Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author: Assembly Revenue & Tax Committee Analyst: Norman Catelli Bill Number: AB 3073

Related Bills: See Prior Analysis Telephone: 845-5117 Amended Date: July 12, 2004

Attorney: Patrick Kusiak Sponsor: ____________

SUBJECT: Claim of Right Deduction/Clarify Application of 2% Floor/Extend Voluntary Disclosure to Limited Liability Companies

_____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ____________.

_____ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

_____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended ____________.

_____ FURTHER AMENDMENTS NECESSARY.

_____ DEPARTMENT POSITION CHANGED TO ____________.

__X__ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED June 15, 2004, STILL APPLIES.

__X__ OTHER - See comments below.

SUMMARY

This bill would:

- Conform California law to the federal claim of right provisions, and
- Extend the voluntary disclosure program to limited liability companies (LLCs) and their owners.

SUMMARY OF AMENDMENTS

The July 12, 2004, amendments:

- Added a provision that amends the Corporations Code, administered by the Secretary of State, to clarify that an LLC may engage in any lawful activity, whether for-profit or not-for-profit.

- Added a provision that would extend the voluntary disclosure program, administered by Franchise Tax Board (FTB), to LLCs and their owners.

This analysis addresses only those provisions of the bill affecting provisions of the Revenue and Taxation Code (RTC) administered by the FTB.

Board Position:			Legislative Director	Date
__X__ S	_____ NA	_____ NP		
_____ SA	_____ O	_____ NAR	Brian Putler	7/19/04
_____ N	_____ OUA	_____ PENDING		

For the reader's convenience, the analysis of the voluntary disclosure program provision is included below. A revised revenue estimate combining both provisions of the bill is included below.

PURPOSE OF THE BILL

The portions of this bill sponsored by the FTB are intended to:

- Clarify tax law and ease taxpayer compliance and administration burdens regarding claim of right provisions, and
- Encourage LLCs and their owners to voluntarily comply with California income tax laws.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment. The claim of right provisions would be operative on January 1, 2004. Specifics of the bill make the voluntary disclosure program operative for agreements entered into on or after January 1, 2005.

POSITION

At its March 6, 2002, meeting, the three-member Franchise Tax Board voted 2-0 to sponsor the provisions of this bill relating to the claim of right provisions.

At its December 2, 2003, meeting, the three-member Franchise Tax Board voted 2-0 to sponsor the provisions of this bill relating to the voluntary disclosure program.

ANALYSIS

BACKGROUND

Nexus is a constitutional prerequisite that must be satisfied before any state can exercise its power to tax. Nexus is generally defined as a level of presence or activity within the state that creates a legally sufficient connection between the state and the business or individual so that it is constitutionally permissible for the state to impose a tax.

Certain out-of-state businesses may not be aware of their California franchise or income tax liability or filing requirements, and the FTB may not readily identify them through its filing enforcement or other compliance programs. These businesses' franchise or income tax liability may be "discovered" by FTB only after years of presence or activity in California or not at all, if their presence or activities occurred only for a few years. Because of the substantial penalties that apply to the delinquent filing of returns and payment of taxes and the potential for audit by FTB for all years preceding "discovery," these taxpayers may be reluctant to come forward and voluntarily disclose their California presence or activities and report any tax liability.

AB 2880 (Caldera, Stats. 1994, Ch. 367), an FTB-sponsored bill, established a California Voluntary Disclosure Program for certain out-of-state banks and corporations.

In addition to corporations, AB 2880, as introduced, applied to limited partnerships, certain trusts, and certain partners and beneficiaries. During the legislative process, however, because concern was expressed that waiver of penalties for flow-through entities and their partners/beneficiaries might be viewed as amnesty for a small group of individuals, these entities were eliminated from the bill. S corporations, which are also pass-through entities, were included in the bill as corporate entities, but the status of their shareholders was not addressed.

SB 38 (Lockyer, Stats. 1996, Ch. 954) added S corporation shareholders to California's voluntary disclosure program. To limit the concern that applying the waiver authority to S corporation shareholders could be viewed as amnesty for these individuals, participation in the California voluntary disclosure program was limited to those S corporation shareholders who were nonresidents on the day that the agreement was signed.

SB 1185 (Senate Revenue & Taxation Committee, Stats. 2001, Ch. 543), an FTB-sponsored bill, added trusts, and nonresident beneficiaries to California's voluntary disclosure program.

FEDERAL/STATE LAW

Voluntary Disclosure

Federal tax law does not utilize the legal concept of nexus.

Under state law, FTB is authorized to enter into voluntary disclosure agreements with:

- Qualifying business entities,
- Qualified shareholders,
- Qualified trusts, and
- Qualified beneficiaries.

A "qualifying business entity" includes any out-of-state or nonexempt corporation that has never filed a California income tax return and that voluntarily applies to the program prior to any contact from FTB regarding income or franchise tax liability.

A "qualified shareholder" is a nonresident shareholder of an S corporation that has applied for a voluntary disclosure agreement and disclosed all material facts pertaining to the shareholder's liability.

A "qualified trust" is a trust that has never been administered in California and that has had no resident beneficiaries in California for the six taxable years ending immediately preceding the signing date of the voluntary disclosure agreement. However, a "qualified trust" would include a trust with a resident beneficiary whose interest in the trust is contingent and who has never received a distribution from the trust.

A "qualified beneficiary" is an individual who is a beneficiary of a qualified trust and is a nonresident on the signing date of the voluntary disclosure agreement and for each of the preceding six taxable years.

Under the terms of the voluntary disclosure agreement, FTB waives penalties for noncompliance with specified reporting and payment requirements for the six taxable years immediately preceding FTB's signing of the agreement. For taxable years ending more than six years prior to the agreement, the business's income or franchise taxes, additions to tax, fees, or penalties also are waived. The three-member Franchise Tax Board must approve all voluntary disclosure agreements.

Limited Liability Companies

Current state law authorizes the creation of a business entity known as an LLC. An LLC consists of one or more members that may be individuals, partnerships, limited partnerships, trusts, estates, associations, corporations, other LLCs, or other business entities. The members of an LLC are afforded limited liability similar to shareholders of a corporation but have pass-through treatment for taxes comparable to the tax treatment of a partnership.

Under federal and state tax law, an LLC may elect to be treated as a corporation or a partnership. An LLC with a single member may be treated as a corporation or disregarded for income tax purposes. When an entity is "disregarded," its activities are deemed to be the activities of the owner (e.g., a sole proprietorship or a division of a parent company).

Existing state law requires an LLC not classified as a corporation for tax purposes to pay both an annual tax and an annual fee. The annual tax is an amount equal to the minimum franchise tax and is paid annually until the effective date of cancellation or, if later, the date the LLC ceases to do business within the state. The annual fee is based on the LLC's total income from all sources reportable to this state for the taxable year.

An LLC classified as a corporation is eligible to participate in the voluntary disclosure program. However, an LLC taxed as either a partnership or an entity disregarded for tax purposes is not allowed to participate even though the LLC pays an entity level tax and fee.

<u>THIS BILL</u>

This provision would extend the voluntary disclosure program to LLCs and their corporate and nonresident individual members. This would be accomplished by:

- Expanding the definition of qualified entity eligible to participate in the voluntary disclosure program to include an LLC as defined in RTC Section 17941.
- Adding a definition for "qualified member" consistent with the types of entities eligible to participate in the voluntary disclosure program and with the definition of a "qualified shareholder."
- Clarifying that "fees," as well as tax and interest, must be paid. This change is necessary since LLCs pay "fees" in addition to "taxes."

This provision would also make the following minor and technical changes:

- Clarify that qualified entities subject to the franchise tax must pay at least the minimum franchise tax for each of the six taxable years.

- Clarify that a "contingent beneficiary" is a beneficiary that has not received any distribution from the trust within the six taxable years preceding the signing date of the voluntary disclosure agreement.
- Change the term "qualified business entity" to "qualified entity" for consistency in the voluntary disclosure provisions.
- Change the term "reliance" to "reasonable reliance" for consistency within the RTC.

IMPLEMENTATION CONSIDERATIONS

This provision would be implemented within FTB's existing voluntary disclosure program and would require some changes to existing tax forms and instructions, which could be accomplished during the normal annual update.

TECHNICAL CONSIDERATIONS

On page 21, line 15, the phrase "*or qualified shareholder, qualified member, or qualified beneficiary.*" should be added to be consistent with the preceding subparagraph.

On page 23, line 25, the reference should be to "Section 23153" not "Section 25153."

On page 24, line 1, the subdivision should be in lower case, i.e., (g).

On page 26, line 15, the colon should be a semi-colon.

OTHER STATES' INFORMATION

A review of *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York* laws found that each state other than *Massachusetts* and *New York* has a voluntary disclosure program. *Michigan's* program specifically includes LLCs. The laws of these states were reviewed because of similarities to California's economy, business entity types, and tax laws.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on the discussion below, the revenue gain from this bill is as follows:

Revenue Impact ($ Millions)			
Fiscal Year	2005-06	2006-07	2007-08
Revenue Gain-Voluntary Disclosure	Negligible gain	Negligible gain	Negligible gain
Revenue Loss-Claim of Right	Insignificant loss	Insignificant loss	Insignificant loss

A negligible gain does not exceed $250,000.
An insignificant loss does not exceed $150,000.

This bill does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The voluntary disclosure proposal potentially would generate negligible revenue gains not exceeding $250,000 annually. The number of qualified members that voluntarily enter into a disclosure agreement, and the amount of taxes paid by those entities and members would determine the revenue impact of this proposal.

The estimate above is based on actual data from the Voluntary Disclosure Unit. The volume of voluntary disclosure agreements for LLCs and the amount of tax revenue generated is expected to be less than that of corporations under the current program. Currently, about 25 applications are received each year for corporations resulting in average revenue collections of approximately $550,000. Assuming 25% of applications would come from LLCs and their qualified members, the income tax revenue impact would be negligible.

ARGUMENTS/POLICY CONCERNS

- This provision would encourage multi-jurisdictional LLCs and their owners to comply with California tax law, thereby advancing the objectives of California's voluntary compliance program. This provision also would clarify the voluntary disclosure statutes to reduce confusion for taxpayers and department staff.

- This provision would reduce the "tax gap" by obtaining compliance and collecting taxes from those that currently have a California tax liability but otherwise would not file and pay.

LEGISLATIVE STAFF CONTACT

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