part[3] or any partnership. In the case of multiple-tiered partnerships, it is unclear if each tier partner (a taxpayer by definition) would be allowed to exclude $10,000. If the intent is that each individual, estate, or trust is limited to a maximum exclusion of $10,000, then the bill should be amended.
- The bill's definition of "business income of a taxpayer" includes a trade or business conducted by a pass-thru entity. Many large businesses are conducted in the form of pass-thru entities. If the author's intent is to limit the exclusion to small businesses only, then the bill should be amended to specifically define a "small business" for purposes of the exclusion and to limit the exclusion to those small businesses.

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[1] Occurs when reporting the individual taxpayer's distributive share of items, such as on a partner's K-1.
[2] California Revenue and Taxation Code (R&TC) section 17004.
[3] Part 10, Div. 2, R&TC, Person Income Tax Laws.

LEGISLATIVE HISTORY

ABX1 40 (Fuentes & Fletcher, 2011/12) included a provision that would have excluded 10 percent of the first $50,000 of business income from a trade or business conducted by the taxpayer or the taxpayer's distributive share of business income from a pass-thru entity. This bill was held in the Senate Rules Committee.

SB 116 (DeLeon, 2011/12) was a similar bill, which included a provision that would have excluded 10 percent of the first $50,000 of business income from a trade or business conducted by the taxpayer or the taxpayer's distributive share of business income from a pass-thru entity. This bill failed to pass out of the Senate by the constitutional deadline.

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 and *Texas* do not have an individual income tax. The other states use federal tax information as the basis for computing business income. The federal Schedule C (business income for a sole proprietor) does not make an adjustment to exclude 20 percent of business income.

FISCAL IMPACT

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

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Estimated Revenue Impact of AB 2540 As Amended March 7, 2012 For Taxable Years Beginning On or After January 1, 2012 Assumed Enactment After June 30, 2012 ($ in Millions)		
2012-13	2013-14	2014-15
-$900	-$650	-$650

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Pro: This bill would provide much needed relief to California's entrepreneurs that are the lifeblood of California's economy.

Con: Some taxpayers may say that with the state's current fiscal crisis, additional tax expenditures should be avoided.

POLICY CONCERNS

An exclusion for business income moves the Personal Income Tax system away from the principle of horizontal equity, in which taxpayers with identical amounts of income are taxed the same. For example, two taxpayers each have income of $100,000, one whose income comes from a salary and the other one's income from Schedule C, trade or business. This bill would tax the Schedule C filer less than the taxpayer with a salary, assuming there were no other tax-related income, deductions, or credits, because $10,000 of the Schedule C income would be excluded, whereas none of the salary would be excluded.

LEGISLATIVE STAFF CONTACT

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