

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Ackerman Analyst: John Pavalasky Bill Number: SB 1183

Related Bills: _____ Telephone: 845-4335 Introduced Date: January 18, 2006

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Foreign Corporations/Transacting Intrastate Business

SUMMARY

This bill would expand the conditions under which a foreign corporation would be exempted from obtaining a certificate of qualification from the Secretary of State (SOS).

This bill also revises rules relating to amending articles of incorporation that do not impact the Franchise Tax Board and are not discussed.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to clarify what activities constitute transacting intrastate business.

EFFECTIVE/OPERATIVE DATE

This bill would become effective January 1, 2007, and would apply on and after that date.

POSITION

Pending.

ANALYSIS

STATE LAW

Corporations Code

The Corporations Code allows a "foreign corporation" to transact intrastate business provided certain statutory requirements, such as first obtaining a certificate of qualification from the SOS, are met. Under section 2203 of the Corporations Code, any foreign corporation, which transacts intrastate business and does not hold a valid certificate from the SOS, may be subject to a penalty of twenty dollars (\$20) for each day that unauthorized intrastate business is transacted.

Board Position:

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Department Director

Date

S. Stanislaus

5/10/06

“Foreign corporation” is defined to mean any corporation other than a domestic corporation, as well as a business association organized as a trust under the laws of a foreign jurisdiction.

“Transact intrastate business” means entering into repeated and successive transactions of its business in this state, other than interstate or foreign commerce.¹ The statute specifies that a foreign corporation is not considered to be transacting intrastate business merely because its subsidiary transacts intrastate business.²

Revenue and Taxation Code

Transacting intrastate business, as applicable for the Corporations Code, is the jurisdictional standard for when the state can regulate a corporation. Transacting intrastate business is not the jurisdictional standard for imposing the Corporation Franchise Tax or Corporation Income Tax.

Corporation Franchise Tax

The Revenue and Taxation Code³ provides that every corporation and every limited liability company (LLC) taxable as a corporation that is either organized, qualified to do business, or doing business in this state is subject to the corporation franchise tax, which is imposed for the privilege of doing business in California. The corporation franchise tax is not imposed on a corporation’s income, but instead it is measured by a corporation’s California source net income. “Doing business” is defined as actively engaging in any transaction for profit.⁴ A single transaction can be sufficient to be doing business. “Doing business” includes the purchase and sale of stocks or bonds, endorsing the notes of a subsidiary corporation by a parent corporation, and the leasing of real property by the parent corporation to the subsidiary and other tenants, and liquidating activities consisting of sales, rentals, collections on notes, among innumerable other activities. A foreign corporation that engages in a transaction for the purpose of financial or pecuniary gain or profit in California is considered “doing business” in this state regardless of whether the transaction is considered exclusively engaged in interstate commerce and is therefore subject to the Corporation Franchise Tax.

Corporation Income Tax

Corporations that are not organized in or qualified to do business in California and not doing business in California but are deriving income from California sources are subject to the corporation income tax.

Personal Income Tax

Limited partnerships, limited liability partnerships, LLCs taxable as partnerships or disregarded as an entity separate from its owner, and certain other business entities pay an annual tax, in the amount equal to the minimum franchise tax of \$800, for the privilege of doing business in California.

¹ Corporations Code section 191(a).

² Corporations Code section 191(b).

³ Revenue and Taxation Code sections 23151- 23153.

⁴ Revenue and Taxation Code section 23101.

Nature and Source of Income and Deductions

A partnership, whether a general partnership, limited partnership, limited liability partnership, or an LLC taxable as a partnership “pass through” income and deductions to their partners (members in the case of LLCs classified as partnerships) as though earned directly by the partner. In turn, each partner includes its proportionate share of the income and deductions on its own tax return. The source and nature of the income is determined at the partnership level and passes through, in character, to the partner.

Corporate partners

Under general partnership principles, a partnership acts on behalf of its partners. Consequently, for tax purposes a partner is considered to be doing business where its partnership does business. In the case of a limited partner in a limited partnership, the Appeal of Amman & Schmidt Finanz, decided by the Board of Equalization on April 11, 1996, held that because “doing business” under the Revenue and Taxation Code is defined as “actively engaged in a transaction for profit” and limited partners are prohibited from being actively engaged in the management of a limited partnership, a limited partner will not be considered to be “doing business” as a result of owning that limited partnership interest in a limited partnership that is “doing business.” Members of an LLC classified as a partnership are partners in a partnership, but because the LLC is not a limited partnership, the members of that LLC are not treated as limited partners.

Failure to file return penalty on foreign corporation failing to qualify to do business in this state

A penalty of \$2,000 per taxable year is imposed on any foreign corporation that fails to file a required tax return when that foreign corporation is doing business in this state, within the meaning of Revenue and Taxation Code section 23101, and that foreign corporation failed to qualify to do business in this state under the Corporations Code. The penalty is in addition to any other penalty under the Revenue and Taxation Code.

THIS BILL

This bill would expand the current Corporations Code provision that a foreign corporation is not considered to be transacting intrastate business merely because its subsidiary transacts intrastate business to expressly provide that a foreign corporation is also not considered to be transacting intrastate business merely because of its status as any one or more of the following:

1. A shareholder of a domestic corporation.
2. A shareholder of a foreign corporation transacting intrastate business.
3. A limited partner of a domestic limited partnership.
4. A limited partner of a foreign limited partnership transacting intrastate business.
5. A member or manager of a domestic limited liability company.
6. A member or manager of a foreign limited liability company transacting intrastate business.

FISCAL IMPACT

Based on the policy concerns addressed in this analysis, the department's costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue losses.

| Estimated Revenue Impact of SB 1183 As Introduced 1/18/06 (\$ In Millions) | | |
|--|---------|---------|
| 2006-07 | 2007-08 | 2008-09 |
| a/ | a/ | a/ |

a/ Loss of less than \$500,000

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

Revenue Discussion

Under present law, foreign (non-California) corporations that have "qualified to transact intrastate business" with the SOS but are not "doing business" for purposes of the Revenue and Taxation Code are required to pay the minimum franchise tax of \$800 annually.

Under this bill, the enumerated foreign corporations that no longer would need to qualify with the SOS and also already are not "doing business" for purposes of the Revenue and Taxation Code would no longer be required to pay the minimum franchise tax if it either does not qualify with the SOS or it surrenders its right to engage in that business within this state. Surrendering is accomplished by filing a certificate of surrender with the SOS along with a tax clearance certificate issued by the Franchise Tax Board.⁵ The number of foreign corporations that no longer need to qualify to transact intrastate business or would file a certificate of surrender if this bill is enacted is unknown. If, for example, 500 such entities would no longer be required to pay the minimum franchise tax, revenue losses would be \$400,000 annually (500 entities x \$800 minimum tax = \$400,000).

ARGUMENTS/POLICY CONCERNS

The expansion of the exception to the definition of "transacting intrastate business" for a foreign corporation to specifically include its status as a member or manager of domestic or foreign LLCs might mislead a foreign corporation that is a member of an LLC classified as a partnership into

⁵ Corporations Code section 2112

believing it has no obligation to file a tax return because that foreign corporation did not qualify to transact intrastate business under the Corporations Code. Unlike the passive nature of a limited partner's interest in a limited partnership, a member of an LLC that is classified as a partnership for tax purposes is treated as a partner in a partnership, not a limited partner in a limited partnership. For tax purposes, a partner is considered to be doing business where its partnership does business. That foreign corporate member of an LLC classified as a partnership would be considered doing business in this state, within the meaning of Revenue and Taxation Code section 23101, if the LLC classified as a partnership is doing business in California. If that foreign corporation fails to file a California return, it would be subject to a penalty of \$2,000 per taxable year because that foreign corporation failed to qualify to do business in this state under the Corporations Code. It should be noted that the revised Corporations Code exception is not being provided to a foreign corporation that is a general partner in either a general or limited liability partnership that is transacting intrastate business.

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