

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Firebaugh Analyst: Kristina E. North Bill Number: AB 678

Related Bills: None Telephone: 845-6978 Introduced Date: February 19, 2003

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: New Corporations/Exempt From Tax & Fees Until Corporation Is In Existence For 3 Years Or Grosses \$500,000

SUMMARY

This bill would exempt certain corporations from any state-imposed tax or fee.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to provide a more favorable business climate for small businesses in California.

EFFECTIVE/OPERATIVE DATE

This bill would become effective January 1, 2004, and would apply on or after that date.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Under current federal law, corporations generally are taxed based on their taxable income during the taxable year. A corporation's taxable income for federal purposes generally equals its gross income less deductions for the taxable year.

Existing state law levies three primary taxes under the Corporation Tax Law.

- ◆ *Corporate Franchise Tax.* All corporations that are "doing business" in this state (whether organized in-state or out-of-state) are subject to the corporate franchise tax. The tax is measured by the corporation's net income for that taxable year, but cannot be less than the *minimum franchise tax* (MFT). All corporations subject to the corporation franchise tax must pay at least the MFT (\$800).

In addition, every corporation organized in this state or qualified to do business in this state is subject to the MFT. Every corporation subject to the MFT remains liable for that tax until the effective date of dissolution or withdrawal, or if later, the cessation of business within this state. For corporations that incorporate or qualify with the Secretary of State (SOS) on or after January 1, 2000, the MFT for the first taxable year does not apply.

Board Position:

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Department Director
Gerald H. Goldberg

Date
03/28/03

- ◆ *Corporate Income Tax.* In general, the corporation income tax is imposed on all corporations that derive income from sources within California, but are not doing business in California and are thus not subject to the Corporate Franchise Tax. The corporate income tax rate is set at 8.84% by reference to the corporate franchise tax rate.
- ◆ *Bank Tax.* Banks and financial institutions doing business in this state are subject to the bank tax rate. The bank tax rate equals the sum of the corporate franchise tax rate (8.84%) plus 2%.

In addition, existing state law also requires these entities to compute an alternative minimum tax (AMT). AMT must be paid if tentative minimum tax exceeds the amount of regular tax due. The current California bank and corporation AMT rate is 6.65%.

Existing state law also contains numerous other taxes and fees that may be imposed on corporations including property tax, sales and use tax, and employment tax.

THIS BILL

This bill would exempt a corporation from all state imposed taxes or fees until the first of the following occurs:

- ◆ the corporation has been in existence for three years, or
- ◆ the corporation grosses, cumulatively, \$500,000 in revenues.

This bill would define “fee” to mean any charge, other than a tax, levied by the state upon a corporation that would not be imposed except for that corporate status.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation considerations. Additional concerns may be identified as the bill moves through the legislative process.

- ◆ Definitions are needed for the following terms:
 1. “State tax” – This bill states that no state tax or fee may be imposed by the state. As a result, this bill would eliminate a corporation’s requirement to pay any state-imposed taxes or fees, including income tax, sales tax, employment tax, property tax, corporation fees, hazardous waste removal fees, vehicle license fees, etc. If the author’s intent is to prohibit only income taxes, the term “state tax” should be so defined.
 2. “Corporation’s existence” – This bill does not specify when a corporation is deemed to exist for purposes of this bill. Under existing law, a corporation’s existence could be construed to begin the date the corporation files its articles of incorporation with the SOS or is created under the laws of another jurisdiction. In the case of a foreign (non-California) corporation, its existence also could be construed to begin when it first qualifies to do business in this state or first begins doing business in this state (even if the corporation had been in existence for many years, but was not doing business in California). Without clarification, disputes may arise between taxpayers and the department.

3. "Grosses" - It is unclear under this bill how corporations will compute their "gross" without further clarification.
 4. "Cumulatively"- It appears that "cumulatively" could span over more than one taxable year. It's not clear if this is the author's intent. Generally, for tax purposes income is measured on an annual basis, either by fiscal year or calendar year, consistent with the "annual accounting concept" that is fundamental to the tax law.
 5. "Revenues" - It is unclear if "revenues" would mean receipts or income. If income, it is unclear what type of income would be included in revenues, i.e., business or non-business income, taxable or tax exempt, or both, etc.
- ◆ Since the qualifying corporations would no longer be required to pay income tax under this bill, it would appear unnecessary for the exempt corporation to file an income tax return. As a result, it would be difficult for the department to verify if the corporation was eligible.

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, Illinois, Massachusetts, Michigan, Minnesota, and New York laws do not provide an exemption comparable to the exemption that would be allowed by this bill.

FISCAL IMPACT

Until the implementation concerns have been resolved, the department's costs to administer this bill cannot be determined.

ECONOMIC IMPACT

Revenue Estimate

Revenue Impact*			
(\$ Millions)			
Fiscal Year	2004/2005	2005/2006	2006/2007
Revenue Loss	-16	-16	-17

*Reflects only state corporate income and franchise taxes.

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

Revenue Discussion

This estimate addresses corporate income and franchise taxes paid to the Franchise Tax Board only, either the \$800 minimum tax, or the measured corporate tax at 8.84% or 1.5% tax rates.

The amount of franchise and minimum taxes attributed to qualifying companies under this bill is projected to be \$16 million for the 2004 tax year (approximately 19,000 corporations). Roughly three-fourths of companies are calendar-year filers, with the remainder being fiscal-year filers.

For 2004/2005, the revenue impact from calendar-year filers is estimated to be -\$12 million in 2005. This amount is added to the revenue impact from fiscal-year filers for 2004 of -\$4 million for a total 2004/2005 impact of -\$16 million. The 2005/2006 revenue impact is the total of calendar-year filers in 2006 of -\$13 million and fiscal-year filers in 2005 of -\$4 million for a total of -\$17 million. The 2006/2007 revenue impact is the total of calendar-year filers in 2007 of -\$13 million and fiscal-year filers in 2005 of -\$4 million for a total of -\$17 million.

The issue of "fees" was not addressed since the Franchise Tax Board does not administer fees.

LEGISLATIVE STAFF CONTACT

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