STATE OF CALIFORNIA
Franchise Tax Board

Bill Analysis

Author: Glazer	Sponsor:	Bill Number: SB 1501
	Related Bills: See Legislative History	Amended: June 24, 2024, and July 3, 2024

SUBJECT

Pass-Through Entity Elective Tax Prepayment and Credit Reduction

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 full June 15 prepayment and, under the Personal Income Tax Law (PITL), would decrease the PTE elective tax credit (PTETC) received by the qualified taxpayer for taxable years beginning on or after January 1, 2024, and before January 1, 2026.

RECOMMENDATION

No position—The three-member Franchise Tax Board has not formally voted or taken a position on this bill.

SUMMARY OF AMENDMENTS

The June 24, 2024, amendments removed provisions of the bill authorizing a qualified taxpayer to elect to pay the elective tax without making the June 15 prepayment if the qualified entity paid a 5% penalty and replaced them with the provisions discussed in this analysis. The July 3, 2024, amendments provide that the PTETC received by the qualified taxpayer would be decreased when a qualified entity does not pay or underpays the June 15 prepayment.

REASON FOR THE BILL

The reason for the bill is to allow a qualified entity to make the PTE elective tax election if the qualified entity does not pay the full June 15 prepayment.

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 elect to pay the elective tax without making the required June 15 prepayment equal to the greater of $1,000 or 50% of the elective tax paid by the qualified entity in the prior taxable year. This would apply only if the qualified entity pays the full amount of the elective tax on or before the due date of the original return without regard to any extensions.

This bill also, under the PITL, would reduce the qualified taxpayer's PTETC if the qualified entity did not make the full June 15 prepayment and makes the election as described above. If the qualified entity does not make any June 15 prepayment, this bill would reduce the PTETC by 10%. If the qualified entity makes a prepayment that is less than what is due by June 15, this bill would reduce the PTETC by 10% of the June 15 prepayment amount due but not paid.

This bill would also, under the AFITL, impose interest on the unpaid or underpaid prepayment amounts from June 15 until the date that the prepayment amount is paid.

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. 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 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 the 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 Revenue and Taxation Code (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 PTE'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.

The PITL, under Part 10 of the RTC, provides the PTETC for 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 SBRA. The PTETC is an amount equal to 9.3% of the qualified taxpayer's guaranteed payments and pro rata or distributive share, as applicable, of the qualified net income subject to the election made by an electing qualified entity.

Implementation Considerations

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

The assessment of interest on unpaid or underpaid prepayment amounts from June 15 until the date of the prepayment amounts would require FTB to develop technology to integrate business entity and individual taxpayer systems to determine, track, and compute interest. The FTB may not be able to develop the technology to accomplish this in the timeframe before this provision would become operative.

Technical Considerations

None noted.

Policy Considerations

The bill would provide different credit reductions under Section 17052.10(b)(2)(B)(i) and Section 17052.10(b)(2)(B)(ii). The different credit reductions may create opportunities whereby a qualified entity may make a nominal prepayment amount to qualify for the smaller credit reduction under (B)(ii).

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 PTE's partners, shareholders, or members to include a partnership. In addition, for purposes of the PTETC, 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 PTETC 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 PTEs 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

FTB's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified. This bill requires assessment of interest on any underpayment of the June 15 prepayment amount. Thus, FTB may incur additional costs to integrate business entity and individual taxpayer systems to determine, track, and compute interest.

Due to the shortened timeframe when the original bill was enacted and became 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 resulted in inefficient workloads that must be remedied with this expansion of the incentive that 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 continue to be reported 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 proposal, the number of qualified PTEs that would choose to not to make the full prepayment by June 15th, and the qualified amounts paid would need to be known. It is assumed taxpayers would choose the option which results in the least amount of payment the qualified entity would need to make until the entire amount of tax is due. Because it is difficult to predict the number of entities that would choose not to make the full prepayment and the qualified amounts subject to the PTETC reduction percentage, the impact to the General Fund is unknown.

No Prepayments Made by June 15th

It is estimated that the average annual elective PTE tax paid by qualified entities is approximately $120,000. Assuming the prior year and current year elective PTE tax are the same, for every 5,000 qualified entities that make the election, the total elective PTE tax owed would be $600 million. Should these taxpayers choose not to make a prepayment by June 15th, the total PTETC generated would be reduced by 10%, or $60 million, resulting in a PTETC generated of $540 million.

Because these taxpayers are not making the $300 million June 15th prepayments, it is assumed that the total elective PTE tax owed of $600 million would be paid when the return is filed. The net revenue impact, including the compounded interest on the underpayment of the elective PTE tax prepayment, would be approximately $75 million.

Partial Prepayments Made by June 15th

Should this same population choose to make a partial prepayment of $1,000 by June 15th, the PTETC generated would be reduced by 10% of the difference between the elective PTE tax prepayment due by June 15th of $300 million and the prepayment amount of $5 million. This would reduce the PTETC amount by $30 million and result in a PTETC generated of $570 million.

In this case, taxpayers are not making the full elective PTE tax prepayment of $300 million but are instead making a partial elective PTE tax prepayment of $5 million by June 15th. It is assumed that these entities would pay the remaining elective PTE tax of $595 million when the return is filed. The net revenue impact, including the compounded interest on the underpayment of the elective PTE tax, would be approximately $46 million.

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

Assembly Committee on Appropriations Analysis, dated August 5, 2024.

Support

California Society of Certified Public Accountants

California Taxpayers Association

Opposition

None on file.

ARGUMENTS

Assembly Committee on Appropriations Analysis, dated August 5, 2024.

Proponents

None on file.

Opponents

None on file.

LEGISLATIVE CONTACT

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