

ANALYSIS OF AMENDED BILL

Author: Machado Analyst: Norman Catelli Bill Number: SB 555
 Related Bills: See Legislative History Telephone: 845-5117 Amended Date: April 20, 2005
 Attorney: Patrick Kusiak Sponsor: _____

SUBJECT:

Limited Liability Company Double Withholding/Repeal Section 24348.5/Bids on Foreclosure by Savings and Loan Associations/Gains or Losses

SUMMARY

This bill would:

1. Coordinate the tax payment and withholding requirements applicable to nonresident members of certain limited liability companies (LLCs), and
2. Repeal Revenue and Taxation Code (R&TC) Section 24348.5, an obsolete provision relating to savings and loans.

This analysis addresses only the provisions of the bill affecting Franchise Tax Board (FTB).

The two relevant provisions of this bill will be discussed separately.

This is the department's first analysis of this bill.

PURPOSE OF THE BILL

The purpose of this bill is to:

- Provide FTB with the tools to eliminate duplicate withholding thereby minimizing taxpayer contact and simplifying administrative requirements, and
- Repeal an obsolete (deadwood) provision from the R&TC.

EFFECTIVE/OPERATIVE DATE

This bill would generally be effective and operative on January 1, 2006. By its own terms, the provision allowing the coordination of LLC tax payments and withholding requirements would be operative for taxable years beginning on or after January 1, 2005.

POSITION

Support.

On December 1, 2004, the Franchise Tax Board voted 2-0, with the representative from the Department of Finance abstaining, to sponsor the provisions of this bill.

Board Position:

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Department Director

Date

Gerald H. Goldberg

4/28/05

SUMMARY OF FISCAL IMPACT

The provisions of this bill would not significantly impact the department's costs.

SUMMARY OF ECONOMIC IMPACT

Based on data and assumptions discussed below, the Personal Income Tax (PIT) and Corporate Tax Law (CTL) revenue loss from this bill would be as follows:

Estimated Revenue Impact of SB 555 Effective On Or After January 1, 2006 Enactment Assumed After June 30, 2005 (\$ Millions)			
	2005-06	2006-07	2007-08
LLC Coordinate Withholding	No impact	No impact	No impact
Repeal Obsolete S&L statute	No impact	No impact	No impact

a/ Loss of less than \$250,000.

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

The revenue discussion is included with each provision.

1. Coordinate Tax Payment and Withholding Requirements On Nonresident Members of LLCs

ANALYSIS

FEDERAL/STATE LAW

Current federal law requires a partnership (foreign or domestic), including an LLC taxable as a partnership, that has income effectively connected with a U.S. trade or business to pay a withholding tax on the effectively connected taxable income that is allocable to its foreign partners. Effectively connected taxable income is generally the gross income minus the allowable deductions related to the partnership's U.S. business activities. A publicly traded partnership (a partnership whose interest is regularly traded on an established securities market) not treated as a corporation under section 7704 of the IRC must withhold tax on actual distributions of effectively connected income, unless it chooses to withhold under these rules. The withholding rate is 35% of the effectively connected income allocable to the foreign partners for the partnership's tax year.

This withholding tax does not apply to income that is not effectively connected with the partnership's U.S. trade or business. This type of income is usually interest, dividends, or capital gains, and is generally subject to withholding at a flat rate of 30% unless reduced or eliminated by treaty.

California law has three payment regimes for noncorporate LLCs:

- Domestic nonresident member withholding,
- Foreign (non-U.S.) nonresident member withholding, and
- Nonconsenting nonresident (NCNR) member's tax.

Domestic nonresident members are subject to a 7% withholding rate against the actual distribution of California source income that has not been reported to California and is in excess of \$1,500.

Foreign (non-U.S.) nonresident members are subject to withholding at the member's applicable tax rate on the member's share of California source income, with no minimum threshold.

The NCNR members' tax and consent regime was created in response to a concern about the state being able to collect tax from nonresident members. At the time, there was a concern that nonresident taxpayers may argue that states lack "nexus" (i.e., the constitutional authority to tax nonresident LLC members). The NCNR regime was developed as an alternative if an appellate court endorsed that argument. The tax under this regime is determined by applying the nonconsenting member's applicable tax rate on the member's share of California source income, with no minimum threshold.

A nonresident member is subject either to domestic nonresident withholding or to foreign (non-U.S.) nonresident withholding, but not to both at the same time. However, each may also be subject to the NCNR member's tax if they do not timely sign the required consent.

THIS BILL

This bill would provide FTB with the statutory authority to reduce the amount of the NCNR tax to eliminate duplicate payments of tax on the same taxable income.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

LEGISLATIVE HISTORY

SB 469 (Stats. 1994, Ch. 1200) created the Beverly-Killea Limited Liability Company Act of 1994, which authorized the formation of LLCs in California and recognized out-of-state LLCs doing business in California as business entities.

OTHER STATES' INFORMATION

The states surveyed include *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.

Illinois and *Massachusetts* do not subject nonresident partners, members, or shareholders to withholding requirements.

Michigan, effective for amounts required to be withheld for the quarter ending December 31, 2003, requires partnerships (including LLCs treated as partnerships) and "S" corporations to withhold tax of the share of income attributable to nonresident shareholders, partners, and members. The nonresident's share of income will be treated as "wage income" and administered through the employer-withholding program.

Minnesota requires “S” corporations and partnerships (including LLCs treated as partnerships) to withhold a tax for nonresident individual shareholders or partners on their respective shares of taxable Minnesota source income. An automatic exception is made if the Minnesota adjusted gross income is \$1,000 or less.

New York, for taxable years beginning on or after January 1, 2003, requires “S” corporations and partnerships (including LLCs treated as partnerships) to make estimated tax payments on behalf of their nonresident partners, members, or shareholders. The estimated tax payments are based on the nonresident’s highest tax rate times an estimate of the share of income. Waivers are available and an automatic exception is made if expected tax liability is \$300 or less.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

This provision would have no impact on state income tax revenue.

Revenue Discussion

The waiver of the second withholding would have no impact since taxes were already paid by the LLC.

2. Repeal Obsolete Provision Relating to Savings and Loans

ANALYSIS

FEDERAL/STATE LAW

AB 2065 (Stats. 2002, Ch. 488) conformed California law to federal bad debt deduction rules for savings and loan associations as well as banks. That bill, however, failed to repeal R&TC Section 24348.5, a provision made obsolete by that bill, relating to special rules a savings and loan association used in computing its bad debt deduction with respect to the foreclosure of property securing its loans.

THIS BILL

This bill would repeal R&TC Section 24348.5 as obsolete, thereby clarifying that California law fully conforms to federal law regarding the computation a savings and loan association is required to use to determine its bad debt deduction with respect to the foreclosure of property securing its loans.

IMPLEMENTATION CONSIDERATIONS

Implementation of this provision would not impact the department.

LEGISLATIVE HISTORY

AB 2065 (Stats. 2002, Ch. 488) conformed California law to federal bad debt deduction rules for savings and loan associations as well as banks.

OTHER STATES' INFORMATION

This provision is in the nature of code maintenance, therefore a comparison to other states' laws would not be meaningful.

FISCAL IMPACT

This bill would not impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This provision would have no impact on state income tax revenue.

Revenue Discussion

The repeal of the obsolete statute relating to savings and loan associations would have no impact on state income tax revenue.

POLICY CONCERNS

Obsolete provisions should be eliminated to prevent confusion for taxpayers and the department when applying state law.

LEGISLATIVE STAFF CONTACT

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