



FTB NOTICE

FRANCHISE TAX BOARD

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FTB NOTICE 96-5

SUBJECT: CALIFORNIA NONCONFORMITY TO RECENT FEDERAL LEGISLATION

The Franchise Tax Board ("FTB") has received numerous inquiries regarding California conformity to federal law changes regarding S corporations and the proposed 'check-the-box' regulations for selecting entity classification. The purpose of this Notice is to advise the public of the California differences in tax laws applicable to those matters so as to educate the public and thereby avoid inadvertent noncompliance with California law.

Small Business Job Protection Act of 1996

On August 20, 1996, President Clinton signed into law the Small Business Job Protection Act of 1996. This bill made several changes to subchapter S of the Internal Revenue Code ("IRC"), dealing with the taxation of S corporations and their shareholders.

California conforms generally to the provisions of subchapter S of the IRC. However, the version of the IRC adopted by California is the IRC as in effect on January 1, 1993. Until California conforms to a later version of the IRC, any subsequent federal changes must be specifically adopted by the Legislature before they become effective for California purposes. Therefore, any corporation which would not qualify as a federal S corporation under provisions of the IRC as in effect on January 1, 1993, will not qualify as a California S corporation.

For example: a new corporation with forty (40) shareholders that qualifies for S status pursuant to the amended federal law and elects S status for federal purposes will not be a qualified S corporation for California purposes. Instead, California must treat such corporation as a C corporation. Also, an existing S corporation that expands its membership to admit previously disqualified shareholders or more than 35 shareholders will experience a terminating event and its treatment as an S corporation for California purposes will cease. Instead, it will be taxed as a C corporation for California purposes.

Check-the-Box Classification Regulations

Also during 1996, the Internal Revenue Service promulgated proposed regulations revising Treasury regulations sections 301.7701-1, -2, -3, and -4 for entity classification as either partnerships or corporations for tax purposes.

California law does not incorporate the federal regulations in this area, but applies 18 Cal. Code Regs. § 23038 for business entity classification purposes. Under these regulations, California classification results are analyzed in a similar manner, and similar results are produced, as under the existing federal regulations. Until either statutory or regulatory changes are made to California law in this area, the proposed federal check-the-box regulations will not apply for California tax purposes.

For example: an existing LLC operating agreement lacks centralized management and free transferability of ownership (thereby lacking 2 of the 4 corporate characteristics under current classification law). If in response to the changes in the federal regulations, the members amend the LLC operating agreement to remove restrictions on transferability and the LLC 'checks-the-box' for federal classification as a partnership, that LLC will be treated as a corporation for California tax purposes because, after the change, it lacks only one corporate characteristic.

In addition, the proposed Treasury regulations allow a single-owner entity to elect not to be treated as a corporation, but rather as either a sole proprietorship or division of its owner. California classification regulations do not provide for ignoring the existence of an entity; for California tax purposes, a single-owner entity will be taxed as a corporation.

The proposed regulations are currently under review by the Joint Committee on Taxation, so it is unknown whether the expected release date of 1996 year end will be met. Given the uncertainty of the release of final federal regulations, the Franchise Tax Board staff is deferring action to amend FTB regulations until final federal regulations are adopted.

DRAFTING INFORMATION

The principal author of this Notice is Kimberly Mitchell Bott of the Franchise Tax Board Legal Branch. For further information regarding this Notice, contact Ms. Bott at the Franchise Tax Board Legal Branch, P.O. Box 1720, Sacramento, CA 95741-1720, (916) 845-3007.