Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Campbell	Analyst:	John Pavalasky	Bill Number:	AB 612
Related Bills:	See Legislative History	Telephone:	845-4335	Amended Date:	3-24-03
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Alimony Deduction For Nonresidents/Exempt-Interest Dividends/Limited Liability Company Fees

____	DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ______________________.
x	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 INTRODUCED February 19, 2003 STILL APPLIES.
____	OTHER - See comments below.

SUMMARY

This bill, as introduced, would allow a nonresident or part-year resident taxpayer of California a prorated alimony deduction, thus making California law consistent with case law from the U.S. Supreme Court and resolving a federal constitutional issue.

SUMMARY OF AMENDMENTS

The March 24, 2003, amendments add two additional provisions to the bill, as follows:

- The first would eliminate the 50% test for qualification of a Regulated Investment Company (RIC) (commonly called a mutual fund) to designate "exempt interest dividends."
- The second relates to the limited liability company (LLC) fee and would redefine "total income from all sources reportable to this state" to mean only that income generated in this state.

PURPOSE OF THE BILL

Pending

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and apply to taxable years beginning on or after January 1, 2003.

Board Position:			Department Director	Date
____ S	____ NA	____ NP	Gerald H. Goldberg	4/22/03
____ SA	____ O	____ NAR		
____ N	____ OUA	X PENDING		

POSITION

Pending.

ECONOMIC IMPACT

Revenue Estimate Summary

Estimated Revenue Impact Effective January 1, 2003 [$ In Millions]			
	2003-04	2004-05	2005-06
1. Nonresident Alimony Deduction	Negligible Loss*	Negligible Loss*	Negligible Loss*
2. Eliminate 50% Test For RIC	-$45	-$45	-$45
3. LLC Fee	-$10	-$10	-$10
Total	-$55	-$55	-$55

* Negligible loss is less than $250,000 annually.

Each of these issues will be discussed separately.

1. Allows a nonresident or part-year resident taxpayer of California a prorated alimony deduction.

   See analysis of the bill as introduced February 19, 2003, for the discussion of this item.

2. Eliminate the 50% test for qualification of a RIC (commonly called a mutual fund) to designate "exempt interest dividends."

FEDERAL/STATE LAW

Current Federal Law

Federal law provides that obligations of the federal government and the interest paid on those obligations are exempt from state income taxation.

Federal law defines a RIC as any domestic corporation or certain trusts that at all times during the taxable year is registered or has an election under the Investment Company Act of 1940 to be treated as a management company or unit investment trust.

Further, federal law requires that a corporation or trust shall be treated as a RIC only if:

- It elects on its tax return to be a RIC,
- At least 90% of its gross income is derived from dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock or securities,
- At the close of each quarter during the taxable year, at least 50% of the RIC’s total assets is represented by cash and cash items, government securities, securities of other RICs, and other securities, including equity and debt securities. Other securities, with respect to any one issuer, are limited to not exceed 5% of the total assets, and not more than 10% of the voting securities of the issuer.
- Not more than 25% of the value of its total assets is invested in the securities of one issuer, or two or more issuers of which the taxpayer controls.

Federal law also provides under a special rule that when at least 50% of the value of a RIC's total assets consist of state and local bond obligations, that RIC is qualified to pay exempt-interest dividends to its shareholders.

Exempt-interest dividends are designated by the RIC as "exempt-interest dividends" in a written notice mailed to its shareholders no later than 60 days after the close of the RIC's taxable year. Exempt-interest dividends are traceable, or directly attributable, to interest received by the RIC during the taxable year on obligations that, when held by an individual, would be exempt from federal taxation. Federal law allows RIC shareholders to treat an "exempt-interest dividend" as tax-exempt interest if the RIC meets the 50% asset test described above. If the RIC fails the 50% asset test, then the RIC is not entitled to designate an "exempt-interest dividend" and all dividend amounts are simply treated as a normal taxable dividend paid by a corporation and thus are included in the shareholder's gross income.

Current State Law

State law conforms to federal law with regard to the definition and treatment of a RIC, with two significant modifications. First, for purposes of determining if a RIC is eligible to pay exempt-interest dividends to its shareholders, the RIC may include, in addition to California state and local obligations, any federal obligations in determining whether it meets the 50% asset test described above. As a result, if the RIC meets the 50% threshold requirement under this modified test, exempt-interest dividend amounts include interest received both on the federal and on the California state and local obligations held by the RIC.

Second, for state purposes the determination of whether interest on state and local obligations is exempt from California income taxation is determined by reference to Section 3(c) of Article VIII of the California Constitution, instead of Internal Revenue Code section 103. Thus, only obligations that pay interest that is exempt from California taxation under the California Constitution can generate exempt-interest dividends for California income tax purposes. The result is that obligations of other states do not qualify and certain California obligations that would not qualify for purposes of the federal 50% test under Internal Revenue Code section 103 do qualify under this modification.

THIS BILL

This bill would allow the RIC to designate as an "exempt-interest dividend" any dividend in an amount not in excess of interest income received from federal or California obligations. These designated "exempt-interest dividends" would be exempt from tax for state purposes when paid as a dividend to shareholders. Thus, the bill would expand the amount of interest treated as "exempt-interest dividends" by repealing the requirement for the RIC to satisfy the current 50% minimum qualified asset threshold before being allowed to pay "exempt-interest dividends" to shareholders.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this proposal would result in the following order of magnitude revenue losses. Estimates assume only prospective application of the proposal beginning with 2003.

Estimated Revenue Impact [$ In Millions]		
2003-04	2004-05	2005-06
-$45	-$45	-$45

Revenue Discussion

The revenue impact of this proposal would be determined by the amount of RIC dividends, exempt under this proposal, that would be otherwise taxable and the marginal tax rates of taxpayers receiving such dividends.

Published data on ownership of federal securities indicates the estimated ownership of U.S. Treasury securities by mutual funds at year-end 2001 totaled $260 billion. Applying an average yield of 5% for all maturities suggests potential dividend distributions from RICs of about $13 billion of interest on federal securities. If California's share of these potential distributions is equal to its share of the nation's population (12%) and one-third of this amount is currently taxable, applying a 7% marginal tax rate would result in a revenue loss of $36 million at the 2001 level. Assuming only one-third of potential distributions are currently taxable allows for any existing RIC pass-through of exempt-interest distributions (50% or more quarterly asset test), corporate shareholders, pension and IRA holdings consisting in part of shares of mutual funds with federal securities within the mutual fund portfolio, etc.

Single-state (California) municipal bond funds or unit investment trusts pass-through tax-exempt interest under current law by meeting the quarterly asset test of 50% or more. National municipal bond funds and unit investment trusts have portfolios consisting of state and local bond issues of several different states and generally do not meet California's 50% test. Under this proposal, these funds or trusts would qualify to pass through tax-exempt dividends to California taxpayers equal to the value of California issues over all issues in the portfolio.

Based on total outstanding debt of California state and local governments and the approximate percentages of this debt held by national municipal bond funds and shareholders that are California taxpayers, it is estimated that at 2001 levels an additional $65 million of dividends would pass through tax-exempt. Applying an average marginal tax rate of 9% for these taxpayers would derive additional losses on the order of $6 million.

Estimated loss from federal securities (base year 2001)	$36 million
Estimated additional loss from California securities (base year 2001)	6 million
Estimated loss from federal and California securities (base year 2001)	$42 million

The estimated loss from federal and California securities of $42 million was then adjusted from this 2001 base loss to allow for new debt issued, existing debt retired, the change in interest rates, and by rounding to the nearest $5 million to derive the $45 million order of magnitude loss shown in the table.

ARGUMENTS/POLICY CONCERNS

For a RIC that fails the 50% asset test, but nonetheless holds any federal and/or California obligations, some taxpayers argue that subjecting the portion of any dividend paid to the RIC shareholders that is attributable to interest received by the RIC on those obligations to state taxation is in conflict with the California Constitution and federal law. They believe that the dividend paid to the RIC's shareholders is a direct result of interest received from the California and federal obligations held by the RIC. However, unlike a partnership, a RIC is not a pass-through entity for income tax purposes, but is instead a separate taxpaying entity that is entitled to preferential dividend deduction and character preservation rules on the dividends it pays to its shareholders.

3. Redefine "total income from all sources reportable to this state" for purposes of determining the LLC fee

FEDERAL/STATE LAW

There is no fee imposed on an LLC under federal law. Under federal law an LLC is treated, at the election of the taxpayer, as either a partnership or a corporation, or if owned by a single entity, disregarded for federal and state income tax purposes.

Existing state law requires that for a business entity to receive the benefits associated with organizing or registering as an LLC in this state and not being taxed as a corporation, the entity be required to pay both an annual tax, currently $800, and an annual fee based on the “total income” from all sources reportable to California.

“Total income” is a term that is defined as “gross income” plus the cost of goods sold (if any). That definition was necessary because “gross income” is defined as total sales, *less the cost of goods sold*, plus any income from investments and from incidental or outside operations or sources. Thus, an LLC must first determine what amounts are properly included in its “gross income.” Once the LLC determines its “gross income,” it then adds back the cost of goods sold (if any) plus all other income from investments or other operations, irrespective of source. In 2001, AB 898 (Leach) (Stats. 2001, Ch. 391) excluded from “total income” any income, gain, or distribution received by an LLC that was allocated or attributable to the LLC only as a result of being a member of another LLC. This exclusion applies if the allocation or attribution of income or gain or distributions is directly or indirectly attributable to income used to determine the fee of another LLC. AB 898 also established a new, permanent LLC fee structure, as follows:

The LLC fee is:

- $0 if the “total income” from all sources reportable to California is less than $250,000;
- $900 if the “total income” from all sources reportable to California is $250,000 or more, but less than $500,000;
- $2,000 if the “total income” from all sources reportable to California is $500,000 or more, but less than $1 million;
- $6,000 if the “total income” from all sources reportable to California is $1 million or more, but less than $5 million; and
- $11,790 if the “total income” from all sources reportable to California is $5 million or more.

THIS BILL

This bill redefines "total income from all sources reportable to this state" to mean only that income generated in this state. Thus, the LLC fee would be reduced for those LLCs having income from sources outside of California.

IMPLEMENTATION CONSIDERATIONS

This bill uses terms that are undefined, i.e., “income generated in this state.” The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this fee. California uses an allocation and apportionment methodology to determine the California-source income of a taxpayer with income from sources both within and without California that is taxable by this state. That methodology is well known and could be used instead of the “income generated in this state” methodology, which is undefined.

LEGISLATIVE HISTORY

AB 898 (Leach) (Stats. 2001, Ch. 391) eliminated the annual calculation of the LLC fee structure and established a new, permanent LLC fee structure.

OTHER STATES’ INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida: No minimum franchise tax or other similar tax or fee for LLCs or any other type of business entity.

Illinois: LLCs treated as corporations pay an annual franchise tax based on paid in capital. The tax can range from a minimum of $25 to a maximum of $1 million.

Massachusetts: LLCs, like corporations, pay an excise tax equal to 9.5% of net income attributable to the state, and $2.60 per $1,000 upon the value of the taxpayer’s tangible property not subject to local taxation.

Michigan: LLCs as well as other business entities, pay a single business tax for the right to do business. The tax is 2.3% of the adjusted tax base.

Minnesota: Imposes an annual fee determined by property, payroll, and sales in the state. The fee can range from $0 to $5,000.

New York: Imposes an annual filing fee equal to $50 multiplied by the number of members of the LLC, with a minimum fee of $325 and a maximum fee of $10,000.

FISCAL IMPACT

If the implementation considerations addressed in this analysis are resolved, the department’s costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following order of magnitude revenue losses.

Estimated Revenue Losses of Calculating the LLC Fee Using Only Income Generated In (i.e. Allocated And Apportioned To) California [$ In Millions]		
2003-04	2004-05	2005-06
-$10	-$10	-$10

Revenue Discussion

The revenue impact of this provision of the bill would be determined by the number of LLCs that have income from sources outside California, the fee apportionment factor for each of these taxpayers, and the amount of income not subject to the fee under this bill that would be otherwise subject to the fee under current law.

Using LLC sample data for 1998, the fee was calculated using total income regardless of source and recalculated using only income "generated in" (i.e. allocated and apportioned to) California. The difference in these two calculations reflected the loss at 1998 levels. Roughly 10% of the LLCs have income from sources outside California. Based on trends in the growth of the LLC fee, revenue losses at the 1998 level were projected to fiscal years indicated above.

ARGUMENTS/POLICY CONCERNS

The LLC fee is not a tax on income but is a fee, using "total income" to measure the total amount of activity conducted by that business entity, to receive the benefits associated with organizing or registering as an LLC in this state and not be taxed as a corporation. The fee was originally included in the statute authorizing the creation of LLCs in California and the recognition of LLCs created in other jurisdictions. The fee was established to ensure revenue neutrality and was to be adjusted annually. The annual adjustment was eliminated when the fee amounts were made permanent. Some of the benefits include limited liability without having to form a corporation, while having the tax on the net income of the business entity treated like a partnership. This dual benefit is more valuable as the business entity grows larger and larger because the net income is passed-through to the members of the LLC rather than taxed once at the entity level and then taxed again to the members when paid out as dividends. Whether the total income is "generated in this state" or not does not diminish the worth of the dual benefit of organizing or registering as an LLC in this state.

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