SENATE RULES COMMITTEE
Office of Senate Floor Analyses
(916) 651-1520 Fax: (916) 327-4478

UNFINISHED BUSINESS

Bill No: SB 851
Author: Portantino (D)
Amended: 8/25/22
Vote: 21

SENATE EDUCATION COMMITTEE: 7-0, 3/9/22
AYES: Leyva, Ochoa Bogh, Cortese, Dahle, Glazer, McGuire, Pan

SENATE APPROPRIATIONS COMMITTEE: 7-0, 5/19/22
AYES: Portantino, Bates, Bradford, Jones, Kamlager, Laird, Wieckowski

SENATE FLOOR: 38-0, 5/26/22
AYES: Allen, Archuleta, Atkins, Bates, Becker, Borgeas, Bradford, Caballero, Cortese, Dahle, Dodd, Durazo, Eggman, Glazer, Gonzalez, Grove, Hueso, Hurtado, Kamlager, Laird, Leyva, Limón, McGuire, Melendez, Min, Newman, Nielsen, Ochoa Bogh, Pan, Portantino, Roth, Rubio, Skinner, Stern, Umberg, Wieckowski, Wiener, Wilk
NO VOTE RECORDED: Hertzberg, Jones

ASSEMBLY FLOOR: Not received

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

SOURCE: Author

DIGEST: This bill allows owners of pass-through entities that elect to pay the additional tax to apply those tax payments made on their behalf to the calculation of the other states tax credit.

Assembly Amendments delete the contents of the bill approved by the Senate on 5/26/22 and insert the current language.

ANALYSIS:

Existing law:

1) Provides for multiple business entity types knows as “pass-through entities (PTEs).” These entities include S-corporations, Limited Liability Companies, Limited Liability Partnerships, and Limited Partnerships.

2) Requires PTEs to distribute net income generated from the business to its owners (called shareholders, members, or owners).

3) Requires owners of the PTEs to report the income on their personal income tax returns and pay appropriate tax. This “pass-through” is meant to prevent double taxation of the same income, which can occur with C-corporations, who pay an entity level tax and whose owners pay tax on dividend income or capital gains from the sale of stock.

4) Allows PTEs to deduct state and local taxes paid as a business expense on their federal tax return.

5) Allows PTEs to pay an elective 9.3 percent tax on behalf of their owners’ pro rata share of income from the PTE. Each owner can decide if they wish for their PTE to pay tax on the income it generates on their behalf (AB 150, Committee on the Budget, Chapter 82, Statues of 2021).

6) Allows the owner of a PTE to claim a credit on their personal income tax return that is equal to the amount of tax paid by the PTE on behalf of the owner if the entity elects to pay the tax, and the owner elects to pay their pro rata portion of the tax. The PTE credit passed through to owners can reduce the tax below the tentative minimum tax.

7) Requires California residents to be taxed on all income regardless of source, including income derived from other states.

8) Allows individuals to offset their California tax when they pay net income taxes on the same income in other states by allowing taxpayers to claim an other state tax credit (OSTC) on their tax return.

9) Stipulates that the calculation of the OSTC is computed as the lesser of:

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

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

10) Specifies that tax paid by a PTE on behalf of their owner is not in the calculation of California net tax for purposes of generating an OSTC credit.

11) Limits the use of the OSTC to limit the credit only to tax generated in the taxable year and does not allow the credit to be carried over.

12) Sets forth a specific order for taxpayers to claim credits; for example, taxpayers must apply credits that do not contain carry forwards before ones that do.

13) Provides that the PTE credit must be exhausted before a taxpayer can apply their OSTCs in the 2021 year, but reversed the order in the future beginning in the 2022 taxable year (SB 113, Committee on the Budget, Chapter 3, Statutes of 2022).

This bill:

1) Allows the PTE elective taxes that a PTE pays on behalf of their owners to be included in the calculation of net California tax for the owners when determining how much OSTC can be claimed.

2) Allows the credit that the owner of the PTE receives to be offset by the additional tax paid on their behalf.

3) Applies commencing in the 2022 taxable year.

Background

State and local tax deduction. Federal law generally allows individuals to deduct their state and local income taxes, sales, and property taxes (SALT) on their federal income tax return. Beginning in 2018, the Federal Tax Cuts and Jobs Act (TCJA), changed several itemized deductions, including limiting the total deduction for SALT to $10,000 ($5,000 if married filing separate) for personal income taxpayers. The SALT limitation placed on individuals is set to expire after the 2025 taxable year. The SALT cap only affects individuals, not business entities. Unlike individuals, business entities are allowed to deduct ordinary and necessary businesses expenses without a limitation. This includes all taxes paid to other states.

AB 150. In November 2020, the Internal Revenue Service (IRS) notified taxpayers that it intends to issue regulations clarifying that tax payments made at the entity level are not subject to the SALT deduction limitation applicable to partners and shareholders. The Notice provides that pass-through entities can pay SALT at the entity level, and the tax deduction that flows through to the individual partners and shareholders qualifies as a business expense deduction, so not subject to the individual SALT limitation for itemized deduction purposes.

In response to this ruling, the Legislature enacted legislation (AB 150, Chapter 82, Statues of 2021) to allow owners of a PTEs to elect to have the entity they own pay their portion of individual tax owed on the income they generate from the entity on its business tax return on their behalf. Unlike its owners whose deductions are limited by the SALT cap, the business can then deduct the taxes paid on their federal return as business expenses. For example, two friends own a restaurant. The restaurant makes $400,000 in net income this year, distributing $200,000 in income to each partner, both of whom then include this income on their personal income tax returns. At a personal income tax rate of 9.3%, each owner would pay roughly $18,600 in state taxes. However, each partner can only deduct $10,000 in state personal income taxes from their federal income taxes because of the SALT cap. Using the above example, if the owners elect to pay the PTE tax, the restaurant would pay the state the same $37,200 in tax ($18,600 x 2) as its partners would have, but can then deduct this amount on its federal income tax return as a business expense, reducing its income subject to federal taxes. Additionally, the state income tax credit allowed to the owners reduces the owners' state personal income tax, because the restaurant paid the tax on their behalf. The state receives the same $18,600 in California taxes, but by shifting the tax obligation to the PTE, both owners save roughly $3,790 in federal taxes because the income distributed to them will be less after the entity deducts all state taxes paid. The owners would also have more room under the SALT cap to deduct any other California taxes they pay.

Other state tax credit. California taxpayers can sometimes have taxable income that can be sourced to other states in addition to California. For example, a California resident who derives income from rental property in Indiana is subject to income taxes both in Indiana and California. In this case, taxpayers may qualify for a credit for income taxes paid to another state.

The OSTC is computed as the lesser of:

- California tax liability × (double taxed income ÷ California adjusted gross income); or,
- Other state tax liability × (double taxed income ÷ Adjusted gross income taxable by other state)

However, OSTC law says that California net taxes paid does not include taxes paid to California on behalf of its owners by their PTE, but does require the owner to apply the PTE credit when calculating their OSTC. When the PTE credit is included, the taxpayer's OSTC can be rendered worthless because the California tax liability is eliminated by the PTE credits allowed. By requiring PTE payments to be included in California tax liability when taxpayers calculate their OSTCs, SB 851 ensures that taxpayers with income derived in other states who have PTE credits can claim OSTCs they qualify for

FISCAL EFFECT: Appropriation: No Fiscal Com.: Yes Local: No

According to the Franchise Tax Board, this bill would result in a revenue loss of $125 million in fiscal year 2022-23, $60 million in fiscal year 2023-24, and $60 million in fiscal year 2024-25.

SUPPORT: (Verified 8/31/22)

State Controller Betty Yee
California Society of Certified Public Accountants
Deloitte
Ernst & Young
Grant Thornton
KPMG
PricewaterhouseCoopers

OPPOSITION: (Verified 8/31/22)

None received

ARGUMENTS IN SUPPORT: According to the author, "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 and obtain the related 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 PTE tax election could cause the members of the pass-through entity to lose their OSTC's. 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."

Prepared by: Jessica Deitchman / GOV. & F. / (916) 651-4119
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