STATE OF CALIFORNIA
Franchise Tax Board

Bill Analysis

Author: Portantino Bill Number: SB 851

SUBJECT

Small Business Relief Act (SBRA) Elective Tax and Other State Tax Credit (OSTC)

SUMMARY

This bill would, under the Personal Income Tax Law (PITL), change the calculation of the OSTC to increase the net tax payable by the allowed Pass-Through Entity (PTE) tax credit amount claimed in the same taxable year.

REASON FOR THE BILL

The reason for the bill is to provide an owner of a pass-through entity that receives a PTE tax credit a specified method for computing their OSTC.

ANALYSIS

This bill would, for taxable years beginning on or after January 1, 2022, and before January 1, 2026, change the calculation of the OSTC. Specifically, this bill would allow a taxpayer to increase the "net tax payable", as that term is used in Revenue and Taxation Code (RTC) section 18001 and section 18002, by the amount of the allowed PTE tax credit (relating to the elective tax under the SBRA) for the taxable year.

RTC section 41 would not apply to the amendment resulting from the application of the bill.

Effective/Operative Date

As a tax levy, this bill would be effective immediately upon enactment. The amendments to RTC section 17052.10 would be specifically operative for taxable years beginning on or after January 1, 2022, and before January 1, 2026, and the amendment to RTC section 19904 would be operative immediately.

Federal/State Law

Federal Law

No comparable provision in federal law.

State Law

Existing state laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) 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.

OSTC

Generally, when taxpayers are subject to tax by California and another state on the same income, existing California law generally allows an OSTC for the lesser of the net income taxes payable to another state or the net income taxes payable to California. The credit is based on net income taxes payable to the other state and to California on income that is taxable under California law and the law of the other state and the other state does not allow California residents a credit against the taxes imposed by that state for taxes paid to California. However, an OSTC is not allowed for taxes paid to a state that allows its residents an OSTC for net tax payable to California irrespective of whether its residents are allowed a California OSTC.

The OSTC is also allowed for a taxpayer who is a member of an S corporation based on the taxpayer's pro rata share of any income taxes paid by an S corporation to the other state, with some limitations.

The OSTC is also allowed for the taxpayers who are a partner in a partnership or a member of a limited liability company (LLC) taxed as a partnership, based on their pro rata share of net income taxes paid to the other state by the partnership or LLC, as if those taxes had been paid directly by the taxpayer who is a partner or a member.

The OSTC cannot reduce net tax below tentative minimum tax (TMT); and any unused credit cannot be carried over.

PTE Tax Credit

Under the PITL, for taxable years beginning on or after January 1, 2021, and before January 1, 2026, a qualified taxpayer, who is a partner, shareholder, or member of a qualified entity under the SBRA that makes an annual election to pay the elective tax, is allowed a PTE tax credit in an amount equal to the qualified amount.

In addition, a qualified taxpayer includes a LLC that is disregarded for federal tax purposes that meets both of the following:

- Is owned by an individual, fiduciary, estate, or trust that consented to have the sum of their guaranteed payments and pro rata share or distributive share of income, as applicable, subject to tax under the PITL, included in qualified net income of the electing qualified entity under the SBRA.
- Is a partner, shareholder, or member of an electing qualified entity.

For the PTE tax credit, the following definitions apply:

- Electing qualified entity means a qualified entity that has elected to pay the elective tax under the SBRA.
- Qualified entity means an entity taxed as a partnership or S corporation, and that has partners, shareholders, or members in the taxable year that are exclusively corporations or taxpayers as defined in RTC section 17004. Qualified entity does not include publicly traded partnerships or entities that are permitted or required to be in a combined reporting group.
- Qualified amount means an amount equal to 9.3% of the qualified taxpayer's pro rata or distributive share, as applicable, of qualified net income subject to the election made by an electing qualified entity under the SBRA. The definition of "qualified net income" also includes guaranteed payments, as defined by Internal Revenue Code (IRC) section 707(c), that are subject to tax under the PITL for the taxable year of each qualified taxpayer.
- 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 that consented to have their pro rata share or distributive share of income included in the qualified net income of the electing qualified entity; and does not include a business entity that is disregarded for federal tax purposes, or its partners or members, except for certain disregarded LLCs, as described above.

The PTE tax credit can reduce net tax below the TMT. Also, for taxable years beginning on or after January 1, 2022, the order of the credits allowed to be taken against net tax was amended, allowing the PTE tax credit to be taken after the OSTC, and before credits that contain refundable provisions but do not have carryover provisions.

The PTE tax credit can be carried over for five years or until exhausted.

Implementation Considerations

None noted.

Technical Considerations

None noted.

Policy Considerations

None noted.

LEGISLATIVE HISTORY

SB 113 (Senate Committee on Budget and Fiscal Review, Chapter 3, Statutes of 2022), among other items, modified the definition of "qualified net income" to include guaranteed payments and expanded the definition of a "qualified entity" to allow the entity's partners, shareholders, or members to include a partnership. In addition, for purposes of the PTE tax credit, under the PITL, the bill modified the definition of "qualified amount" on which the credit is based to include guaranteed payments, and modified a "qualified taxpayer" eligible to claim the credit to include certain disregarded LLCs. The bill also changed the order in which credits are used to offset a tax liability.

AB 150 (Assembly Committee on Budget, Chapter 82, Statutes of 2021), among other items, created the SBRA, and for taxable years beginning on or after January 1, 2021, and before January 1, 2026, allows entities taxed as a partnership or an S corporation to pay an additional elective tax at the entity level. In addition, under the PITL, AB 150 allows a qualified taxpayer, who is an owner of a qualified entity that makes an annual election to pay an additional elective tax authorized by the bill, a tax credit in an amount equal to 9.3% of the qualified taxpayer's pro rata or distributive share, as applicable, of the qualified net income subject to the election made by an electing qualified entity for taxable years beginning on or after January 1, 2021, and before January 1, 2026.

PROGRAM BACKGROUND

None noted.

FISCAL IMPACT

This bill would require the revision of forms and form instructions, as well as taxpayer outreach. However, the department anticipates these costs to be minimal.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of SB 851
Assumed Enactment after June 30, 2022

($ in Millions)

Fiscal Year	Revenue
2022-2023	-$125
2023-2024	-$60
2024-2025	-$60

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 bill would affect two groups of taxpayers differently. Some taxpayers have already elected to make PTE payments even though they have lost some of their OSTC as a result. For this group, the bill reverses the reduction in OSTC credits, resulting in a revenue loss to the state. The bill would not change PTE payments for this group. Other taxpayers chose not to elect to make PTE payments because of concerns about the interaction with OSTC. These taxpayers will see no change in their OSTC if this bill is adopted but will increase their participation in the PTE program. In general, increased participation in PTE results in revenue gains to the state because there are some taxpayers who do not have enough state tax liability to use all of their PTE credit but still participate because the reduction in their federal taxes is greater than the amount of credit they cannot use at the state level. The net effect of this bill on state revenue will depend on the relative size of these two groups of taxpayers.

Because tax returns for the first year in which PTE was available are not due until October, we have very limited data on which to base this estimate. FTB estimates that at the time we conducted the analysis we had received returns with about one fifth of what we believe will be the total amount of PTE credits allowed for tax year 2021. Returns reporting both PTE and OSTC were sampled, and the reduction in OSTC due to PTE calculated for those returns. Based on this analysis FTB estimated the full year revenue loss from increased usage of OSTC and assumed the same impact in subsequent years. FTB then assumed an increase in PTE elections if the bill is adopted that would have produced a 30 percent increase in the reduction of OSTC if those taxpayers had elected PTE in 2021. Because it is already past the June 15 deadline for electing PTE, the estimate assumes that this increase will start in tax year 2023. The estimates for the revenue loss from increased OSTC, the increase in entity level PTE payments and the usage of PTE credits were then converted to fiscal years and reported in the table above.

The estimate is highly sensitive to several key assumptions including: the amount of OSTC claimed on tax returns with PTE that have not yet been filed, the proportion of affected taxpayers that did not elect PTE, the ratio of PTE to OSTC for the nonelecting taxpayers and the ability of this group of taxpayers to use their PTE credits once they start to elect.

LEGAL IMPACT

None noted.

APPOINTMENTS

None noted.

SUPPORT/OPPOSITION

None listed.

VOTES

Location	Date	Yes Votes	No Votes
Concurrence	August 31, 2022	40	0
Assembly Floor	August 31, 2022	78	0
Senate Floor	May 26, 2022	38	0

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