Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Villines	Analyst:	John Pavalasky	Bill Number:	AB 2319
Related Bills:		Telephone:	845-4335	Introduced Date:	February 22, 2006
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Exemption from Minimum Annual or Franchise Tax for a Business's First Three Taxable Years/ Allow Refund of Limited Liability Company (LLC) Annual Tax Previously Paid

SUMMARY

This bill would, for new businesses having no income, provide a three year exemption from the $800 minimum tax.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to reduce the tax on new California businesses that are not profitable during their first three years of operation.

EFFECTIVE/OPERATIVE DATE

This bill would be effective immediately and apply to taxable years beginning on or after January 1, 2006.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENTS

Department staff is available to assist with amendments to resolve the implementation and policy concerns discussed in this analysis.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

Current federal law in general classifies business entities as sole proprietorships, partnerships, or corporations. Under federal regulations, the election of business entity type is made by the taxpayer checking the appropriate box on the income tax return. That federal regulation has become known as the "check-the-box regulation." See Attachment 1 for a detailed description of the federal classification and taxation of business entities. Federal law has no tax on business entities comparable to the California minimum franchise or annual tax.

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Current California Law

California conforms to federal law regarding entity classification, including the "check-the-box" regulations.

In California, however, limited partnerships (LPs), limited liability partnerships (LLPs), and limited liability companies (LLCs), which are treated as partnerships under the "check-the-box" regulations, are subject to an annual tax equal to the amount of the minimum corporate franchise tax (currently $800). Items of income, deductions, and credits are "passed through" and taxable to the owners, i.e., they are treated as pass through entities. An LLC treated as a partnership is also subject to a fee based on the gross income of the LLC.

Corporations incorporated under the laws of this state, qualified with the California Secretary of State to transact intrastate business in this state, and every corporation doing business in this state, are subject to the corporate franchise tax. The franchise tax is the greater of the minimum corporate franchise tax (currently $800) or the measured tax (currently 8.83% of the corporation's net income for the taxable year). However, every corporation that incorporates or qualifies to do business in this state on or after January 1, 2000, is not subject to the minimum franchise tax for its first taxable year. That exemption from the minimum franchise tax for its first taxable year expressly does not apply to LPs, LLPs, LLCs, which elect to be taxed as corporations under the "check-the-box" regulations, and RICs, REITs, REMICs, FASITs, and QSubs.

Certain nonprofit cooperative associations organized on or after January 1, 1994, are exempt from the minimum franchise tax for the first five consecutive taxable years after a certificate is issued under the Food and Agricultural Code. The minimum franchise tax expressly does not apply to credit unions. Certain inactive gold and silver mining corporations are subject to a reduced minimum franchise tax of $25 instead of $800.

AB 1859 (Stats. 2004, Ch. 416) enacted a streamlined procedure for an LLC to dissolve (certificate of cancellation) when the company had not conducted any business and meets specified criteria. That bill also exempted an LLC that files that certificate of cancellation from the annual minimum franchise tax applicable to an LLC. However, that bill expressly provided that nothing in that new provision entitled an LLC to receive a reimbursement for any annual taxes or fees already paid.

THIS BILL

This bill would expand the current minimum franchise tax exemption for certain new corporations that currently only applies for its first taxable year to now applying for any of its first three taxable years. Under this bill, the minimum franchise tax exemption would only apply to corporations that incorporate or qualify to do business in this state on or after January 1, 2006, but further provided that the amount of the corporation's net income in a taxable year equals zero. As under current law, that exemption from the minimum franchise tax expressly does not apply to those LPs, LLPs, and LLCs, which elect to be taxed as corporations under the "check-the-box" regulations, and RICs, REITs, REMICs, FASITs, and QSubs.

This bill would also exempt certain new LPs, LLPs, and LLCs, which are treated as partnerships under the "check-the-box" regulations, from the annual tax (currently $800) for any of that entity's first three taxable years. Under this bill, the annual tax exemption would only apply provided that the amount of that entity's ordinary income from trade or business activities for a taxable year equals zero.

Additionally, this bill would repeal the provision that expressly prevents an LLC from receiving a reimbursement for any annual taxes or fees already paid, which was enacted in AB 1859 (Stats. 2004, Ch. 416) as part of the streamlining of the dissolution procedure for an LLC.

IMPLEMENTATION CONSIDERATIONS

This bill contains terms critical for the qualification of an entity for the tax exemptions provided in the bill that could be interpreted in more than one manner, as follows:

1. The exemption phrase contained in the provisions relating to LPs, LLPs, and LLCs that allows the exemption for "any of its first three taxable years" provided that "ordinary income from trade or business activities for a taxable year equals zero" could be interpreted to mean any of the following:

- Entities would only need to meet the income test in any one of its first three taxable years in order to receive the exemption in all three of its first three taxable years.
- Entities would be required to meet the income test in all three of its first three taxable years in order to qualify for the exemption for any of its first three taxable years.
- Entities that meet the income test in a taxable year qualify for the exemption only for that taxable year.
- Entities having significant taxable gains from the sales of assets that are not inventory, i.e. capital gain, would not be disqualified from the exemption from the annual tax.
- Entities having income and expenses from income producing activities that are not treated as "trade or business activities," i.e. investment income or rental income for an entity that is not engaged in the trade or business of investing or renting, would not be disqualified from qualifying for the exemption from the annual tax.
- Entities must aggregate all income and deductions to arrive at "ordinary income from trade or business activities," i.e. determined on a net income basis.
- Entities having even one dollar of "ordinary income from trade or business activities for a taxable year" would not qualify for the exemption even though the "net income" is zero or a loss.
- Entities having losses would not qualify for the exemption because the income is not exactly zero.
- Entities having losses would qualify for the exemption because "income" could be interpreted to mean positive net income.

2. The exemption phrase contained in the provisions relating to corporations allows the exemption for "any of its first three taxable years" provided that the "amount of the corporation's net income in a taxable year equals zero" could be interpreted to mean any of the following:

- A corporation would only need to meet the income test in any one of its first three taxable years in order to receive the exemption in all three of its first three taxable years.

- A corporation would be required to meet the income test in all three of its first three taxable years in order to qualify for the exemption for any of its first three taxable years.
- A corporation that meets the income test in a taxable year would qualify for the exemption only for that taxable year.
- A corporation with losses would not qualify for the exemption because the income is not exactly zero.
- A corporation with losses would qualify for the exemption because net income means a positive net income.

The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this exemption from annual tax or minimum franchise tax. Department staff is available to assist with amendments to resolve these implementation considerations.

LEGISLATIVE HISTORY

AB 1859 (Stats. 2004, Ch. 416) enacted a streamlined procedure for an LLC to dissolve (certificate of cancellation) when the company has not conducted any business and meets specified criteria.

FISCAL IMPACT

If the bill is amended to resolve the implementation considerations addressed in this analysis, the department's costs are expected to be minor.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Based on data and assumptions discussed below, the PIT and Corporation Tax revenue loss from this bill would be as follows:

Estimated Revenue Impact of AB 2319 Effective For Taxable Years Beginning On Or After January 1, 2006 Enactment Assumed After June 30, 2006 ($ Millions)		
2005-06	2006-07	2007-08
-$3.0	-$5.5	-$6.0

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

Revenue Discussion

In 2004, the number of companies in their first three years of existence and with net income equal to zero was 5,348. The number of companies was multiplied by $800, the current amount of annual tax or minimum franchise tax, resulting in a revenue loss of over $4 million (5,348 x $800). The revenue loss for future years was increased by an annual growth rate of 10% to account for the increase in the number of companies that would qualify for this exemption. The resulting taxable year estimates were converted to the cash flow fiscal year estimates shown in the table. The first fiscal year 2005-06 is lower since it includes only the first half of 2006. The full impact of the bill would occur in the second fiscal year, 2006-07.

ARGUMENTS/POLICY CONCERNS

This bill would repeal the provision that expressly prevents an LLC from receiving a reimbursement for any annual taxes or fees already paid, which was enacted in AB 1859 (Stats. 2004, Ch. 416) as part of the streamlining of the dissolution procedure for an LLC. Under this bill, an LLC that takes part in the streamlined dissolution procedure could contend that it was entitled to any minimum franchise tax previously paid, and additionally could argue that the LLC fee previously imposed was also refundable since the LLC fee is not imposed on an LLC that elects to be taxed as a corporation.

This bill would replace an absolute exemption from the minimum franchise tax for a corporation's first taxable year with an exemption for the first three taxable years of a corporation, but that exemption is conditioned on the corporation having no net income in a taxable year. This bill could, therefore, impose the minimum franchise tax for the first taxable year on corporations presently exempted.

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Appendix 1 – Federal Classification and Taxation of Business Entities

Federal Classification of Business Entities

Current federal law in general classifies business entities as sole proprietorships, partnerships, or corporations. Under federal regulations, the election of business entity type is made by the taxpayer checking the appropriate box on the income tax return. That federal regulation has become known as the "check-the-box regulation." Generally, a business entity created in the United States with two or more members defaults to partnership classification, while a business entity with one owner is "disregarded as an entity separate from its owner," i.e., the business entity's income and deductions are reported on the owner's tax return.

1. Sole Proprietorships

A sole proprietor is an individual that carries on a trade or business that is not a partnership or corporation.

2. Partnerships

A partnership is the relationship between two or more persons who join to carry on a trade or business, with each person contributing money, property, labor, or skill and each expecting to share in the profits or losses of the business, regardless of whether a formal partnership agreement is made.

A joint undertaking merely to share expenses is not a partnership. Mere co-ownership of property that is maintained and leased or rented is not a partnership. However, if the co-owners provide services to the tenants, a partnership exists.

The following types of unincorporated business entities may be treated as a partnership, including:

- General Partnership (GP) – A partnership composed of only partners that are each liable for the partnership debts, i.e., general partners.
- Limited Partnership (LP) – A partnership formed under a state limited partnership law that consists of at least one general partner and one or more partners whose personal liability for partnership debts is limited to the amount of money or other property that the partner contributed or is required to contribute to the partnership, i.e., limited partners.
- Limited Liability Partnership (LLP) – A partnership formed under a state limited liability partnership law where no partner is personally liable for the debts of the LLP or any other partner, nor is any partner liable for the acts or omissions of any other partner, solely by reason of being a partner.
- Limited Liability Company (LLC) – A limited liability company is an entity formed under a state law by filing articles of organization as an LLC and consists of one or more members. None of the members of an LLC are personally liable for its debts. An LLC with two or more members is generally taxed as a partnership, but the LLC may elect under the "check-the-box" regulations to be taxed as a corporation. An LLC with one owner is "disregarded as an entity separate from its owner," i.e., the LLC's income and deductions are reported on the owner's tax return.

3. Corporations

A corporation is any entity formed by filing articles of incorporation under a foreign or U.S. state law and any unincorporated business entity that elects under the “check-the-box” regulations to be taxed as a corporation. Certain wholly owned corporate subsidiaries are “disregarded as an entity separate from its owner,” i.e., the corporation’s income and deductions are reported on the parent corporation’s tax return.

Federal Taxation of Business Entities

1. Sole Proprietorship

All income and deductions of a business entity conducted as a sole proprietorship are included in the Form 1040 personal income tax return of the individual, along with the individual’s distributive share of partnership income, deductions, gains, losses, and separately stated partnership items, and other nonbusiness income and deductions, to determine the taxable income of the individual. If an individual is the sole owner of a business entity that is “disregarded as an entity separate from its owner,” the business entity’s income and deductions are reported on the owner’s tax return and included in determining the taxable income of that individual. The business entity’s income is only taxed on the individual’s personal income tax return, i.e., one level of taxation.

2. Partnerships

All income and deductions of a business entity conducted as a partnership are reported on Form 1065 – U. S. Partnership Return of Income. Form 1065 is an information return used to report the income, deductions, gains, and losses from the operation of a partnership. A partnership does not pay tax at the entity level but “passes through” any profits, losses, and separately stated items to its partners. A partner must include its distributive share of partnership income, deductions, gains, losses, and separately stated partnership items on the partner’s tax return and included in determining the taxable income of that partner, i.e., one level of taxation.

3. Corporations

All income and deductions of a business entity taxable as a corporation are reported on Form 1120 – U. S. Corporation Income Tax Return or Form 1120-F – U. S. Income Tax Return of a Foreign Corporation. Certain wholly owned corporate subsidiaries, including a qualified Subchapter S subsidiary (QSub), are “disregarded as an entity separate from its owner,” i.e., the corporation’s income and deductions are reported on the parent corporation’s tax return and included in determining the taxable income of that parent corporation. Dividends paid by a corporation to its shareholders are not deductible by the corporation but are taxable when received by the shareholders, i.e., two levels of taxation.

Certain corporations may elect to be treated as small business (S) corporations. That election means that the S corporation income is not taxed at the entity level but instead it “passes through” any profits, losses, and separately stated items to its shareholders in the same manner as a partnership, i.e., one level of taxation.

Special rules apply to regulated investment companies (RIC), real estate investment trusts (REIT), real estate mortgage investment conduits (REMIC), and financial asset securitization investment trusts (FASIT) that require those organizations to distribute at least 90% of their income to owners of beneficial interests (investors) in that entity. In order to avoid two levels of tax on this income, those organizations are allowed to deduct the dividends distributed to their investors from their taxable income, while the investor is taxable on any dividends it receives and is not allowed a dividends received deduction. Thus, even though these special corporate organizations are not treated as a pass through entity (partnership), the use of these special rules has the effect of "passing through" the taxation of the income earned by those organizations to their investors, i.e., one level of taxation.