



Bill Analysis

Author: McGuire and Caballero, et al.

Sponsor:

Bill Number: SB 104

Related Bills: See Legislative History

Amended: April 5 and April 12, 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 entities taxed as a partnership or 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 an owner of a qualified entity, which makes an annual election to pay additional elective tax authorized by the bill, a tax credit in an amount equal to 94.9 percent (94.9%) of the owner's pro rata or distributive 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 April 5, 2021, amendments modified provisions of the bill to replace the reference to an entity that is a "partnership, limited partnership, limited liability partnership, limited liability company (LLC) taxed as a partnership or S corporation" with an entity that is "taxed as a partnership or S corporation;" clarified that the net income of the qualified entity is the resident owners' total share of the qualified entity's net income from all sources and the nonresident owners' total share of the qualified entity's California source net income; and made other nonsubstantive amendments.

Amended April 5 and April 12, 2021

The April 12, 2021, amendments added another coauthor and made one nonsubstantive amendment.

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), 18633.5 (LLC returns), or 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 (9.3%) for the taxable year for which the election is made.

For purposes of this provision, the net income of the qualified entity is the resident owners' total share of the qualified entity's net income from all sources and the nonresident owners' total share of the qualified entity's California source net income.

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 Franchise Tax Board (FTB). All partners, members and shareholders of the qualified entity would be bound by the election for the taxable year.

Amended April 5 and April 12, 2021

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

1. "Qualified entity" means an entity that meets both of the following requirements for the taxable year:
 - a) The entity is taxed as a partnership 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, the AFITL, or the CTL.

This provision would allow 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 (2 %) of adjusted gross income could be deducted. Also, itemized deductions were further limited for high-income taxpayers.

Amended April 5 and April 12, 2021

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

- 1) 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.
- 2) Limiting the total deduction for state and local income, sales, and property taxes to ten thousand dollars (\$10,000) (five thousand dollars (\$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 state and local taxes (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.

ARGUMENTS

To be determined.

Analysis Provision 2:

RTC Section 17052.10, 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 an owner of a qualified entity, which is taxed 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 (94.9%) of the qualified amount, as defined. For California nonresidents and part-year residents, certain tax credits are allowed, but must be proportioned by the same ratio as the nonresident or part-year resident's taxable income to total taxable income. This provision would specify that the tax credit generated by this provision would be allowed to a nonresident or part-year resident in its entirety.

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 (9.3%) of the qualified taxpayer's pro rata or distributive 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.

Amended April 5 and April 12, 2021

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.

Amended April 5 and April 12, 2021

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 one million five hundred thousand dollars (\$1,500,000) for fiscal year 2021-2022, and estimated on-going annual costs of one million two hundred thousand dollars (\$1,200,000). The department will pursue a budget change proposal if necessary.

ECONOMIC IMPACT (Both Provisions)*Revenue Estimate*

The following estimate is revised to reflect that the elective tax paid at the entity level would reduce the amount of federal income flowing to the owners of those businesses, and would reduce their federal tax liabilities. Additional detail regarding the components of the estimate is included below.

This bill would result in the following revenue impact:

Estimated Revenue Impact of SB 104 as Amended on April 12, 2021
Assumed Enactment after June 30, 2021

(\$ in Millions)

Fiscal Year	Revenue
2021-2022	-\$1,900
2022-2023	\$750
2023-2024	\$650

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 entities taxed as a partnership or an S corporation to elect to pay an additional tax of 9.3 percent (9.3%) on their business income. This additional tax would reduce the amount of income the owners of those businesses would have to report for federal tax purposes. In addition, owners would receive a credit against California tax equal to 94.9 percent (94.9%) of their share of the tax paid by the business entity.

Amended April 5 and April 12, 2021

Using available tax return data, an analysis was completed to identify taxpayers with business income to determine whether they would elect to pay the additional tax and how that election would impact California revenue.

This estimate analyzed the taxpayers' combined state and federal impact of electing to pay the additional tax. The estimate assumed that taxpayers would elect to pay the additional tax if the benefits from their federal tax savings from the reduction in pass-through income and credits generated with the state would be greater than the additional California tax paid. It is assumed this would result in a revenue gain to the state. For taxpayers whose combined state and federal benefits would result in a higher tax liability to the shareholder, it is assumed that they would not elect to pay the additional tax.

There is a small group of taxpayer shareholders whose combined state and federal benefits would be less than the additional business tax liability incurred and would choose not to elect to participate. However, these taxpayers are the minority shareholders of business entities where the majority ownership would benefit from the election and would force the election on all owning shareholders. An adjustment was made to the estimate to account for this scenario.

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

It is estimated that taxpayers will be able to use about \$8.1 billion in tax credits in 2021. The remaining credits may be used in the following three remaining years.

This results in net revenue gain of approximately \$1.2 billion for tax year 2021.

The tax year estimates are converted to fiscal year estimates, and then rounded to arrive at the amounts reflected in the above table.

LEGAL IMPACT

None noted.

APPOINTMENTS

None noted.

Amended April 5 and April 12, 2021

SUPPORT/OPPOSITION (Both Provisions)

Support

As per the Senate Governance and Finance Committee analysis of SB 104, dated March 22, 2021, the following organizations support this bill: Allegis Redwood Maxim Public Affairs; California Chamber of Commerce; Coalition for Small and Disabled Veteran Businesses; National Federation of Independent Business-CA; S Corp Association.

Opposition

As per the Senate Governance and Finance Committee analysis of SB 104, dated March 22, 2021, no opposition listed.

ARGUMENTS

To be determined.

LEGISLATIVE CONTACT

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