The following is the Franchise Tax Board's analysis of SB 5 (Lockyer and Lewis) as amended September 11, 1997.

Subject: Federal Conformity - S Corporations & Exclusion of Gain from a Sale of a Principal Residence

SUMMARY OF BILL

SB 5 would:

- substantially conform **California law** to the changes made by the Small Business Job Protection Act of 1996 (SBJPA) (PL 104-188) to the federal rules relating to S corporations. SB 5 also would provide transitional relief under the Revenue and Taxation Code regarding estimated tax payments. A C corporation that elects to be an S corporation in 1997 could request to have part (the amount in excess of the S corporation's expected tax liability) of the estimated tax payment transferred to the personal income tax accounts of its shareholder's. The tax rate imposed on S corporations would be increased from the current 1.5% rate. The rate would be increased for income years beginning on or after January 1, 1997, as follows: 1997 - 1.6%; 1998 - 1.65%; 1999 - 1.7%; 2000 and thereafter - 1.6%.

- conform to changes made by the Taxpayer Relief Act of 1997 (TRA) (PL 105-34) to the federal treatment of excluding gain up to $500,000 from the sale or exchange of a principal residence. The existing state "once in a lifetime exclusion of $125,000" and "roll over of gain" provisions would not be applicable during the operative dates of these provisions, which are for sales on or after May 7, 1997, and on or before June 30, 1998.

S CORPORATIONS PROVISIONS

This bill would generally conform **California law** to 16 provisions of the SBJPA as it relates to S corporations. Thirteen of the items would be conformed to without exception and three items with exceptions.

1. Increasing the number of S corporation shareholders to 75.
2. Electing small business trusts may hold S corporation stock.
3. Post death qualification extended to two years for certain trusts.
4. Financial institutions can hold safe-harbor debt.
5. Inadvertent invalid elections and termination (with exception).
6. Agreement to terminate year.
7. Expansion of the post-termination transition period.
8. S corporations may own subsidiaries (with exception).
9. Distributions during loss years.
10. Treatment of S corporations under Subchapter C (with exception).
11. Carryover of losses and deductions under the at-risk rules.
12. Treatment of inherited stock.
13. Treatment of gain from subdivided real estate.
14. Financial corporations may be S corporations.
15. Exempt organizations can be S corporation shareholders.
16. S corporations that terminated within the previous five years may re-elect to be S corporations.

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Amended September 11, 1997

Effective Date

Unless otherwise provided, the provisions of this bill affecting S corporations would apply to taxable and income years beginning on or after January 1, 1997.

Legislative History

AB 203 (1996/97), AB 1039 (1996/97)

Program History/Background

For income years beginning on or after January 1, 1987, California conformed to the federal S corporation provisions, with specified exceptions. For federal purposes, the taxable income or loss of an S corporation is taken into account by the corporation's shareholders, rather than by the entity, regardless whether such income is distributed. The shareholders of a small business corporation may elect to have the corporation be treated as an S corporation. Under **California law**, a “small business corporation” is defined as a domestic corporation which has elected federal S status and which does not have (1) more than 35 shareholders, (2) as a shareholder, a person (other than certain trusts or estates) who is not an individual, and (3) more than one class of stock. For purposes of the 35-shareholder limitation, a husband and wife are treated as one shareholder.

Under **California law**, in addition to the pass-through of the S corporation’s income and deductions 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 or 1.5% of its net income for the income year. Unlike other corporations, however, an S corporation is allowed to compute depreciation under the modified cost recovery system (MACRS) and is subject to the same at-risk and passive activity loss rules as an individual. An S corporation is not subject to the alternative minimum tax. Credits are allowed against this corporate level tax in an amount equal to one-third of the amount otherwise allowable.

Each nonresident shareholder or nonresident fiduciary of an S corporation must file with the S corporation return a statement of consent by that shareholder or fiduciary to be subject to the jurisdiction of California to tax that shareholder’s or fiduciary’s pro rata share of income attributable to California sources. The S corporation must include in its return for each income year a list of the shareholders. Failure to meet these requirements provides grounds for retroactive revocation of the Californian S corporation election.

A corporation that makes a valid election to be treated as an S corporation for California purposes is not allowed to be included in a combined report of a unitary group.

Specific Findings

1. Increasing the number of shareholders to 75.

Existing **federal law** provides that for years beginning on or after January 1, 1997, an S corporation may have 75 shareholders.

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Existing **California law** conforms to **federal law** as it read January 1, 1993, which allows an S corporation to have no more than 35 shareholders.

This bill would conform **California law** with the **federal law** allowing S corporations to have a maximum of 75 shareholders.

2. Electing small business trusts.

Existing **federal law** allows individuals, bankrupt estates, certain trusts and Electing Small Business Trusts (ESBT) to be shareholders in an S corporation. In order to qualify as an ESBT, all beneficiaries of the trust must be individuals or estates eligible to be S corporation shareholders, except that charitable organizations may hold contingent remainder interests. No interest in the ESBT may be acquired by purchase. For this purpose, "purchase" means any acquisition of property with a cost basis. Thus, interests in the ESBT must be acquired by reason of gift, bequest, etc. A trust must elect to be treated as an ESBT.

Each potential current beneficiary of the ESBT is counted as one shareholder for purposes of the 75 shareholder limitation (or if there were no potential current beneficiaries, the ESBT would be treated as the shareholder). A potential current income beneficiary means any person, with respect to the applicable period, who is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the ESBT.

The portion of the ESBT which consists of stock in one or more S corporations is treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the ESBT. The ESBT is taxed at the highest individual rate (currently, 39.6 % on ordinary income and 28 % on net capital gain) on this portion of the ESBT's income.

Existing **California law** conforms to **federal law** as it read January 1, 1993, which only allows individuals, bankrupt estates and certain trusts (normally a grantor trust with only one owner or a voting trust) to be shareholders in S corporations. Currently, ESBTS may not be S corporation shareholders.

This bill would conform **California law** with the **federal law** allowing S corporations to have ESBTs as shareholders. This bill would require that an election by the trust to be treated as an ESBT for federal purposes applies for state tax purposes as well. No separate state election would be allowed.

3. Post death qualification extended to two years for certain trusts.

Existing **federal law** provides that a grantor trust may hold S corporation stock for two years from the date of the grantor's death. Similarly, testamentary trusts may also hold S corporation stock for a two-year period beginning with the date the stock was transferred to the trust.

Existing **California law** conforms to **federal law** as it read January 1, 1993, which allows both trusts discussed above only a 60-day holding period.

This bill would conform **California law** with the **federal law** allowing certain trusts to hold S corporation stock for two years.

4. Financial institutions can hold safe-harbor debt.

Existing **federal law** provides that an S corporation may have only one class of stock. In some circumstances, debt can be considered equity (stock) and even a second class of stock. Therefore, **federal law** has safe harbor rules denoting that certain straight debt shall not be treated as a second class of stock. Straight debt is defined as any written unconditional promise to pay a certain sum of money on demand or on a specified date. The debt instrument also must meet certain other requirements: the interest rate or payment dates are not contingent on profits, the borrower's direction, or similar factors; the debt cannot be converted into stock; and the creditor is an individual (other than a nonresident), an estate, a trust or person regularly in the business of lending money. A person is defined as any legal entity.

Existing **California law** conforms to **federal law** as it read January 1, 1993, which includes the safe harbor for straight debt rules with one exception. California has not conformed to allowing the creditor to be a person regularly in the business of lending money.

This bill would conform **California law** with the **federal law** allowing straight debt safe harbor rules to allow a person who regularly engages in the business of lending money to hold debt instruments of an S corporation.

5. Inadvertent invalid elections and terminations (with exception).

Existing **federal law** provides that if the Secretary determines an S corporation inadvertently made an invalid S corporation election or inadvertently terminates its S corporation election, the corporation shall be treated as an S corporation for the period specified by the Secretary. Invalid elections that qualify for a determination are those due to: (1) elections received by the Secretary 2 1/2 months after the start of the corporation's tax year to which the election applies, (2) the corporation did not meet the definition of a "small business corporation" on the date the election was filed, and (3) the corporation did not obtain the consent of all shareholders by the date the election was filed. Inadvertent termination are limited to terminations due to: (1) a corporation which ceased to be a small business corporation or (2) a corporation's passive investment income exceeded 25% of the corporation's gross receipts for three consecutive taxable years and has C corporation earnings and profits. Other stipulations under the inadvertent rules require, where applicable, the correction of the cause of the termination or invalid election and the making of any adjustments consistent with the treatment as an S corporation for the period being allowed as an S corporation by the Secretary. All shareholders and the corporation must agree to the adjustments.

A corporation may request an inadvertent invalid election or termination determination for any taxable year beginning after December 31, 1982.

Existing **California law** conforms to **federal law** as it read January 1, 1993, which allows the FTB to determine that a termination was inadvertent because: (1) a corporation ceased to be a small business corporation or (2) a corporation's passive investment income exceeded 25% of the corporation's gross receipts for three consecutive taxable years and has C corporation earnings and profits. The corporation must correct the cause of the termination and make the necessary adjustments for the period consistent with the treatment as an S corporation. The shareholders and the corporation must agree to the adjustments.

Late or invalid elections are not allowed to be considered under the FTB's inadvertent termination authority.

This bill would conform **California law** prospectively with the **federal law** allowing the correction of invalid elections. Under the bill, the FTB would allow an S corporation to correct an invalid or late election for income years beginning on or after January 1, 1997, in specified circumstances as provided in current **federal law**. The bill also would provide that if a federal determination is made regarding a invalid election, allowing the taxpayer to be an S corporation for federal purposes prior to January 1, 1997, the corporation would automatically be considered to be an S corporation for state purposes for its first income year beginning after December 31, 1996. The corporation would be able to revoke its S corporation election under existing provisions in the law. Under a transitional clause, the time allowed to revoke its S election would be extended by the bill to six months after the bill's enactment.

6. Agreement to terminate year.

Existing **federal law** provides that if an S corporation shareholder's entire interest in the corporation is disposed of, the S corporation can elect to allocate the pass-through items as if the year consisted of two tax years. A "specific accounting method" allocation is accomplished by "closing" the corporation's books as of the day a shareholder's ownership interest terminated. This allocation is based on normal accounting rules, using the company's books and records for each respective period.

The S corporation can elect to use the specific accounting method if all the shareholders affected by the stock disposition consent. The shareholders affected by the stock disposition includes the shareholder whose interest is terminated and all shareholders who acquired shares from the terminating shareholder during the tax year. If the shares were transferred to the corporation, all shareholders who owned stock during the year are affected shareholders.

Existing **California law** conforms to **federal law** as it read January 1, 1993, which allows for a specific accounting method and the closing of the books, if all the shareholders consent, not just the affected shareholders.

This bill would conform **California law** to **federal law**, allowing an S corporation to use a specific accounting method and close the books with only the affected shareholders consenting. A separate election for state purposes would be allowed by the bill.

7. Expansion of the post-termination transition period.

Existing **federal law** provides that after an S election has been terminated or revoked, the shareholder may continue to use previously suspended losses (to the extent of basis) and receive non-taxable distributions (to the extent of the Accumulated Adjustment Account balance) until the end of the post-termination transition period.
The post-termination transition period could conceivably include three periods. The first post-termination transition period begins on the first

day of the new C corporation’s tax year and ends the later of: (1) one year later, or (2) the due date (including extensions) for filing the return for the last year as an S corporation .

The second post-termination transition period includes a 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the S corporation's election and that adjusts a Subchapter S item of income, loss or deduction of the S corporation during the S period. In addition, the definition of “determination” includes a final disposition by the Secretary for a claim for refund and, under regulations, certain agreements between the Secretary and any person, relating to the tax liability of the person.

The third period begins on the day that a determination has been made that the corporation had terminated its S corporation election in a previous taxable year. A determination, in this case, means a court decision, a closing agreement, or an agreement between the Secretary and the corporation that the corporation failed to qualify as an S corporation.

In addition to the above, existing **federal law** requires that a shareholder’s tax return must be consistent with the S corporation’s return. The shareholder may file inconsistently, if a statement is attached to the return identifying the inconsistency. If the shareholder does not inform the Secretary of the inconsistency, the Secretary may treat the inconsistency on the shareholder’s return as a mathematical or clerical error and assess accordingly. Penalties may be imposed upon on a shareholder for not being consistent with the S corporation return.

Existing **California law** conforms to **federal law** as it read January 1, 1993, which provides for the post-termination transition period to include the first and third post termination periods discussed above. Current **California law** does not allow for a post-termination transition period pursuant to an audit.

California law does not have a provision requiring that the shareholder’s return be consistent with the S corporation’s return.

This bill would conform **California law** to **federal law** by providing that a transition period includes a 120-day period pursuant to an audit determination which adjusts the income, loss or deduction of an S corporation.

This bill would also conform **California law** to the **federal law** requiring consistent treatment of Subchapter S items on the shareholder’s tax return and the S corporation return.

8. S corporations may own subsidiaries (with exception).

Existing **federal law** allows an S corporation to own 100% of the stock of a C corporation. The C corporation subsidiary can elect to join in the filing of a consolidated return with its affiliated C corporations. However, the S corporation cannot be included in the federal consolidated return. Dividends received by an S corporation from a C corporation owned 80% or more by the S corporation are not treated as passive investment income (which may terminate the S election) to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business. Dividends received from a C corporation, in which the S corporation owns less than 80% of the stock, are considered passive investment income.

In addition, an S corporation is allowed to own a qualified Subchapter S subsidiary (QSSS). A QSSS is a domestic corporation that: (1) is not an ineligible corporation (i.e., a corporation that would be eligible to be an S corporation if the stock of the corporation were held directly by the shareholders of its parent S corporation), (2) 100% of the stock of the subsidiary is held by its S corporation parent, and (3) the parent elects to treat the subsidiary as a QSSS. Under the election, the QSSS is not treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of the subsidiary are treated as the assets, liabilities, and items of income, deduction, and credit of the parent S corporation.

Existing **California law** conforms to **federal law** as it read January 1, 1993, which provides that a small business corporation cannot be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations). Thus, an S corporation cannot own 80% or more of the stock of another corporation. Also, a small business corporation cannot have as a shareholder another corporation (whether an S corporation or a C corporation).

This bill would conform **California law** to **federal law** provisions allowing an S corporation to own 100% of a C corporation. The bill also would provide that dividends received from an affiliated C corporation under certain circumstances would not be considered passive investment income.

Additionally, this bill would conform **California law** to the federal QSSS provisions. The election of QSSS treatment for federal purposes would be treated as an election for state purposes, unless the parent itself elects to be treated as a C corporation for state purposes.

This bill would adopt the federal provisions providing that all assets, liabilities, items of income, deduction, and credit would be treated as assets, liabilities, items of income, deduction, and credit of the parent S corporation.

The bill would additionally provide that the activities of the QSSS would be treated as activities of the parent S corporation. The parent would be subject to the minimum tax, and the QSSS would be subject to a tax of $800 annually. The QSSS tax would be assessed annually on the QSSS; however, the liability to pay the tax would become the liability of the parent S corporation.

9. Distributions during loss years.

Existing **federal law** provides that stock basis in an S corporation is initially (at acquisition) computed in the same manner as the stock basis for a C corporation. From this point on, the basis computation rules for an S corporation's stock differ greatly from C corporation stock. Each shareholder's basis in the S corporation stock repeatedly changes in response to the flow-through of items of income and loss to the shareholders as well as distributions received by the shareholders. The stock basis in an S corporation is adjusted for any period in the following order: (1) increased by pass-through items of income and gain, (2) decreased by distributions, and (3) decreased by pass-through items of loss and deduction. The amount of loss an S corporation shareholder may take into account for a taxable year may not exceed the sum of the shareholder's adjusted basis in the stock of the corporation and the adjusted basis in any indebtedness of the corporation to the shareholder. Any unused loss is carried forward to succeeding taxable years.

Distributions from an S corporation are nontaxable to the extent of the adjusted basis of the shareholder's stock. The adjusted basis is reduced by the distribution. Distributions in excess of basis are treated as gain from the sale or exchange of property. If an S corporation has accumulated earnings and profits, any distribution in excess of the amount in the accumulated adjustment account (AAA) will be treated as a dividend (to the extent of accumulated earnings and profits). A dividend distribution does not reduce the adjusted basis of the stock. An AAA is the amount of the accumulated undistributed post-1982 gross income less deductions.

For purposes of determining the treatment of distributions made during a taxable year by an S corporation with accumulated earnings and profits, net negative adjustments (i.e., the excess of losses and deductions over income) for the taxable year of the distribution are disregarded in determining the amount in the AAA.

The order of the adjustments made to the AAA differs between a net gain year and a net loss year, as explained below.

A. Net Gain Year

If the aggregate pass-through income and gain items exceed the aggregate pass-through loss and deduction items, the AAA is adjusted in the same order as the stock basis above, namely: (1) increased by pass-through items of income and gain, (2) decreased by distributions, and (3) decreased by pass-through items of loss and deduction.

B. Net Loss Year

If the aggregate loss and deduction items exceed the income and gain items, distributions are taken into account first, which reduces the likelihood that the distribution will be taxable. For net loss years, the AAA beginning balance is: (1) decreased (but not below zero) by distributions, (2) increased by pass-through items of income and gain, and (3) decreased by pass-through loss and deduction items. A distribution will only be taxable if the AAA is reduced below zero after the distribution adjustment.

Existing **California law** conforms to **federal law** as it read January 1, 1993. The amount of loss an S corporation shareholder can take into account for a taxable year is the sum of the shareholder's adjusted basis in the corporation and the adjusted basis in any indebtedness of the corporation to the shareholder. Any excess loss is carried forward.

Any distribution to a shareholder by an S corporation generally is tax-free to the shareholder to the extent of the shareholder's basis in the stock. The shareholder's adjusted basis is reduced by the tax-free amount of the distribution. Any distribution in excess of the shareholder's adjusted basis is treated as a gain from the sale or exchange of property. In addition, if the S corporation has accumulated earnings and profits, any distribution in excess of the AAA will be treated as an ordinary dividend to the extent of the C corporation's earnings and profits (E&P). Distributions in excess of E&P reduce the cost basis of the stock (return of capital) and the remainder is treated as a gain from the sale or exchange of a capital asset. Income (regardless of whether taxable) and expenses (regardless of whether deductible) serve, respectively, to increase and decrease an S corporation shareholder's basis in the stock of the corporation. The order the adjustments are to be made to the AAA account is: (1) pass-through items of income and gain, (2) pass-through items of deduction and loss, and (3) distributions. The tax treatment of distributions made during a taxable year by an S corporation with accumulated earnings and profits is based on the amount in the AAA at the end of the taxable year.

This bill would conform **California law** to **federal law**. The order in which adjustments are to be made in determining stock basis and the AAA would be in conformity with the **federal law**. Thus, distributions would be taken into account before pass-through items of deduction or loss.

10. Treatment of S corporations under Subchapter C (with exception).

Existing **federal law** provides for purposes of the application of Subchapter C rules, an S corporation, in its capacity as a shareholder of another corporation, is treated as a corporation. This allows the liquidation of a C corporation into an S corporation to be governed by the generally applicable Subchapter C rules, including rules allowing the tax-free liquidation of a subsidiary into its parent corporation. Following a tax-free liquidation, the built-in gains of the liquidating corporation may later be subject to tax upon a subsequent disposition. An S corporation also is eligible to make an election to treat certain stock purchases as asset acquisitions provided certain other requirements are otherwise met. This results in immediate recognition of all the acquired C corporation's gains and losses (and the resulting imposition of a tax) and the benefit of a stepped-up basis in the assets acquired.

Existing **California law** conforms to **federal law** as it read January 1, 1993, which treats an S corporation, in its capacity as a shareholder of another corporation, as an individual rather than a corporation. Thus, S corporations cannot take advantage of corporate rules relating to tax-free liquidation of subsidiaries and asset acquisitions discussed above.

This bill would provide for purposes of the application of Subchapter C rules, an S corporation, in its capacity as a shareholder of another corporation is to be treated as a corporation. Consequently, an S corporation would be able to utilize federal corporate rules relating to tax-free liquidation of subsidiaries and asset acquisitions. The bill also would provide that an asset acquisition election made for federal purposes would be treated as an election for state purposes. The corporation could not file a separate state election.

11. Carryover of losses and deductions under the at-risk rules.

Existing **federal law** permits losses that are not deductible in one taxable year because of the at-risk rules to be carried forward to the S corporation's post-termination transition period. Losses carried over are deductible to the extent stock basis and at-risk basis have increased during the corporation's post-termination transition period.

Existing **California law** conforms to **federal law** as it read January 1, 1993, which specifically provides that losses suspended due to insufficient stock basis may be carried over to the post-termination period. Present law does not specify what happens to losses suspended under the at-risk rules after an S corporation terminates its election and becomes a C corporation.

This bill would conform **state law** to the federal provision which specifically provides that losses suspended due to the at-risk rules would be carried over to the post-termination period.

12. Treatment of inherited stock.

Existing **federal law** provides that a person acquiring stock in an S corporation from a decedent must treat as income in respect of a decedent (IRD) that person's pro rata share of any item of income of the corporation that would have been IRD if acquired directly from the decedent. If an IRD is included in the value of the decedent's estate, a deduction for the estate tax attributable to the IRD item generally is allowed to the person (estate or individual) reporting the IRD. The stepped-up basis in the stock in an S corporation acquired from the decedent is reduced by the extent to which the value of the stock is attributable to items consisting of IRD.

Existing **California law** conforms to **federal law** as it read January 1, 1993, which does not contain specific language stating the treatment of inherited S corporation stock. **Federal law** contains various provisions relating to property acquired from a decedent. California conforms to these provisions. The existing provisions compute the basis of inherited stock and IRD in the same manner as this bill proposes.

This bill would conform **state law** to the **federal law** which codifies in one place various existing provisions.

13. Treatment of gain from subdivided real estate.

Existing **federal law** presumes a parcel of land held by a taxpayer other than a C corporation, generally is not treated as ordinary income property solely by reason of the land being subdivided if: (1) such parcel had not previously been held as ordinary income property and if in the year of sale, the taxpayer did not hold other real property; (2) no substantial improvement has been made on the land by the taxpayer, a related party, a lessee, or a government; and (3) the land has been held by the taxpayer for five years. Therefore, land held by an S corporation is generally considered a capital asset.

Existing **California law** conforms to **federal law** as it read January 1, 1993, which does not allow the presumption that real property held by an S corporation is a capital asset.
This bill would conform **state law** to **federal law** allowing the presumption that land held by an S corporation generally is not treated as ordinary income property solely by reason of the land being subdivided if such land meets the three federal requirements discussed above.

14. Financial corporations may be S corporations.

Existing **federal law** allows a bank to be an S corporation unless such institution uses a reserve method of accounting for bad debts. The bad debt reserve method is a moving average based on the historical performance of the taxpayer or taxpayer's industry. Small banks (banks with assets less than $500 million) are allowed to use the reserve method.

Existing **California law** conforms to **federal law** as it read January 1, 1993, which specifically provides that financial institutions eligible to use the reserve method for bad debts cannot be an S corporation. Under **state law** all banks, savings and loan associations or financial corporations can use the bad debt reserve method.

This bill would conform **California law** to **federal law** by allowing banks that do not use the reserve method of accounting for bad debts to elect to be an S corporation.

15. Exempt organizations can be S corporation shareholders.

Existing **federal law** provides that effective for income years beginning after December 31, 1997, qualified tax-exempt organizations may be shareholders in S corporations. For purposes of determining the number of shareholders of an S corporation, a qualified tax-exempt organization will count as one shareholder. Qualified retirement plan trusts and certain charitable organizations may be qualified shareholders of an S corporation.

Items of income or loss of an S corporation will flow-through to qualified tax-exempt shareholders as unrelated business taxable income (UBTI), regardless of the source or nature of such income (e.g., passive income of an S corporation will flow through to the qualified tax-exempt shareholders as UBTI.) In addition, gain or loss on the sale or other disposition of stock of an S corporation by a qualified tax-exempt shareholder will be treated as UBTI.

In addition, certain special tax rules relating to employee stock ownership plans (ESOP) will not apply with respect to S corporation stock held by the ESOP.

A qualified tax-exempt shareholder that purchases stock in an S corporation (whether such stock was acquired when the corporation was a C or an S corporation) and receives a dividend distribution from the S corporation (i.e., a distribution of Subchapter C earnings and profits), except as provided in regulations, must reduce its basis in the stock by the amount of the dividend.

Existing **California law** conforms to **federal law** as it read January 1, 1993, which does not allow exempt organizations to be shareholders in S corporations.

This bill would conform **California law** with **federal law** by allowing qualified tax-exempt organizations to be eligible S corporation shareholders for income years beginning after December 31, 1997.

S corporations that terminated within the previous five years may re-elect to be S corporations.

Existing **federal law** provides that if an S election was terminated in a taxable year beginning before January 1, 1997, the corporation may immediately file an election for S corporation status without the consent of the Secretary. If an S election was terminated in a taxable year beginning after December 31, 1996, the corporation must wait five taxable years to re-elect S corporation status.

Existing **California law** conforms to **federal law** as it read January 1, 1993. A small business corporation that elects S corporation status and subsequently terminates the election is not eligible to make another election for five taxable years.

This bill would conform **California law** to **federal law** by allowing small business corporations with a termination in effect prior to January 1, 1997, to immediately make a new S corporation election.

17. Transitional Changes.

This bill would allow a transitional change for estimated tax payments made by a C corporation. A C corporation that elects to be an S corporation in 1997 would be allowed to file an application to have part of the estimated tax payment transferred to the personal income tax accounts of its shareholders. The application must be for the transfer of at least $500. The corporation must file an application with the FTB setting forth: (1) the amount the S corporation estimates as its tax liability, (2) the amount and date of each estimated tax payment made prior to the this application, and (3) for each affected shareholder, the shareholder’s name, social security number, address, percent of ownership, amount of each overpayment to be transferred and the date of the payment. Within a 45 day period from receiving the application, the FTB would be required to make a determination regarding the transfer. The corporation would be required to furnish a statement to all shareholders disclosing the amounts and dates of the transfers being made to their personal income tax accounts.

18. Tax Rate Increase.

Existing **federal law** does not tax the profits of an S corporation. Under federal provisions, an S corporation is strictly a pass-through entity.

Existing **California law** provides that an S corporation is taxed like C corporations except at a reduced tax rate. The tax rate is presently 1.5%.

This bill would increase the tax rate imposed on S corporations from 1.5%. The rate would be increased for income years beginning on or after January 1, 1997, as follows: 1997 - 1.6%; 1998 - 1.65%; 1999 - 1.7%; 2000 and thereafter - 1.6%. The purpose of this increase is to structure the bill as revenue neutral.

SB 1233 of the 1997/98 Legislative session contains a provision that effectively would “chapter out” the S corporation tax rate increase contained in this bill, if SB 1233 is chaptered after this bill. This bill and SB 1233 have both been sent to enrollment. It is anticipated that SB 1233 will be chaptered after this bill.

Policy Considerations

Conforming to federal tax law is generally desirable because it is less confusing for the taxpayer, particularly when dealing with complex areas such as S corporations. With conformity, the taxpayer will only be required to know one set of rules. Conformity also eases FTB's administration of the law by utilizing many federal forms and instructions. This bill substantially conforms to all parts of the SBJPA relating to S corporations that are applicable to California.

Generally, under the Personal Income Tax Law (PITL) and Bank and Corporation Tax Law (B&CTL), a proper election for federal purposes is treated as properly filed with the FTB unless: (1) the election is in conflict with the PITL, B&CTL or FTB regulations, or (2) the taxpayer files an election with the FTB requesting a different treatment than that requested from the IRS. Separate state elections may be made because of differences between **federal and state law** in other areas not directly related to the election itself, such as net operating losses, corporate depreciation and sourcing/apportionment rules. This bill would make three new elections relating to S corporations for federal purposes binding for state purposes: (1) trusts to be treated as ESBT, (2) 100% owned subsidiaries to be treated as QSSS and (3) the election to treat certain stock purchases as an asset acquisition.

As an S corporations can use MACRS depreciation and this bill would substantially conform to federal S corporation law, tax implications of making the federal elections binding is mitigated. By not allowing separate state elections to be made, reporting of income and deductions on the state return is consistent with the reporting on the federal return. The department relies on results of federal examinations to adjust the income or deductions at the state level. If any of the three elections mentioned above were allowed to be different for state purposes, the department could not rely on a federal examination. The department would then have to re-audit the taxpayer and make its own determination.

This bill would not treat a QSSS as a separate corporation for tax purposes. B&CTL has consistently treated corporations as separate and distinct entities. Although a combined report is required for corporations that are unitary, a combined report is not the merging of two or more corporations. A combined report is a methodology used to determine each corporation's individual taxable income. The bill somewhat mitigates the departure from separate entity policy by having both the parent S corporation and QSSS subject to a minimum tax.

Because the bill would make the activities of the QSSS the activities of the parent, an out-of-state parent would be subject to minimum tax. Under present **California law** the parent would have to be doing business in California to be subject to the minimum tax. Arguably, however, when the QSSS is considered as a division or branch of the parent, the parent is doing business as a result of the QSSS activities.

The bill also would provide that a credit generated from a QSSS would pass through to the parent. Under present law, unless otherwise specified in the statute, a credit belongs to the corporation generating it. Generally, a credit cannot be apportioned or allocated.

EXCLUSION OF GAIN FROM THE SALE OF PRINCIPAL RESIDENCE PROVISIONS

SB 5 (Lockyer and Lewis)
Amended September 11, 1997

Effective Date

The provisions relating to the treatment of gain from the sale of a personal residence would be effective for residences sold after May 6, 1997, and before June 30, 1998.

Specific Findings

Under present **California law** and **federal law** prior to May 7, 1997, no gain is recognized on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence is purchased and used by the taxpayer as his or her principal residence within a specified period of time. This replacement period generally begins two years before and ends two years after the date of sale of the old residence. The basis of the replacement residence is reduced by the amount of any gain not recognized on the sale of the old residence by reason of this gain rollover rule. Additionally, in general, an individual, on a one-time basis, may exclude from gross income up to $125,000 of gain from the sale or exchange of a principal residence if the taxpayer (1) has attained age 55 before the sale and (2) has owned the property and used it as a principal residence for three or more of the five years preceding the sale. **California law** provides that if a taxpayer was a member of the Peace Corps, time served in the Corps, up to 18 months, could be counted toward the three years the taxpayer is required to reside in the residence to qualify for the “once in a lifetime $125,000 exclusion”. In addition, brokers considered real estate reporting persons (i.e., escrow companies, lenders, brokers, etc.) are required to report to the Internal Revenue Service the amount of gross proceeds and other amounts in transactions involving real estate (including residences). A copy of the federal return is required to be submitted to the Franchise Tax Board.

Under current **federal law**, a taxpayer generally is able to exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion is allowed each time a taxpayer selling a principal residence meets certain eligibility requirements, but generally no more frequently than once every two years (sales occurring before May 7, 1997, are not considered for the two-year rule). **Federal law** provides that gain would be recognized to the extent of any depreciation allowable with respect to the rental or business use of such principal residence for periods after May 6, 1997. To be eligible for the exclusion, a taxpayer must have owned the residence and used it as a principal residence for at least two of the five years prior to the sale or exchange.

The federal House, Senate and Joint Committee Reports state a taxpayer who fails to meet these requirements (use for two out of the last five years and no sale within two years of another sale) by reason of a change of place of employment, health, or other unforeseen circumstances is able to exclude the fraction of the $250,000 ($500,000 if married filing a joint return) equal to the fraction of two years that these requirements are met. This proration rule is also available for any sale occurring within thetwo year period following enactment of this provision. However, the law as enacted, appears to limit the exclusion to the fraction of the taxpayer’s realized gain on the sale equal to the fraction of two years that the requirements are met. The Joint Committee staff has indicated they will recommend a technical change to make the statutory language consistent with the unambiguous intent of Congress. The Internal Revenue Service (IRS) is expected to apply the law as intended from the date of enactment.

In the case of joint filers not sharing a principal residence, an exclusion of $250,000 is available on a qualifying sale of the principal residence of one of the spouses. Similarly, if a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years prior to the marriage, the couple would be allowed a maximum exclusion of $250,000. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either, the taxpayers may exclude $500,000 of gain on their joint return. **Federal law** also contains special rules regarding: sale of a remainder interest, cooperative housing corporations (e.g., condominiums), involuntary conversions, and taxpayers residing in nursing homes.

Under **federal law**, the TRA repealed the once-in-a-lifetime exclusion of $125,000 and the rollover of gain from the sale of a principal residence provisions of the Internal Revenue Code. The TRA also modified the reporting requirements of brokers for the sale of the broker's clients principal residences.

SB 1233 of the 1997/98 Legislative session also contains provisions that would conform **California law** to **federal law** as it relates to the exclusion of gain from the sale of a principal residence effective for sales occurring on and after July 1, 1998, (the date this bill becomes inoperative regarding the exclusion for gain from the sale of a principal residence exclusion). This bill and SB 1233 have both been sent to enrollment.

Policy Considerations

It is the department's policy, where California has substantially conformed to **federal law**, to follow the IRS's interpretations of the Internal Revenue Code. This bill would conform **California law** to **federal law** as it relates to he exclusion of gain from the sale of a principal residence without exception. The IRS has not released an interpretation on the amount of gain that can be excluded if the residence is sold due to change in employment, health or an unforeseen event.

FISCAL IMPACT

Departmental Costs

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

SB 5 (Lockyer and Lewis)
Amended September 11, 1997

Tax Revenue Estimate

The total estimated revenue losses from this bill are shown in the following table:

Fiscal Year Cash Flow Impact Effective 1/1/97 $ Millions			
	1997-8	***1998-9***	***1999-0***
Losses due to S Corporation Conformity	$ (18)	$ (21)	$ (22)
Gains due to S Corporation Rate Increases	$ 18	$ 21	$ 22
Exclusion of Gain from Sale of a Principal Residence, Impact on Current Law Gain	$ (16)	$ (29)	
Exclusion of Gain from Sale of a Principal Residence, Impact on Denying Rollover	$ 29	$ 52	
Exclusion of Gain from Sale of a Principal Residence, Loss of Baseline Revenue	$ (38)	$ (68)	
NET REVENUE IMPACT	**$ (25)**	**$ (45)**	**$ 0**

S Corporation Tax Revenue Discussion

The bill as introduced would increase the limit on shareholders from 35 to 75. The amendments encompass a number of additional provisions, including, but not limited to: allowing trusts and certain financials to be shareholders of S corporations, allowing S corporations to fully own subsidiaries, and a dozen other provisions affecting S corporation law. In addition, this bill would increase the tax rate on S corporation income. Note that the rate increases would apply to the income of S corporations that is expected to result from the conformity items, and those increases are estimated to result in revenue gains that would offset the losses from conformity.

The revenue impact of this proposal would be determined by (1) the number of entities that become or remain S corporations in lieu of alternative organizational structures, (2) the net change in taxable personal income (reduced corporate dividends and the pass through of losses and income) and the marginal tax rate of PIT filers who report the gains and losses, (3) increased usage of credits that will result from the pass through of credits that would otherwise be limited to the liability of the entity, (4) the amount of net operating losses (NOLs) that would have been applied against corporate income but which, after the switch to S status, are passed through to the shareholders, (5) increased depreciation deductions that result from expanded use of MACRS, (6) a number of miscellaneous provisions that are discussed in more detail below, and (7) the loss of baseline revenue that would have otherwise been gained due to the loss of S status of existing S corporations that avail themselves of changes in **federal law** which would disqualify them for California S status.

The number and characteristics of S corporations that would evolve as a result of this bill were estimated from federal data presented in "S Corporation Returns, 1993," Gill and Wittman, Internal Revenue Service, Statistics of Income Bulletin, Spring 1996, Washington, D.C. 1996, pp. 27-63. The SOI data shows S corporations nationwide by number of shareholders, income, losses, and assets for 1993. It was assumed that the distribution of Californian S corporations would not be materially different from the nation as a whole. The national data shows a distribution of S corporations with the tail cut off at 35 shareholders. Staff imputed how the shape of the distribution would have evolved if the tail were extended to 75 shareholders. Generally this analysis concludes that a relatively small number of additional S corporations would be attributed to the greater number of shareholders, but those corporations would tend to report significantly greater income (and losses) than the average S corporation reports under current law. The newly estimated net income reported by S corporations was disaggregated into totals for corporations with positive income and those with zero income or losses assuming these corporations would exhibit profit and loss results similar to historical profit and losses. These figures were grown to the year 2000 to provide a proxy for new S corporation income and losses that would be reported assuming the estimated equilibrium would be reached by that year. Data for the intervening years were developed assuming the new equilibrium would be reached incrementally over the period 1997-2000.

Increased credit pass through was estimated from the Manufacturers' Investment Credit amount that would be fully applied by S corporation shareholders on their PIT returns and thus not limited by the entity level tax.

Depreciation would increase as C corporations switch to S corporation status and would thus qualify for the more liberal MACRS depreciation allowances. The revenue impact of this provision was estimated based on the ratio of positive state net income reported by the newly formed S corporations to total state net income reported by positive income C corporations. This ratio was then multiplied by the estimated revenue loss of allowing all corporations to use MACRS.

The revenue impacts of the miscellaneous provisions, for which there are insufficient state data for analysis, were calculated from the U.S. Treasury analysis of HR 3408, adjusted for California's share of the national totals.

A baseline revenue loss reflects the revenue that would have been realized from those corporations that would avail themselves of the federal changes and lose their California S status as a result. Without conformity, that revenue would be a current law revenue gain. By conforming, that revenue would be lost.

Exclusion of Gain from the Sale of a Principal Residence Revenue Discussion

There are about 5.77 million owner occupied residences in California. In any given year, about 450,000 of those residences are sold. Of those sales, about 4%, or 18,000, result in taxable gains. The gains, if any, associated with the remaining 432,000 sales are deferred under the rollover provisions of current law. Of the 5.3 million residences that do not sell, a small percentage of owners (4% according to a recent federal study) would sell if the owners were not exposed to taxation on any of the gain. If **federal law** were changed and **state law** remains the same, an even smaller percentage of owners would sell (2% in this estimate) and those sales would be taxable.

This estimate was prepared in several steps. First, potentially affected taxpayers were divided into three groups: 1. Those who sell and report taxable gains under current law (about 18,000 annually); 2. Those who sell under current law and roll the gains into a replacement residence about 430,000 annually), and 3. Those who do not sell under current law but would if the built in gains were not taxed. Of the first group, those who sell under current law and report taxable gains, a micro analysis of tax returns shows that this proposal would exempt about 98% of currently reported gains. The loss of revenue associated with this group is shown in the above table.

The second group, those who under current law sell and roll the gain into a replacement residence, was estimated to consist of about 432,000 sales annually based on sales reported by the California Association of Realtors adjusted for those with reported gains. The tax impact of denying the rollover provisions to this group and excluding $250,000 (single) and $500,000 (joint) of the gain was estimated from a study of over two million residences that claimed the homeowners exemption and which were linked to tax returns. The assessors' data showed the date of purchase and purchase price as well as 1991 assessed values. Assessed values were adjusted to approximate fair market value by applying residence price indices for the period after Proposition 13. The amount of gain for each residence was estimated by adjusting the basis to take into account acquisition costs (3%), selling costs (6% fee plus 2% as a proxy for last minute spruce ups), and improvements (10% of the difference between purchase and sale price). This provides an estimate of the amount of gain that is embedded in owner occupied residences. The next step was to examine the tax impact on a taxpayer by taxpayer basis of whether the gain would exceed the exclusion amounts. The gain in most cases (423,000 or 98% of sales) would be completely excluded. Of the remaining 9,000 or so residences that have gains in excess of the exclusion amounts, the tax impact for those taxpayers was calculated on a taxpayer by taxpayer basis taking into account overall income and filing status of affected taxpayers.

Of the third group, the 5.3 million residences that do not sell, a small percentage of owners (4% according to a recent federal study) would sell if the owners were not exposed to taxation on any of the gain. If **federal law** were changed and **state law** remains the same, an even smaller percentage of owners would sell (2% in this estimate) and those sales would be taxable. Since the 4% reported in the federal study represents a build up over a long period of time, for this estimate it was assumed that those sales would take place over a three-year period at the rates of 10% (first year), 50% (second year) and 40% (third year). In addition, since these sales would involve state tax consequences, it was assumed that only 2% of those residences would sell over the three year period. This yields an additional 100,000 residences that would sell and report gains in the first three years of this law being effective. These are residences that would sell and not qualify for the rollover (these sellers would not purchase a qualified replacement residence since if that were the case the transaction would not be taxable under current law). The average tax impact of these sales was assumed to be similar to the tax consequence of the 18,000 or so sales that are reported under current law. This portion of the revenue estimate reflects the amount of revenue that would be realized if **California law** were not changed. These sales would be stimulated by the favorable federal tax treatment and would result in an increase in taxable gains for state purposes. By conforming, this revenue would be lost.

The above discussion is based on “full years” of conformity. This bill would only make the exclusion operative for approximately 14 months. The revenue figures above have been prorated to reflect the partial year of operation.

POSITION

Pending.

On February 11, 1997, the FTB voted to take a pending position on this legislation.