



Bill Analysis

Author: Glazer

Sponsor:

Bill Number: SB 1501

Related Bills: See Legislative
History

Amended: March 20, 2024

SUBJECT

Small Business Relief Act (SBRA) Penalty

SUMMARY

This bill would, under the Small Business Relief Act (SBRA), allow a qualified entity to elect to pay the pass-through entity (PTE) elective tax without making the required payment by June 15 of the taxable year of the election if the qualified taxpayer pays a penalty equal to 5% of the elective tax for taxable years beginning on or after January 1, 2024, and before January 1, 2026.

RECOMMENDATION

No position—The Franchise Tax Board (FTB) has not formally voted or taken a position on this bill.

SUMMARY OF AMENDMENTS

The March 20, 2024, amendments removed provisions of the bill making nonsubstantive changes to Revenue and Taxation Code (RTC) section 23002 and replaced them with the provisions discussed in this analysis.

This is the FTB's first analysis of the bill.

REASON FOR THE BILL

The reason for the bill is to allow qualified entities to elect to pay the elective tax without making a required payment by June 15 of the taxable year.

ANALYSIS

This bill would, for taxable years beginning on or after January 1, 2024, and before January 1, 2026, under the SBRA, allow a qualified entity to pay the elective tax without making a required payment equal to the greater of \$1,000 or 50% of the elective tax paid by the qualified entity in the prior taxable year, if the qualified entity pays a penalty equal to 5% of the elective tax for that taxable year. The penalty would be required to be included with a qualified entity's return. The qualified entity would be required to pay the penalty on or before the due date of the original return without regard to any extension of time for filing the return.

This bill would, under the Personal Income Tax Law (PITL), specify that interest will accrue on the penalty for the period beginning on the due date of the return, without regard to any extensions, and ending on the date of payment of the penalty if the qualified entity fails to pay the penalty by due date of the original return.

Effective/Operative Date

This bill would be effective January 1, 2024, and specifically operative for taxable years beginning on or after January 1, 2024, 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. 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 to \$10,000 (\$5,000 if married filing separate). This is commonly referred to as the state and local taxes (SALT) deduction limitation.

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 Tax (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 these PTEs 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

The SBRA, under Part 10.4 of the RTC, for taxable years beginning on or after January 1, 2021, and before January 1, 2026, allows a qualified entity doing business in this state to annually elect to pay an elective tax. For entities required to file a return under Sections 18633 (partnership returns), 18633.5 (limited liability company (LLC) returns), or 18601 (S corporation returns), the elective tax is 9.3% of the qualified net income for the taxable year for which the election is made. The qualified net income of the qualified entity is the sum of the pro rata share or distributive share of income and guaranteed payments subject to tax under the PITL for the taxable year of each qualified taxpayer that consents.

For purposes of the SBRA, a qualified entity means an entity that is taxed as a partnership, an S corporation, or certain disregarded LLCs; and that entity's partners, members, or shareholders in that taxable year are exclusively corporations as defined under the Corporation Tax Law, or individuals, fiduciaries, estates, or trusts subject to tax under the PITL. A qualified entity cannot be a publicly traded partnership, or an entity permitted or required to be included in a combined reporting group.

The SBRA requires the qualified entity electing to pay the elective tax to, on or before June 15th during the taxable year of the election, make a payment equal to, or greater than, 50% of the elective tax paid in the prior taxable year or \$1,000, whichever is greater. If the payment is not timely paid or is underpaid as of June 15th, the qualified entity is not able to make the election for that taxable year.

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 elective 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.

SB 851 (Portantino, Chapter 705, Statutes of 2022) under the PITL, changed the calculation of the other state tax credit to increase the net tax payable by the allowed PTE elective tax credit amount claimed in the same taxable year.

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

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

Due to the shortened timeframe the original bill was enacted and effective, FTB did not have sufficient time to establish a robust technology process to record, post, and reconcile these payments between the business entity and its investors. This has resulted in inefficient workloads that must be remedied with this expansion of the incentive which will present further complex challenges to accurately record, post, and reconcile these payments between the business entity and its investors.

Additionally, as the financial outlook for future fiscal year budgets continues to be reported on as challenging, if budget reductions are proposed that impact FTB operations, a prioritization of current ongoing work that will need to be stopped or delayed as a result of a budget reduction should be compared against any new work that is requested.

ECONOMIC IMPACT

Revenue Discussion

To determine the magnitude of the potential impact of the bill, the number of PTEs which would opt to pay the 5% penalty instead of the required June 15th payment and the amount of elective tax for these entities would need to be known. It is assumed taxpayers would choose the option which would be the most beneficial. Because it is difficult to predict the number of entities that would opt for the penalty payment and the amount of the elective tax subject to the penalty, the impact to the General Fund is unknown.

However, it is assumed for every 25,000 of qualified entities that would choose to opt to pay the penalty and assuming an average elective tax of \$120,000 per qualified entity, the estimated elective tax subject to the penalty would be approximately \$3 billion. Applying the penalty amount of 5% would result in approximately \$150 million in penalties assessed.

The estimate does not account for any interest that may be assessed on late penalty payments.

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.

LEGAL IMPACT

None noted.

EQUITY IMPACT

None noted.

APPOINTMENTS

None noted.

SUPPORT/OPPOSITION

Senate Revenue and Taxation Committee Analysis 04-23-2024

Support: California Society of Certified Public Accountants

Opposition: None on file

ARGUMENTS

Proponents: None on file

Opponents: None on file

LEGISLATIVE CONTACT

FTBLegislativeServices@ftb.ca.gov