

ANALYSIS OF AMENDED BILL

Author: Ruskin Analyst: Gail Hall Bill Number: AB 1614
 Related Bills: See Legislative History Telephone: 845-6111 Amended Date: June 22, 2006
 Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Limited Liability Company (LLC) Fee

SUMMARY

This bill would apply the rules for assigning the income of entities doing business within and outside the state to the calculation of the LLC fee.

SUMMARY OF AMENDMENTS

The June 22, 2006, amendments removed the provisions relating to tax amnesty, added provisions relating to the LLC fee, and added legislative findings and declarations.

PURPOSE OF THE BILL

The author's office has indicated the purpose of this bill is to remove any uncertainty surrounding undefined terms used in the statute and to make a fair and equitable application of the fee to all LLCs doing business within and outside of the state.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment. It would be operative for taxable years beginning on or after January 1, 2001.

POSITION

Pending.

ANALYSISFEDERAL/STATE LAW

Federal law lacks provisions that require an LLC to pay an annual tax or fee.

Under current state law, an LLC not classified as a corporation must pay the \$800 annual LLC tax and the annual LLC fee if it is organized, doing business, or registered in California. The annual LLC fee is based on the LLC's total income from all sources reportable to the state. Total income

Board Position:

_____ S _____ NA _____ NP
 _____ SA _____ O _____ NAR
 _____ N _____ OUA X PENDING

Department Director

Selvi Stanislaus

Date

7/13/06

is defined as gross income from whatever source derived¹ plus the cost of goods sold that are paid or incurred in connection with a trade or business. Current law lacks a definition for “from all sources reportable to the state,” but the department and taxpayers have defined this term to mean worldwide gross receipts without apportionment. Total income excludes the flow-through of income from one LLC to another LLC if that income has already been subject to California’s annual LLC fee. The following chart is used to compute the fee:

[---If Total Income From All Sources Reportable To This State Is---]

Equal To Or Over (\$)	But Not Over (\$)	LLC Fee (\$)
250,000	499,999	900
500,000	999,999	2,500
1,000,000	4,999,999	6,000
5,000,000	And over	11,790

California has adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), with certain modifications, to determine how much of a taxpayer’s total income, which is earned from activities both inside and outside of California, is attributed to California and subject to California franchise tax. An apportionment formula is used to determine the amount of “business”² income attributable to California. The apportionment formula consists of property, payroll, and sales factors. Allocation rules are used to assign nonbusiness income to a state. The source of the nonbusiness income would determine which rule to use to determine which state would be allocated (assigned) the nonbusiness income.

BACKGROUND

The Superior Court of the State of California has issued a Statement of Decision finding that the LLC fee is a tax and violates the “fair apportionment” requirement of the Commerce Clause and the Due Process Clause of the Fourteenth Amendment of the United States Constitution. The LLC in this decision registered with the California Secretary of State but conducted its business activities solely outside of California. The law required the LLC to calculate its fee using worldwide gross receipts, and even though all of the LLC’s gross receipts were from activities conducted outside of California, the LLC paid the fee as if it were conducting 100% of its business activities in California. The Court ruled that the LLC was unfairly taxed on income earned outside of California. A fundamental constitutional principle of the Due Process and Commerce Clauses governing state taxation is that a state tax must be fairly apportioned and must be relative to the level of activity in the state. FTB is appealing this decision.

¹ Revenue & Taxation Code (R&TC) Section 24271 and Internal Revenue Code (IRC) Section 61.

² R&TC Section 25120(a) defines business income as income arising from or an integral part of the activities of a trade or business. Nonbusiness income is all income other than business income.

This bill would apply the apportionment and allocation rules for assigning the income of entities doing business within and outside the state to the calculation of the state's LLC fee to remove this constitutional issue.

THIS BILL

This bill would apportion the state's LLC fee based on an LLC's level of activity in the state. This would be accomplished by providing a definition in the statute for "total income from all sources reportable to the state" to mean total income after applying the apportionment and allocation rules.

Current Statute

(b)(1) For purposes of this section, "total income" means gross income, as defined in Section 24271, plus the cost of goods sold that are paid or incurred in connection with the trade or business of the taxpayer.

Proposed Statute

(b)(1) For purposes of this section, "total income from all sources reportable to this state" means gross income, as defined in Section 24271, plus the cost of goods sold that are paid or incurred in connection with the trade or business of the taxpayer, derived from or attributable to this state within the meaning of Chapter 17 (commencing with Section 25101) of Part 11.³

LEGISLATIVE HISTORY

SB 469 (Stats. 1994, Ch. 1200), known as the California Limited Liability Act, authorized limited liability companies for the first time to organize and register in the state. To offset the estimated loss in tax revenue due to the increase in businesses organizing as LLCs instead of corporations, an annual LLC fee was required based on the total income from all sources reportable to the state.

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, and Minnesota lack provisions requiring an LLC to pay an annual fee.

New York – Every domestic and foreign LLC that is treated as a partnership and has any income, gain, loss, or deduction from New York sources is subject to an annual filing fee. The amount of the filing fee is \$50 multiplied by the total number of members in the LLC. The minimum fee a LLC must pay is \$325 and the maximum fee is \$10,000, annually. Members include resident and nonresident individuals, estates and trusts, corporations, or other LLCs or partnerships.

³ References the Section in the R&TC that discusses the apportionment and allocation rules for income that is derived from or attributable to sources both within and outside of California.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, the revenue impact from this bill would be as follows:

Estimated Revenue Impact of AB 1614 Effective on January 1, 2007 Enactment Assumed After June 30			
2005-06	2006-07	2007-08	2008-09
- \$105 million	- \$45 million	- \$50 million	- \$50 million

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 bill provides that the apportionment and allocation rules would be applied to total income from all sources reportable to this state before the LLC fee is calculated. Applying the apportionment and allocation rules would reduce the fees paid by some LLCs. In 2004, there were \$246 million in LLC fees collected from 164,206 LLC returns. A representative sample of more than 1,800 LLC returns for fee year 2004 was examined to determine the amount of revenue that would be lost if the apportionment and allocation rules were applied to the calculation of LLC fees. LLC returns were examined to determine which LLCs would have their fees reduced by the bill, and the amounts by which those fees would be reduced. These results were extrapolated from the sample and applied to the entire LLC population. Based on the sample, it is estimated LLCs would pay approximately 13 percent less in LLC fees if this bill becomes law.

This bill would apply to fee years beginning on or after January 1, 2001. It is estimated that of the \$1.4 billion of LLC fees collected for fee years 2001 through 2006, approximately 80 percent of LLCs due refunds if this bill becomes law, would actually file claims to have their LLC fees refunded. After applying the 13 percent estimated reduction of LLC fees, the estimated revenue loss if this bill becomes law would be \$150 million (\$1.4 billion x 80% x 13%). The \$150 million revenue loss is shown in the chart above as a \$105 million loss in fiscal year 2005/2006 and a \$45 million loss for fiscal year 2006/2007.

For fiscal years 2007/2008 and 2008/2009, it is estimated that LLC fees totaling approximately \$350 million and \$385 million would be collected, respectively. After applying the 13 percent reduction of LLC fees, a revenue loss of approximately \$50 million is estimated for both fiscal years. These amounts were rounded to the nearest \$10 million.

The existing structure of LLC fees is being challenged in court (see the BACKGROUND section above). The estimate above is based on the assumption that the fees will ultimately be upheld. Should the courts reject the LLC fees entirely, and no legislative alternative such as this bill is adopted, the potential revenue loss is estimated to be \$1.12 billion (\$1.4 billion x 80%) for open fee years 2001 through 2006, plus an ongoing revenue loss beginning at \$400 million per year. The ongoing revenue loss would grow in future years if either the number or the average size of LLCs grows.

LEGISLATIVE STAFF CONTACT

Gail Hall
Franchise Tax Board
(916) 845-6111
gail.hall@ftb.ca.gov

Brian Putler
Franchise Tax Board
(916) 845-6333
brian.putler@ftb.ca.gov