STATE OF CALIFORNIA
Franchise Tax Board

Bill Analysis

Author: Wallis	Sponsor:	Bill Number: AB 1576
	Related Bills: See Legislative History	Introduced: February 17, 2023

SUBJECT

Repeal of Business Credit Limitations for Disregarded Entities

SUMMARY

This bill would, under the Personal Income Tax Law (PITL) and Corporation Tax Law (CTL), sunset the permanent limitation on any tax credits generated by a disregarded business entity that are reported on the owner's return.

RECOMMENDATION

No position.

SUMMARY OF AMENDMENTS

Not applicable.

REASON FOR THE BILL

The reason for the bill is to eliminate the limitation on credits generated by disregarded entities.

ANALYSIS

Under the PITL and CTL, for taxable years on or after January 1, 2023, this bill would sunset the limitation imposed on the amount of credits attributable to disregarded entities that can be claimed against a taxpayer's tax by providing that the limitation only applies for taxable years beginning on or before January 1, 2023.

This bill would allow taxpayers that directly or indirectly own an interest in a business entity that is disregarded for tax purposes to claim any amount of credit or credit carryforward allowable without application of the limitation when the credit is used or claimed by the taxpayer.

Effective/Operative Date

As a tax levy, this bill would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2023.

Federal/State Law

Federal Law

No comparable provision in federal law.

State Law

Current law, under the PITL and CTL, imposes a limitation on the amount of credits attributable to disregarded entities that can be allowed against a taxpayer's tax to the amount of the taxpayer's regular tax that is attributable to the income of the disregarded entity.

The amount of any credit or credit carryforward allowable for any taxable year attributable to the disregarded business entity is limited as follows:

1) The amount of credit that may be applied to reduce a taxpayer's tax may not exceed the difference between the regular tax that taxpayer would owe if the income of the business entity were included in taxpayer's income and the amount of regular tax owed without including the income of the business entity.
2) A credit is not allowed if the taxpayer's regular tax, determined by including the income attributable to the disregarded business entity is less than the taxpayer's regular tax, determined by excluding the income attributable to the disregarded business entity; and
3) If the amount of the credit allowed pursuant to the section establishing the credit exceeds the amount allowable under (1) and (2), the excess amount may be carried over to subsequent taxable years.

The limitation attaches at the time the credit is generated by the disregarded entity and is a permanent limitation.

The limitation calculation applies when the credit is used or claimed by the parent entity. The practical result of the limitation calculation is that the disregarded entity would need to have taxable income in order for the parent entity to utilize the limited credit.

In 2008, Revenue and Taxation Code (RTC) section 23663 was enacted to allow for the assignment of credits among affiliated members of the same combined reporting group under the CTL. However, the limitation cannot be avoided by assigning the credit because the limitation calculation requires that the entity utilizing the credit be the single member or single partner.

Implementation Considerations

The Franchise Tax Board (FTB) has identified the following implementation considerations and is available to work with the author's office to resolve these and other considerations that may be identified.

This bill would repeal the limitation imposed on the amount of credits attributable to disregarded entities that can be claimed against a taxpayer's tax by providing that the limitation only applies for taxable years beginning on or before January 1, 2023. Because the limitation attaches at the time the credit is generated by the disregarded entity under current PITL and CTL, it is recommended that the removal of the limitation also be based on credits generated in a particular taxable year.

The author may also want to clarify whether carryovers of credits generated prior to January 1, 2023, would continue to be subject to the limitation.

Technical Considerations

None noted.

Policy Considerations

Except for the members of a combined reporting group, the removal of limitation would increase disparity between disregarded entities and other entity structures because disregarded entities would effectively share their credits with their single member, and other taxpayers would be unable to do so. If this is not the intent, the author may wish to amend the bill to remove the limitation only for credits generated by disregarded entities that are members of a combined reporting group that otherwise can be assigned among affiliated members of the same combined reporting group.

LEGISLATIVE HISTORY

AB 1452 (Assembly Committee on Budget, Chapter 763, Statutes of 2008), a budget trailer bill, among other provisions, allowed the assignment of certain credits to taxpayers under the CTL that are members of the same combined reporting group.

SB 1234 (Alpert, Chapter 608, Statutes of 1997), among other things, limited any tax credits from a disregarded Limited Liability Company (LLC) reported on the owner's return to the excess of the owner's tax liability determined by including income attributable to the disregarded LLC over the owner's tax liability determined by excluding the income attributable to the disregarded LLC.

PROGRAM BACKGROUND

This limitation was enacted in 1997 after California conformed to the federal entity classification regulations or the "check-the-box" regulations for disregarded Single Member Limited Liability Companies (SMLLCs).

The California Legislature adopted two measures to ensure that SMLLCs did not have an unfair advantage over their corporate counterparts: (1) SMLLCs were required to file an annual return and pay an annual minimum tax of $800 regardless of whether they were taxable as a disregarded entity or a corporation, and (2) there was a limitation to the sharing of credits between the SMLLC and its parent.

The limitation was created to reduce disparity between SMLLCs and other entity structures because a SMLLC could effectively share its credits with its single member, and other taxpayers were unable to do so. At the time, the California legislature had created the limitation in response to the SMLLC entity, however the statute was written to apply to all disregarded entities, including disregarded limited partnerships.

Subsequently, in 2008, California enacted RTC section 23663 that allowed for the general assignment of credits among combined reporting group members. While disregarded entities were limited in their sharing of credits, corporations in the same combined reporting group could more easily share their credits. In addition, some California credits that were introduced after the (i) limitation was enacted have included a specific exemption for disregarded entities, from the (i) limitation. For example, the California Motion Picture and Television Production Credits (Film Tax Credits) allow an assignment that explicitly disengages the (i) limitation. (RTC sections 23685(c)(1), 23695(c)(1), and 23698(c)(1).)

FISCAL IMPACT

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be determined.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 1576 as Introduced February 17, 2023
Assumed Enactment after June 30, 2023

($ in Millions)

Fiscal Year	Revenue
2023-2024	-$32
2024-2025	-$21
2025-2026	-$19

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

Based on data from the FTB, it is estimated that the amount of carryover credits from disregarded entities that would no longer be subject to the credit limitation would be approximately $25 million beginning in the 2023 taxable year. In addition, it is estimated that approximately $70 million of prior year carryover credits would no longer be subject to this limitation. Of the $95 million in carryover credits no longer subject to the limitation, approximately 85%, or $79 million, would be available to taxpayers that have sufficient tax liability to offset with credits. Of that amount, approximately 30%, or $24 million, of the carryover credit would be used in taxable year 2023 and the remaining carryover credits would be claimed in the subsequent years.

The tax year estimates are then 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.

SUPPORT/OPPOSITION

To be determined.

ARGUMENTS

To be determined.

LEGISLATIVE CONTACT

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