STATE OF CALIFORNIA
Franchise Tax Board

Bill Analysis

Author: Wallis

Sponsor:

Bill Number: AB 1576

Related Bills: See Legislative History

Amended: April 26, 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

The April 26, 2023, amendments clarified that the bill would apply to credits generated in taxable years beginning on or after January 1, 2023, if the credit can be assigned, resolved all implementation and policy considerations discussed in the Franchise Tax Board's (FTB's) analysis of the bill as introduced on February 17, 2023, and added a new technical consideration.

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 credits generated in taxable years beginning on or after January 1, 2023, this bill would sunset the limitation imposed on the amount of credits attributable to disregarded entities that may be assigned by members of a combined reporting group.

This bill would allow taxpayers that directly or indirectly own an interest in a business entity that is disregarded for tax purposes to claim a credit generated in taxable years beginning on or after January 1, 2023, or related credit carryforward, if allowable, without application of the limitation described below.

Effective/Operative Date

As a tax levy, this bill would be effective immediately upon enactment and operative for credits generated in 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

None noted.

Technical Considerations

The FTB has identified the following technical consideration and is available to work with the author's office to resolve this and other considerations that may be identified.

The removal of the limitation would apply only for taxpayers that are members of combined reporting groups, which are CTL taxpayers. As such, the removal of the limitation does not apply to PITL taxpayers. Therefore, the amendments under the PITL can be deleted as they are unnecessary.

Policy Considerations

None noted.

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 credit 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 Amended April 26, 2023
Assumed Enactment after June 30, 2023

Fiscal Year	Revenue
2023-2024	-$30,000
2024-2025	-$70,000
2025-2026	-$100,000

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, an estimated 230 disregarded SMLLCs would generate approximately $200,000 of credits that would no longer be subject to the limitation imposed by Section 23036(i) in taxable year 2024. Approximately 85% of these credits, or $170,000, would be generated by taxpayers that have sufficient tax liability to offset with the credit. Of that amount, approximately 30%, or $50,000, would be claimed in the year generated and the remaining credit would be used over the subsequent years.

To determine the magnitude of sunsetting the limitation imposed by Section 23036(i) on disregarded limited partnerships, the amount of credits generated by the entity as well as the entity type of the ultimate owner would need to be known. Limited partnerships that are disregarded for federal income tax purposes are not required to file an income tax return pursuant to Section 18633. For this reason, the FTB does not have any applicable data to accurately determine the revenue impact of this proposal on disregarded limited partnerships.

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.

SUPPORT/OPPOSITION

Support

As per the Assembly Revenue and Taxation Committee analysis dated April 28, 2023, there is no support on file for this bill.

Opposition

As per the same analysis dated April 28, 2023, there is no opposition on file.

ARGUMENTS

None noted.

LEGISLATIVE CONTACT

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