Date of Hearing: August 30, 2022

ASSEMBLY COMMITTEE ON REVENUE AND TAXATION
Jacqui Irwin, Chair

SB 851 (Portantino) – As Amended August 25, 2022

Majority vote. Tax levy. Fiscal committee.

**SENATE VOTE**: Not relevant

**SUBJECT**: Personal Income Tax Law: Small Business Relief Act: elective tax

**SUMMARY**: Provides that, for purposes of the other state tax credit (OSTC) calculation, the net tax payable under the Personal Income Tax (PIT) Law shall be increased by the amount of the pass-through entity (PTE) tax credit that reduced the net tax in that taxable year. Specifically, **this bill**:

1) Provides that, for each taxable year the PTE tax credit is allowed, for purposes of the OSTC calculation, the net tax payable under the PIT Law shall be increased by the amount of PTE tax credit that reduced the net tax in that taxable year.

2) Provides that these changes shall apply for taxable years beginning on or after January 1, 2022, and before January 1, 2026.

3) Provides that Revenue and Taxation Code Section 41 shall not apply to the expansion of existing tax expenditures resulting from application of this bill.

4) Makes a non-substantive change to the Small Business Relief Act.

5) Provides that this bill shall take immediate effect as a tax levy.

**EXISTING LAW**:

1) Authorizes, for taxable years beginning on or after January 1, 2021, and before January 1, 2026, a partnership or "S" corporation that meets certain other requirements to elect to pay an elective tax based on its net income, as specified, for the taxable year.

2) Allows various credits under the PIT Law, including a credit to a qualified taxpayer, as defined, that is a partner, shareholder, or member of an entity that elects to pay the elective tax specified above, in an amount equal to a specified percentage of the taxpayer's pro rata share or distributive share, as applicable, of income subject to the elective tax paid by the entity.

3) Provides a credit under the PIT Law to residents for specified taxes paid to another state on income derived from sources within that state.

**FISCAL EFFECT**: The Franchise Tax Board estimates that this bill would reduce General Fund revenues by $125 million in fiscal year (FY) 2022-23, and by $60 million in both FY 2023-24 and FY 2024-25.

**COMMENTS**:

1) The author has provided the following statement in support of this bill:

> SB 851 clarifies the rules for computing the California Other State Tax Credit (OSTC) when an entity elects to pay the Pass-Through Entity Tax (PTET) and obtains credits. The legislature passed AB 150 last summer to provide a way for California taxpayers to deduct their state and local taxes on their federal tax returns, in a manner that avoided the state and local tax cap of $10,000 in federal law (the SALT Cap). After its passage, a number of accountants and other tax professionals opined that making a PTET election could cause the members of the pass-through entity to lose their OSTCs. The Legislature sought to remedy this problem in SB 113, a trailer bill passed in February 2022. However, in May, the FTB concluded that the changes adopted by SB 113 were inadequate, and a further amendment was necessary. SB 851 contains the technical changes developed in consultation with the Franchise Tax Board, to rectify this problem and is consistent with the intent of the legislature's past actions.

2) Supporters of this bill note the following:

> We are writing on behalf of our national accounting firm clients in support of SB 851 (Portantino). As amended August 25, 2022, SB 851 clarifies the rules for computing the California other state tax credit (the "OSTC," Cal. Rev. &Tax Code Section 18001) when an entity elects to pay the Pass-Through Entity Tax (PTET) and obtains Pass-Through Entity Tax Credits (PTE Tax Credits). SB 851 will ensure that when a pass-through entity elects to pay the PTET, individual members of the entity will not lose their individual OSTCs as a result that election.
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> In 2021, the Legislature passed, and the Governor signed AB 150, which enacted the PTET and PTE Credit. The PTET is an entity-level tax that is deductible by the pass-through entity and not subject to the federal $10,000 limit on state and local tax deductions (the "SALT Cap"). AB 150 allowed an entity to elect to pay a 9.3 percent tax to the state, which is federally deductible. The entity's owners then receive PTE Tax credits equal to their pro rata share of the PTET paid to the state. As a result, the entity's owners receive a federal tax savings – with no corresponding cost to the state.
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> After enactment of AB 150, accountants and other tax professionals raised concerns that by electing the PTET, some taxpayers would end up with stranded – or unusable – OSTCs, because the law required that PTE Credits be used before the OSTCs, and unlike the PTE credit, OSTCs cannot be carried forward. In an effort to address this problem, SB 113 (one of the February 2022 trailer bills) contained a provision that changed the order in which credits would be applied to a taxpayer's income – specifying that the OSTCs be applied before PTE Credits.

Unfortunately, this change did not achieve the desired result. In May, the FTB issued an advisory that concluded that additional changes were necessary to the rules governing the calculation of the OSTC, to clarify how one determines the "net tax" to which those credits would apply, in cases where an entity elects to pay the PTET. SB 851 contains the additional changes identified as necessary by the FTB.

The OSTC ensures that partners in national firms (such as accounting firms) are not double taxed for income previously taxed in other states. For most partners in national accounting firms, more than half their income is typically subject to tax in other states, even if the partner never leaves California, because income is attributed to the partners based on where the firm's income is apportioned. As such, under current law – as interpreted by FTB – the benefit of the PTET is eroded, if not eliminated, by the loss of OSTCs – a result we do not believe was intended when AB 150 was enacted, and subsequently amended by SB 113.

3) Committee Staff Comments:

a) *The Tax Cuts and Jobs Act*: On December 22, 2017, former President Trump signed the Tax Cuts and Jobs Act of 2017 (the "TCJA"), which dramatically restructured the federal tax system for both individuals and businesses. For individuals, the TCJA adjusted tax rates, increased the standard deduction, and eliminated personal exemptions. The TCJA also imposed a new $10,000 cap on the deductibility of state and local tax (SALT) payments. Critics of this provision noted that eliminating the full deductibility of SALT payments "roll[ed] back a basic tenet of federal tax law that has been part of the modern federal income tax since it was created in 1913, more than a century ago."[1] Critics of the $10,000 cap on SALT deductions also noted that this provision would negatively impact millions of California taxpayers previously claiming more than $10,000 in SALT deductions on their federal tax returns.

b) *California offers relief to some negatively impacted taxpayers*: On July 16, 2021, Governor Newsom signed into law AB 150 (Committee on Budget), Chapter 82, Statutes of 2021. AB 150 offered certain taxpayers relief from the federal SALT cap by establishing a voluntary PTE tax for qualified entities doing business in California. For taxable years beginning on or after January 1, 2021, and before January 1, 2026, qualifying PTEs (i.e., entities taxed as a partnership or "S" corporation) may annually elect to pay a 9.3% tax on the entity's qualified net income.[2] Qualified taxpayers with an interest in an electing PTE (i.e., partners, members, and shareholders) then receive a credit for their share of the entity level tax, reducing their California PIT liability.[3] In this way, certain individual taxpayers with income from PTEs can get around the $10,000

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[1] "Preliminary Report on the Federal Tax Cuts and Jobs Act," New York State Department of Taxation and Finance, January 2018.
[2] Current law defines "qualified net income" as the sum of the pro rata share or distributive share of income, and any guaranteed payments, subject to California PIT.
[3] Tax credit amounts exceeding a taxpayer's PIT liability for the year can be carried forward for up to five years.

SALT cap by effectively having their state taxes paid at the PTE level.[4] California is by no means alone in establishing an elective PTE tax. Deloitte notes that, as of February 9, 2022, twenty-two states have enacted similar PTE legislation.[5]

c) *So, what is the problem*? Since the enactment of AB 150, it has come to light that the elective PTE tax regime is of limited benefit for some taxpayers with income from both inside and outside of California. In such cases, utilization of the regime, and its attendant state PIT credit, can jeopardize a taxpayer's ability to benefit from the OSTC. The OSTC was enacted to relieve taxpayers with income taxed by two different states. This can happen, for example, when a California resident has income from a PTE conducting business in another state.

It has been reported that many taxpayers who claimed the PTE credit for 2021 saw a significant decrease in the amount of OSTC they could claim. This is a function of how the OSTC is calculated on the state's Schedule S. The amount of OSTC is computed as the lesser of:

i) California tax liability × (double taxed income ÷ California adjusted gross income); or,

ii) Other state tax liability × (double taxed income ÷ Adjusted gross income taxable by other state)

If an individual "eliminates" their California tax liability through application of a PTE tax credit, their California tax liability will be deemed zero. Thus, the product of the calculation set forth in (a) will always be zero and, as a result, the taxpayer will not be entitled to claim any amount as an OSTC. Put another way, when a taxpayer eliminates their PIT liability through the application of credits, under current law there is no "double taxed" income because no taxes have been paid to California.

This result is entirely appropriate in the context of nearly all tax credits, which are generally allowed to taxpayers who engage in behavior the government deems beneficial (e.g., by increasing research expenditures). In the case of the PTE regime, however, taxpayers can reduce their individual California tax liability to zero through the PTE credit but still find themselves being double taxed, albeit indirectly. This is because, in this unique circumstance, the California tax is being paid dollar-for-dollar by the PTE, but the credit for the tax is being claimed by the individual taxpayer.

d) *What would this bill do*? This bill would provide that, for purposes of the OSTC, the term "net tax" shall be increased by the amount of PTE credit that reduced net tax in that taxable year. Put simply, this bill would "count" the PTE credit amount as part of the

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[4] On November 9, 2020, the Internal Revenue Service issued Notice 2020-75 declaring its intent to issue proposed regulations clarifying that SALTs imposed on and paid by a partnership or "S" corporation on income are allowed as a deduction, as specified.

[5] "Considerations for California's pass-through entity tax," Deloitte, 2022.

taxpayer's California tax liability for purposes of the OSTC calculation. This, in turn, would place the taxpayer in the same position they would have been in had they paid the PTE taxes directly at the individual level.

e) *But what about SB 113*? On February 9, 2022, Governor Newsom signed into law SB 113 (Committee on Budget and Fiscal Review), Chapter 3, Statutes of 2022. SB 113 made a number of changes to the PTE tax regime deemed beneficial by the business community. For example, for taxable years beginning on or after January 1, 2021, SB 113 allows the elective tax credit to reduce regular tax below the tentative minimum tax. SB 113 also made changes to the so-called "credit ordering" rules beginning with the 2022 taxable year so that the PTE credit is claimed after the OSTC. Apparently, many in the business community believed that this latter provision "fixed" the OSTC issue outlined above. As Sandy Weiner noted for Spidell's June 2022 California Taxletter:

> We believed that this meant that the California tax liability used on line 2 of Schedule S that is used to calculate the amount of the OSTC would no longer be reduced by the Passthrough Entity Elective Tax Credit.
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> However, according to the [Franchise Tax Board], the only result from changing the credit ordering rule is that taxpayers may claim the full OSTC (which does not allow any credit carryover) first and then claim the Passthrough Entity Elective Tax Credit (which has a five-year carryover for unused credits). For the 2021 tax year, the Passthrough Entity Elective Tax Credit is claimed first. For many taxpayers, the Passthrough Entity Elective Tax Credit reduces the tax liability to zero, which means that they are unable to claim the OSTC at all.

**REGISTERED SUPPORT / OPPOSITION**:

**Support**

California Society of CPAs
National Accounting Firms
State Controller Betty T. Yee

**Opposition**

None on file

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