Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Assembly Revenue and Taxation Committee	Analyst:	Diane Deatherage & Jane Raboy	Bill Number:	AB 1413
Related Bills:	See Legislative History	Telephone:	845-4783	Introduced Date:	March 19, 2013
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Exempt Organizations/Simplify Application Method for Certain Federally Tax-Exempt Organizations/Motion Picture Production Credit-Allow Credit to Reduce Tentative Minimum Tax Beginning on or After January 1, 2011

SUMMARY

The changes to the Revenue and Taxation Code in this bill would:

- Eliminate the requirements for certain federally tax-exempt entities to apply for a California income tax exemption.
- Prohibit a corporation from establishing its California tax exemption until that corporation is listed by the Secretary of State (SOS) and the Franchise Tax Board (FTB) as an "active" corporation.
- Allow the California Motion Picture and Television Production Credit ("Motion Picture Credit") to reduce a corporate taxpayer's tax below tentative minimum tax.

The provisions that would modify tax-exempt status and the Motion Picture Credit are discussed separately in this document.

PROVISION #1: TAX-EXEMPT ORGANIZATIONS - SIMPLIFIED EXEMPTION PROCESS

RECOMMENDATION

No position.

REASON FOR THIS PROVISION

The reason for this provision is to allow additional categories of federally tax-exempt organizations to use the simplified process of applying for state tax-exempt status.

EFFECTIVE/OPERATIVE DATE

This provision would be effective January 1, 2014, and operative as of that date.

FEDERAL LAW

Under the Internal Revenue Code (IRC), certain entities are treated as tax-exempt organizations. A tax-exempt organization can be a trust, unincorporated association, or nonprofit corporation.

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The terms “nonprofit” and “tax-exempt” have different meanings. Nonprofit status is a matter of state law, which governs the organization and creation of the entity. All tax-exempt organizations are nonprofit, but not all nonprofits are tax-exempt.

Tax-exempt status is conferred for purposes of exemption from tax.

Federal tax law provides tax benefits to nonprofit organizations recognized as exempt from federal income tax and those organizations are required to comply with federal tax law to maintain tax-exempt status and avoid penalties.

There are 28 different paragraphs under IRC section 501(c) under which an organization can qualify for federal tax-exempt status. The more commonly known tax-exempt organizations are those recognized by the Internal Revenue Service (IRS) under IRC section 501(c)(3).

IRC Section 501(c)(3) – Charitable Organizations

Tax-exempt organizations recognized under this IRC section include public charities (e.g., United Way, Salvation Army, churches, hospitals, schools, colleges) and private foundations (e.g., Bill and Melinda Gates Foundation, Ford Foundation, The California Endowment, Rockefeller Foundation).

This provision would apply to tax-exempt organizations that have already been recognized by the IRS under the following IRC sections that must apply for tax-exempt status in California.

IRC Section 501(c)(4) – Civic Leagues, Social Welfare Organizations (including Certain War Veterans’ Organizations), or Local Associations of Employees

Civic leagues and social welfare organizations are exempt under section 501(c)(4) of the IRC. Social welfare organizations generally fall into one of the following categories:

- Organizations that may perform some type of public or community benefit but whose principal feature is lack of private benefit or profit;
- Organizations that would qualify for exemption under IRC section 501(c)(3) but for a defect in their organizing documents or if they were not "action organizations;" and
- Nonprofit organizations that traditionally have been labeled in common parlance as social welfare organizations.

IRC Section 501(c)(5) – Labor, Agricultural, or Horticultural Organizations

Labor, agricultural, and horticultural organizations fit under this classification and may not have earnings that inure to the benefit of any member. They are educational or instructive, with the goal of improving conditions of work, and to improve products and efficiency.

IRC Section 501(c)(6) – Business Leagues, Chambers of Commerce, etc.

Trade associations that meet the requirements of IRC section 501(c)(6) are exempt from federal income tax as business leagues. The same provision extends exemption to chambers of commerce, real estate boards, boards of trade, and professional football leagues.

IRC Section 501(c)(7) – Social Clubs

IRC section 501(c)(7) exempts social and recreational clubs from federal income tax. Generally, social clubs are membership organizations supported by dues, fees, charges or other funds paid by their members.

Typical organizations that may qualify for exemption under IRC section 501(c)(7) are:

- College fraternities and sororities
- Country clubs
- Amateur hunting, fishing, tennis, swimming and other sport clubs
- Hobby clubs
- Ethnic clubs
- Yacht clubs

Although not all tax-exempt organizations are required to submit a tax-exempt application with the IRS to be tax-exempt, they may wish to file to receive a determination letter of IRS recognition of their section 501(c) status in order to obtain certain incidental benefits such as:

- Public recognition of tax-exempt status
- Exemption from certain state taxes
- Advance assurance to donors of deductibility of contributions (in certain cases)
- Nonprofit mailing privileges, etc.

STATE LAW

Although most California laws involving tax exemptions are patterned after the IRC, some of the Revenue and Taxation Code (R&TC) tax-exempt sections are not in conformity with their related IRC sections.

The following are the R&TC sections that would be affected by this provision:

R&TC Section	Similar to IRC Section	Types of Organizations
23701a	501(c)(5)	Labor, Agricultural, Horticultural Organizations
23701e	501(c)(6)	Business Leagues, Chambers of Commerce, etc.
23701f	501(c)(4)	Civic Leagues, Social Welfare Organizations (including Certain War Veterans' Organizations), or Local Associations of Employees
23701g	501(c)(7)	Social Clubs

Obtaining state tax exemption is a separate process from obtaining federal exemption. Currently, in order to obtain state exemption from tax under one of the above-listed R&TC sections, an organization must: (1) submit a completed exemption application form to the FTB, (2) pay a filing fee of $25, and (3) receive a letter issued by the FTB indicating the organization is exempt from tax. The exemption application is required to include the organization's Articles of Incorporation, bylaws, and financial statements showing assets, liabilities, receipts, and disbursements.

Beginning in 2008, organizations that received a federal determination of tax-exempt status under IRC section 501(c)(3) could obtain state tax-exempt status by submitting only a copy of the federal determination to the FTB. [1]

To be exempt from state tax, an organization must be organized and operated for one or more exempt purposes listed in California's Corporation Tax Law (CTL).

THIS PROVISION

This provision would allow organizations that are federally tax-exempt under IRC sections 501(c)(4), 501(c)(5), 501(c)(6), or 501(c)(7) to submit a copy of their IRS tax-exempt determination letter to the FTB to establish their state income tax exemption.

As a result, these organizations would no longer be required to file an exemption application with the FTB or submit a $25 filing fee. Instead, the organization would receive state tax exemption automatically by informing the FTB of the IRS tax exemption and submitting a copy of the IRS tax-exempt determination letter.

These organizations would continue to receive an acknowledgement letter issued by the FTB verifying their exemption from state tax. Those organizations that are not issued a federal determination letter could still file an application to obtain California tax-exempt status.

This provision would specify that the FTB would not be prevented from revoking tax-exempt status if the organization fails to meet certain California provisions governing exempt organizations.

This provision would require the organization to inform the FTB of the suspension or revocation of the federal tax-exempt status and, upon receipt of the IRS notice of suspension or revocation, allow the FTB to suspend or revoke the organization's state tax-exempt status.

This provision would prohibit an organization formed as a California corporation or qualified to do business in California that is listed by the SOS or the FTB as "suspended" or "forfeited" from establishing its exemption from state income taxes and would provide that the organization would not receive an acknowledgement from the FTB of the organization's exemption until that corporation is listed by the SOS and the FTB as an "active" corporation.

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[1] R&TC section 23701d(c)(1).

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would require some changes to existing tax forms and instructions, and information systems, which could be accomplished during the normal annual update.

TECHNICAL CONSIDERATIONS

This provision would specify that the effective date of the state exemption would be “no later than” the effective date of the federal exemption (page 8, line 20). The effective date of the state exemption should be specified as "no earlier than" the effective date of the federal exemption.

LEGISLATIVE HISTORY

AB 1677 (Nestande, Chapter 858, Statutes of 2012) increased the general filing-requirement threshold of the California exempt organization annual information return from $25,000 of average annual gross receipts to $50,000 of such receipts.

AB 831 (Silva, 2011/2012) would have exempted a single-member limited liability company from annual tax and annual fee. Also this bill would have prohibited an organization that is listed by the SOS or the FTB as “suspended” or “forfeited” from establishing its California tax-exempt status and would have provided that the organization would not receive an acknowledgement from the FTB of the organization’s exemption until that corporation is listed by the SOS and the FTB as an “active” corporation. AB 831 failed to pass out of the Assembly Revenue and Taxation Committee.

AB 404 (Eng, Chapter 504, Statutes of 2009) eliminated the requirements for certain tax-exempt entities that are granted a federal group exemption to apply separately for state tax exemption, and allowed the FTB to permit inspection of certain exemption documents.

AB 897 (Houston, Chapter 238, Statutes of 2007) eliminated the state requirement for filing a separate application process for certain organizations that receive federal tax-exempt recognition. The organization seeking tax exemption must, however, submit to the FTB its IRS determination letter and be an organization described under IRC section 501(c)(3).

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. A review of the laws of these states found that all six states require exempt organizations to apply for tax-exempt status.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 1413 As Introduced March 19, 2013 Simplified Exemption Process Provision For Taxable Years Beginning On or After January 1, 2014 Assumed Enactment After June 30, 2013				
2013-14	2014-15	2015-16	2015-16	2016-17
$0	- $9,000	- $20,000	- $20,000	- $20,000

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

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Supporters may argue that this provision would allow organizations applying for tax-exempt status in California to eliminate the duplicative application process saving the organizations money and time.

Opponents: Some may argue that the FTB should continue the application process to better control the organizations that are recognized as tax-exempt for California.

PROVISION #2: MOTION PICTURE CREDIT

RECOMMENDATION

No position.

REASON FOR THE PROVISION

The reason for this provision is to allow taxpayers to fully utilize the Motion Picture Credit by correcting a technical oversight in the legislative language that would be required in order for the Motion Picture Credit to reduce the tentative minimum tax.

EFFECTIVE/OPERATIVE DATE

This provision would be effective January 1, 2014, and specifically operative for taxable years beginning on or after or after January 1, 2011.

ANALYSIS

BACKGROUND

The regular tax law excludes certain types of income and provides deductions and credits for certain expenses that reduce a taxpayer's tax liability. Enacted by Congress in 1969, the alternative minimum tax (AMT) attempts to ensure that individuals and corporations that benefit from certain exclusions, deductions, or credits pay at least a minimum amount of tax.

AMT is the excess of the tentative minimum tax over the regular tax. Tentative minimum tax is calculated separately from regular tax. In general, tentative minimum taxable income is computed by starting with taxable income for regular tax purposes, and eliminating or reducing certain exclusions and deductions that are allowed in computing regular tax. An exemption amount is subtracted from tentative minimum taxable income, and the balance is multiplied by the tentative minimum tax rate to compute the tentative minimum tax. California generally conforms to the federal AMT rules, with modifications, such as the allowable exemption amount and the tentative minimum tax rate.

The calculation of tentative minimum tax is also used to determine if a tax credit may be allowed by a taxpayer to reduce regular tax. Some tax credits are precluded from reducing regular tax below tentative minimum tax.

FEDERAL LAW

General business credits allowed for any tax year are limited to the excess of a taxpayer's "net income tax" over the greater of: (1) the tentative minimum tax for the tax year, or (2) 25 percent of the amount of the taxpayer's "net regular tax" that exceeds $25,000. In addition, the empowerment zone employment credit, the New York Liberty Zone business employee credit, "specified credits," and eligible small business credits have various rules for limiting the usage of credits.[2]

STATE LAW

Generally tax credits imposed under the Personal Income Tax Law (PITL) or the Corporation Tax Law (CTL) are precluded from reducing tax (regular tax) below tentative minimum tax except as provided in the statute.[3] (See Appendix A and B for a listing of tax credits that may/may not reduce regular tax below tentative minimum tax). The Motion Picture Credit is one of the credits precluded from reducing regular tax below the tentative minimum tax.

THIS PROVISION

This provision would add the Motion Picture Credit to the credits allowed to reduce tax below tentative minimum tax under the CTL for taxable years beginning on or after January 1, 2011.

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[2] IRC section 38(c).

[3] R&TC sections 17039 and 23036.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

LEGISLATIVE HISTORY

None.

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 corporate income tax is measured by net income, which is based on a taxpayer's adjusted federal income. The federal AMT amount is used with certain modifications for *Florida* income tax purposes. *Florida's* AMT is computed by multiplying *Florida* alternative minimum taxable income by 3.3 percent. The tax due is whichever amount is greater: the regular *Florida* corporate income tax or the *Florida* AMT. In later years, corporations that paid AMT are allowed a credit.

Minnesota imposes a corporate AMT that applies a rate to AMT then subtracts from the product the regular tax liability.

Illinois, Massachusetts, Michigan, and *New York* do not impose an AMT.

FISCAL IMPACT

This provision would increase administrative costs due to the need to process amended returns for the 2011 tax year. As this bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 1413 As Introduced on March 19, 2013 Movie Credit to Reduce Tax below Tentative Minimum Tax For Taxable Years Beginning On or After January 1, 2011 Assumed Enactment After June 30, 2013				
2012-13	2013-14	2014-15	2015-16	2016-17
- $9,300,000	- $800,000	- $1,300,000	+ $10,000	- $600,000

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

POLICY CONCERN

This provision would only apply to corporations and not to taxpayers subject to the PITL. If this is contrary to the author's intent, an amendment would be necessary.

SUPPORT/OPPOSITION

Support: None provided

Opposition: None provided.

ARGUMENTS

Proponents: Supporters may argue that the benefit of allowing the Motion Picture Credit to reduce tentative minimum tax would be greatly reduced because many taxpayers claiming the credit have little or no tentative minimum tax against which to apply the credit.

Opponents: Opponents may argue that allowing the Motion Picture Credit to reduce the tentative minimum tax would be contrary to the legislative intent for enacting the AMT.

LEGISLATIVE STAFF CONTACT

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Appendix A

Tax Credits That May Not Reduce Regular Tax Below Tentative Minimum Tax Under Personal Income Tax Law (PITL) and Corporation Tax Law (CTL)

Current Tax Credits:

- California Motion Picture and Television Production
- Child and Dependent Care Expenses (PITL Only)
- Community Development Financial Institutions Investment
- Disabled Access for Eligible Small Businesses
- Donated Agricultural Products Transportation
- Donated Fresh Fruits or Vegetables
- Enhanced Oil Recovery
- Environmental Tax
- 2010 First-Time Buyer (PITL Only)
- Local Agency Military Base Recovery Area Hiring & Sales or Use Tax
- Manufacturing Enhancement Area Hiring
- 2010 New Home (PITL Only)
- New Jobs
- Prior-Year Alternative Minimum Tax
- Prison Inmate Labor

Repealed Credits with Carryover or Recapture Provisions:

- Agricultural Products
- Contribution of Computer Software (CTL Only)
- Employee Ridesharing (PITL Only)
- Employer Childcare Contribution
- Employer Childcare Program
- Employer Ridesharing
- Energy Conservation
- Farmworker Housing-Construction
- Joint Strike Fighter Wages
- Joint Strike Fighter Property Costs
- Low-Emission Vehicles
- Political Contributions (PITL Only)
- Recycling Equipment
- Residential and Farm Sales (PITL Only)
- Rice Straw
- Ridesharing
- Salmon & Steelhead Trout Habitat Restoration
- Solar Pump
- Solar or Wind Energy System
- Technological Property Contribution (CTL Only)
- Water Conservation (PITL Only)
- Young Infant (PITL Only)

Appendix B

Tax Credits That May Reduce Regular Tax Below Tentative Minimum Tax Under Personal Income Tax Law (PITL) and Corporation Tax Law

Current Tax Credits:

- Child Adoption (PITL Only)
- Dependent Parent (PITL Only)
- Enterprise Zone Hiring and Sales or Use Tax
- Joint Custody Head of Household (PITL Only)
- Low-Income Housing
- Natural Heritage Preservation
- Nonrefundable Renters (PITL Only)
- Other State Tax (PITL Only)
- Research
- Senior Head of Household (PITL Only)
- Targeted Tax Area Hiring and Sales or Use Tax

Repealed Credits with Carryover or Recapture Provisions:

- Commercial Solar Electric System
- Commercial Solar Energy
- Los Angeles Revitalization Zone Hiring and Sales or Use Tax
- Manufacturers Investment
- Orphan Drug
- Solar Energy