STATE OF CALIFORNIA
Franchise Tax Board

Bill Analysis

Author: McGuire & Caballero Sponsor: Bill Number: SB 104

Related Bills: See Legislative History Amended: March 9, 2021

SUBJECT

Small Business Relief Act (SBRA)

SUMMARY

This bill would do the following:

Provision 1, Revenue and Taxation Code (RTC) Part 10.4, SBRA:

This provision, would create the SBRA, and would, for taxable years beginning on or after January 1, 2021, and before January 1, 2026, allow a partnership, limited partnership (LP), a limited liability partnership (LLP), a limited liability company (LLC) taxed as a partnership, and an S corporation to pay an additional elective tax, at the entity level.

Provision 2, RTC Section 17052.10, Tax Credit:

This provision, under the Personal Income Tax Law (PITL), would allow a qualified taxpayer, who is a partner, member, or shareholder of an LP, an LLP, an LLC, or an S corporation that makes an annual election to pay additional elective tax authorized by the bill, a tax credit in an amount equal to 94.9 percent of the partner, member, or shareholder's pro rata share of the elective tax amount paid by the entity for taxable years beginning on or after January 1, 2021, and before January 1, 2026.

RECOMMENDATION

No position.

SUMMARY OF AMENDMENTS

The March 9, 2021, amendments modified the provisions of the bill to allow a qualified taxpayer a tax credit, rather than excluding an amount from gross income; resolved all of the implementation and technical considerations, and all but one of the policy considerations, discussed in the department's analysis of the bill as introduced on January 5, 2021; provided that the Franchise Tax Board (FTB) may adopt regulations to implement the bill; and made other nonsubstantive amendments.

REASON FOR THE BILL

The reason for this bill is to provide tax relief to individuals, who are partners, members, and shareholders of small businesses facing unprecedented economic hurdles due to COVID-19.

ANALYSIS

Analysis Provision 1, SBRA:

Elective Tax at Entity Level

This provision would create the SBRA under newly created Part 10.4. The provision would, for taxable years beginning on or after January 1, 2021, and before January 1, 2026, allow a qualified entity doing business in this state, as defined by Section 23101, to annually elect to pay an elective tax. For entities required to file a return under Sections 18633 (partnership returns) or 18633.5 (LLC returns), the elective tax would be according to or measured by its gross income. For entities required to file a return under Section 18601 (S corporation returns), the elective tax would be according to or measured by its net income. The tax would be computed at the rate of 9.3 percent for the taxable year for which the election is made.

The elective tax authorized by this bill would be in addition to, and not in place of, any other tax or fee required to be paid under the PITL or the Corporation Tax Law (CTL).

The collection and administration of this elective tax would be governed by the provisions of the Administration of Franchise and Income Tax Law (AFITL) unless expressly superseded by the provisions of this bill.

The election shall be irrevocable and made on an original, timely filed return for the taxable year of the election in the form and manner as prescribed by the FTB. All partners, members and shareholders of the qualified entity would be bound by the election for the taxable year.

For purposes of Provision 1, the following definitions would apply:

1) "Qualified entity" means an entity that meets both of the following requirements:
    a) The entity is a partnership, LP, LLC taxed as a partnership, LLP, or "S" corporation.
    b) The entity's partners, members, or shareholders in that taxable year are exclusively taxpayers that are individuals, fiduciaries, estates, or trusts.
2) "Qualified entity" cannot be a taxpayer included or required to be included in a combined reporting group.

The elective tax authorized by this section would be due and payable on or before the due date of the return without regard to any extension of time for filing the return, for the taxable year of the election.

This provision would not change any filing requirements under the PITL or the AFITL.

This provision would allow Franchise Tax Board (FTB) to adopt regulations that are necessary or appropriate to implement this provision. In addition, the requirements of the Administrative Procedures Act would not apply to any regulation, rule, guideline, procedure, or other guidance prescribed to carry out the purposes of this provision.

If enacted, Part 10.4 would remain in effect only until December 1, 2026, and as of that date would be repealed.

Effective/Operative Date

This bill would be effective January 1, 2021, and operative for taxable years beginning on or after January 1, 2021, and before January 1, 2026.

Federal/State Law

Federal Law

Federal law, prior to 2018, allowed individuals to deduct certain expenses, such as medical expenses, charitable contributions, interest, and taxes, as itemized deductions. Certain other expenses for the production of income and certain employee business expenses were considered miscellaneous itemized deductions and only the portion that exceeded 2 percent of adjusted gross income could be deducted. Also, itemized deductions were further limited for high-income taxpayers.

Federal law, for taxable years beginning on or after January 1, 2018, under the Tax Cuts and Jobs Act, changed several itemized deductions, including:

- Suspending both the deduction for miscellaneous itemized deductions and the overall limitation on itemized deductions for high-income taxpayers for taxable years beginning after December 31, 2017, and before January 1, 2026.
- Limiting the total deduction for state and local income, sales and property taxes (SALT) to $10,000 ($5,000 if married filing separate).

The Internal Revenue Service (IRS) issued Notice 2020-75, dated November 9, 2020, which provides that the Department of Treasury and the IRS intend to issue regulations clarifying that tax payments made at the entity level would not be subject to the SALT deduction limitation applicable to partners and shareholders, who itemize deductions. Specifically, the announcement said the proposed regulations would:

> "…clarify that State and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment, and therefore are not subject to the State and local tax deduction limitation for partners and shareholders who itemize deductions."

The Notice provides that pass-through entities can pay SALT at the entity level, and the tax deduction that flows through to the individual partners and shareholders will not be subject to the individual SALT limitation for itemized deduction purposes.

State Law

State law generally conforms to federal law as of the "specified date" of January 1, 2015, with modifications, allowing individuals to deduct certain expenses, such as medical expenses, charitable contributions, interest, and taxes, as itemized deductions. State law retains the deduction for SALT, miscellaneous itemized deductions, and the limitation for high-income taxpayers.

Implementation Considerations

None noted.

Technical Considerations

None noted.

Policy Considerations

None noted.

LEGISLATIVE HISTORY

No legislation similar to this provision of the bill has been identified.

PROGRAM BACKGROUND

None noted.

LEGAL IMPACT

None noted.

APPOINTMENTS

None noted.

SUPPORT/OPPOSITION

To be determined.

ARGUMENTS

To be determined.

Analysis Provision 2:

RTC Section 17132.9, Tax Credit

This provision of the bill, under the PITL, for taxable years beginning on or after January 1, 2021, and before January 1, 2026, would allow a qualified taxpayer, who is a partner, member, or shareholder of a partnership, LP, LLP, LLC treated as a partnership, or an "S" corporation that makes an annual election to pay additional elective tax authorized by the bill, a tax credit in an amount equal to 94.9 percent of the qualified amount, as defined.

For purposes of this provision, the following definitions would apply:

1. "Electing qualified entity" means a qualified entity, as defined above, that has elected to pay the elective tax under Part 10.4.
2. "Qualified amount" means an amount equal to 9.3 percent of the qualified taxpayer's pro rata share of income subject to the election made by an electing qualified entity under Part 10.4.
3. "Qualified taxpayer" means a taxpayer that is an individual, fiduciary, estate, or trust that is a partner, shareholder, or member of an electing qualified entity.

Any excess credit allowed by this provision that exceeds the "net tax," may be carried over to reduce the "net tax" for three years, until the credit is exhausted.

For purposes of complying with Section 41, the Legislature finds and declares that the goal of this tax credit is to provide tax relief to small businesses facing unprecedented economic hurdles due to COVID-19.

If enacted, this section would remain in effect only until December 1, 2026, and as of that date would be repealed.

Effective/Operative Date

This bill would be effective January 1, 2021, and operative for taxable years beginning on or after January 1, 2021, and before January 1, 2026.

Federal/State Law

Existing federal and state laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption or first-time home buying) or to influence behavior, including business practices and decisions (e.g., research credits or hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

There are no federal or state credits currently comparable to the credit this bill would create.

Implementation Considerations

None noted.

Technical Considerations

None noted.

Policy Considerations

None noted.

LEGISLATIVE HISTORY

No legislation similar to this provision of this bill has been identified.

PROGRAM BACKGROUND

None noted.

FISCAL IMPACT (Both Provisions)

This bill would impact the department's systems, resulting in programming, processing and form revisions as well as the need for taxpayer outreach. The department's costs to implement both sections of this bill are estimated to be $1,500,000 for fiscal year 2021-2022, and estimated on-going annual costs of $1,200,000. The department will pursue a budget change proposal if necessary.

ECONOMIC IMPACT (Both Provisions)

Revenue Estimate

This bill would result in the following revenue impact:

Estimated Revenue Impact of SB 104 as Amended on March 9, 2021
Assumed Enactment after June 30, 2021

($ in Millions)

Fiscal Year	Revenue
2021-2022	$420
2022-2023	$55
2023-2024	-$26

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

Revenue Discussion

This proposal would allow businesses that are not C corporations to elect to pay an additional tax of 9.3 percent on their business income. This additional tax would reduce the amount of income flowing to the owners of those businesses, and would reduce both their state and federal tax liabilities. In addition, owners would receive a credit against California tax equal to 94.9 percent of their share of the tax paid by the business entity.

The first step in the estimate was to identify taxpayers with business income and determine based on their tax data whether or not they would elect to pay the additional tax.

For some taxpayers, the credit plus the reduction in tax from the reduced pass-through income would be greater than the tax paid by the business they own, and would result in a net revenue loss to the state from these taxpayers. This estimate assumed that these taxpayers would elect to pay the additional tax.

For other taxpayers, the extra tax at the business level would be greater than the savings on California tax from the credit and the reduction of pass through income, but the difference would be smaller than the amount they would save on their federal taxes from the reduction in pass-through income. This estimate assumed that, since their total state plus federal savings are greater than the business level tax paid, these taxpayers would also elect to pay the additional tax. The net impact to the state from this group would be a revenue gain to the state.

For the remaining taxpayers, the combined state and federal benefits would be less than the additional business tax and they would not elect to participate. This estimate assumed, however, that a small number of these taxpayers would be minority partners/shareholders/members in businesses where the majority of ownership would choose to elect the additional tax. There would be a revenue gain to the state from this small group.

Applying the 9.3 percent tax rate to the business income of taxpayers assumed to elect would produce a revenue gain of approximately $9.7 billion in tax year 2021.

This additional tax paid would result in a reduction of income and is estimated to reduce California tax by approximately $1.2 billion for tax year 2021. In addition, it is estimated that taxpayers will be able to use roughly 90 percent, or about $8.1 billion in tax credits in the year generated. The remaining credits would be used in the three remaining years or until exhausted.

This results in net revenue gain of approximately $350 million for tax year 2021.

LEGAL IMPACT

None noted.

APPOINTMENTS

None noted.

SUPPORT/OPPOSITION

To be determined.

ARGUMENTS

To be determined.

LEGISLATIVE CONTACT

FTBLegislativeServices@ftb.ca.gov