DEPARTMENT OF REVENUE

INDIVIDUAL INCOME TAX
CORPORATE FRANCHISE TAX
PPP Loan Exclusion
Sec. 179 Carryovers; C-Option Corp
Unemployment Subtraction

March 11, 2021

	Yes	**No**
DOR Administrative Costs/Savings	**X**	

Department of Revenue
Analysis of S.F 263 (Bakk), First engrossment, as Proposed to be Amended
(SCS0263A-29 and SCS0263A-48)

	Fund Impact			
	F.Y. 2022	**F.Y. 2023**	**F.Y. 2024**	**F.Y. 2025**
		(000's)		
PPP Loan Exclusion				
Individual Income Tax	($191,500)	($18,200)	($14,400)	($9,900)
Corporate Franchise Tax	($183,500)	($15,900)	($12,200)	($9,200)
Total	($375,000)	($34,100)	($26,600)	($19,100)
Section 179 Carryover				
Individual Income Tax	($3,800)	$1,000	$1,000	$1,000
Corporate Franchise Tax	($1,400)	$400	$400	$400
Total	($5,200)	$1,400	$1,400	$1,400
C-Option Corporation Election	Unknown	Unknown	Unknown	Unknown
Unemployment Benefit Subtraction	($28,400)	$0	$0	$0
General Fund Total*	($408,600)	($32,700)	($25,200)	($17,700)

*Excluding C-Option Corporation Election, which is unknown.

The exclusion is effective for loans forgiven under the Paycheck Protection Program.
The C-option corporation election is effective beginning with tax year 2021.
The Section 179 provision is effective for federal carryovers beginning in tax year 2020.
The unemployment benefit subtraction is effective for tax year 2020.

EXPLANATION OF THE BILL

Paycheck Protection Program Exclusion

The Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136), enacted on March 27, 2020, established the Paycheck Protection Program (PPP) to provide low-interest loans to small businesses with less than 500 employees to assist with payroll, mortgage interest, rent, and utilities. The program was created and modified by the following Acts:

- The CARES Act appropriated up to $350 billion for low-interest loans.
- The Paycheck Protection Program and Health Care Enhancement Act (P.L. 116-139), enacted on April 24, 2020, appropriated an additional $310 billion to the Paycheck Protection Program.

EXPLANATION OF THE BILL (Cont.)

- The Consolidated Appropriations Act, 2021 (CAA 2021) (P.L 116-260), enacted on December 27, 2020, appropriated an additional $284 billion to the program and revised the criteria for loan forgiveness.

The loans are to be spent over an 8-week to 24-week period for qualified business expenses. The total loan covers up to 2.25 times the business's average monthly costs up to $10 million. After the covered period, business can contact the loan provider to seek possible loan forgiveness. Loans are eligible for forgiveness if they meet certain requirements.

The amount of the loan that is forgiven is not included in gross income. The CAA 2021 clarified that expenses paid with forgiven loans may be deducted from income.

Minnesota has not adopted the exclusion for forgiven PPP loans. Allowing the exclusion would reduce taxable income for affected taxpayers, resulting in a reduction in individual income tax and corporate franchise tax revenue.

C-Option Corporation

Current Law: Flow-through entities such as S corporations and partnerships do not pay state or federal income taxes directly. Their income is passed to shareholders, who report the income on their individual income tax returns. There is no election to allow a partnership, S corporation, or limited liability company to file and pay their tax liability as a C corporation

Federal deductions for taxes paid by a business as a flow-through entity are subject to the federal cap on state and local tax deductions. The cap is $10,000 ($5,000 for married separate filers).

Proposed Law: The bill creates an option that allows a partnership, S corporation, or limited liability company to elect to file and compute their tax liability as a corporation subject to the corporate franchise tax (termed a C-option corporation). When a taxpayer files as a C corporation and unlike the flow-through entities, all taxes are deductible as a business expense.

When a taxpayer computes their tax liability as a corporation, its income would be apportioned to Minnesota. In addition, electing taxpayers would be required to use all corporate additions and subtractions. The tax rate would be at the highest individual rate, 9.85%. The corporate franchise tax rate is a flat 9.8%.

If the election is made by the majority owners of the qualifying entity (having more than 50% ownership interest), the election is binding on all of the owners of the entity. The election must be made by the date the return is due or the extended due date. The election is binding for the next four years, unless more than 50% of the ownership interest requests a revocation. If the election is revoked within four years, the entity may not file as a C-option corporation for the next four years. A shareholder's basis in the entity is not affected by the election to file as a C-option corporation.

EXPLANATION OF THE BILL (Cont.)

Shareholders of the qualifying entity may claim a subtraction on their individual income tax return equal to the amount of net income received from the entity. Net income cannot be less than zero.

Unlike C corporations, resident partners, members, and shareholders of a C-option corporation may claim a credit for taxes paid to another state. There are special rules that govern the distribution of carryovers, refunds, and credits for C-option corporations.

Section 179 Carryovers
Section 179 of the Internal Revenue Code allows a taxpayer to treat the cost of qualified business property as an expense in the year the property is placed in service, up to certain limits.

Prior to tax year 2020, Minnesota law required a taxpayer to add back 80% of the difference between the amount deducted federally and the amount that was allowed under pre-2003 federal law (up to $25,000, reduced by one dollar for each dollar that total expenses exceed $200,000). The amount of the addback could be subtracted in equal parts over the next five years.

Minnesota conformed to the federal treatment of Section 179 property beginning with property placed in service in 2020, eliminating the need for the additions and subtractions. However, full conformity does not apply to carryovers from a previous year if the property was placed in service before tax year 2020. For example, Section 179 expenses for property placed in service in 2019 may be carried over to tax year 2020 if the taxpayer is unable to claim the full deduction in 2019. In that case, the expenses would still be subject to the addition and subtractions on the Minnesota return, since the property was placed in service in 2019.

The bill would extend full conformity for Section 179 expensing to include carryovers beginning in tax year 2020, regardless of when the property was placed in service.

Unemployment Benefit Subtraction
The bill creates a temporary subtraction for supplemental unemployment insurance benefits. The Coronavirus Aid, Relief, and Economic Security (CARES) Act (Public Law 116-136) provided federal funding for payments of $600 per week in supplemental unemployment benefits, known as Federal Pandemic Unemployment Compensation. Under state and federal law, unemployment insurance payments are taxable income.

The bill would allow an individual income tax subtraction equal to 18% of Federal Pandemic Unemployment Compensation received in tax year 2020. The subtraction is phased out by one dollar for every four dollars over the following thresholds: $150,000 for married joint filers and qualifying widow(ers), $112,500 for head of household filers, and $75,000 for all other filers.

REVENUE ANALYSIS DETAIL

Paycheck Protection Program

- The first and second round of PPP loans ended on August 8, 2020. At that time, about 5,212,100 loans totaling $525.0 billion had been approved by the Small Business Administration (SBA), as reported in the Paycheck Protection Program Report. Of this total, about 102,400 loans totaling $11.3 billion were approved in Minnesota.
- The CAA 2021 appropriated an additional $284 billion for PPP loans. Based on the loans issued so far, Minnesota businesses are expected to receive an additional $6.1 billion in loans in tax year 2021.
- Based on the distribution and magnitude of the loans, it is assumed 80% of the loans will be forgiven.
- C corporations account for 39.5% of PPP loans in Minnesota, according to information obtained from the Small Business Administration. Pass-through entities, estates, trusts, and individuals account for 51.9%. Nonprofit organizations account for 8.6%.
- Nonprofits are not included in the estimate because their operating income is already excluded from tax.
- The estimate was reduced by 68% to exclude businesses without taxable income in tax year 2020, based on taxable income in 2018, adjusted for expected losses in 2020.
- The SBA data for Minnesota loan recipients does not include out-of-state businesses with sales into Minnesota. The size of that impact is unknown but is assumed to be offset by out-of-state sales of businesses located in Minnesota.
- Amounts that cannot be deducted immediately may be carried forward as net operating losses (NOLs) to offset income in future years. Between 2.7% and 6.3% of NOLs are assumed to be claimed each year over the forecast period.
- The CARES Act removed the 80% limitation on NOLs and allowed losses to be carried back for up to five years. Adopting those provisions when combined with the PPP loan exclusion would result in an additional immediate impact in FY 2022. There will be a revenue gain beginning in FY 2023 as the pool of NOLs will be smaller in future years.
- A marginal rate of 8.0% was assumed for individuals and pass-through entities. A marginal rate of 9.8% was applied to corporations.
- Corporate tax impacts are allocated 30% / 70% to fiscal years. Income tax impacts were allocated to the following fiscal year.

C-Option Corporation

- The number of qualifying entities that would elect to file as a C-option corporation is unknown.
- In tax year 2018, about 179,300 full-year resident returns reported income from an S corporation, partnership, or limited liability corporation.
- Of those, about 42,500 returns had state and local taxes over the deduction limit ($10,000 or $5,000 for married separate filers).
- About 21,800 of those returns had at least some income in the highest income tax bracket. Those are considered to be most likely to file as a C-option corporation, which would have all of its income taxed at the highest income tax rate.

REVENUE ANALYSIS DETAIL (Cont.)

- It is unknown how many of those taxpayers have more than 50% ownership in the qualifying entities.
- It is assumed that an entity would only file as a C-option corporation if the majority shareholders benefit from the election with a reduced combined federal and state tax liability.
- The effect on state tax revenue depends on the tax situation of the underlying shareholders, including the shareholder's marginal tax rate and whether they are at the limit for state and local tax deductions.
- The election is binding on all shareholders, so minority shareholders could be hurt by the election even if the majority shareholders benefit.
- The election is binding for the next four tax years, unless revoked by a majority of shareholders. Taxpayers may not benefit from the election in the following years if their financial situation changes.

Section 179 Carryovers

- Based on information from the Internal Revenue Service Statistics of Income, carryovers accounted for about 6.9% of total Section 179 expenses on individual income tax returns in 2018.
- On Minnesota returns, full-year residents claimed about $1.08 billion in Section 179 expensing in 2018. Carryovers are estimated at 6.9% of that amount, or $74.5 million.
- Assuming a growth rate of 3%, carryovers in 2020 are estimated at $79.0 million.
- A marginal rate of 7.75% is assumed.
- The estimate was increased by 5% to account for nonresidents.
- The corporate franchise tax impact is estimated at 38% of the individual income tax impact, based on the ratio of Section 179 expenses reported on individual and corporate returns.
- Retroactive impacts were allocated to fiscal year 2022. All other tax years were allocated 30% / 70% to fiscal years.

Unemployment Benefit Subtraction

- The estimate is based on the U.S. Department of Labor's publication of Coronavirus Aid, Relief, and Economic Security (CARES) Act funding to states.
- It is assumed that 65% of unemployment insurance claims would result in taxable income on individual returns.
- A marginal rate of 6.5% is assumed.
- The retroactive impact is allocated to fiscal year 2022.

Minnesota Department of Revenue
Tax Research Division
https://www.revenue.state.mn.us/revenue-analyses