

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Oropeza Analyst: Gail Hall Bill Number: SB 749
Related Bills: See Legislative History Telephone: 845-6111 Introduced Date: February 23, 2007
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Limited Liability Company 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 Limited Liability Company (LLC) fee.

PURPOSE OF THE BILL

The author's office has indicated that the purpose of this bill is to remove any uncertainty surrounding undefined terms used in the existing LLC fee 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.

ANALYSIS

FEDERAL/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 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 has interpreted this term to mean worldwide total income without apportionment.

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

Board Position:

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Department Director

Date

Brian Putler

4/19/07

for Selvi Stanislaus

Total income excludes the flow-through of total income from one LLC to another LLC if that income has already been used to determine the annual LLC fee of the other LLC. 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 (also known as 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 or income 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 nature of the "nonbusiness"³ income would determine which rule to use to determine which state would be allocated (assigned) the nonbusiness income.

BACKGROUND

In *Northwest Energetic Services, LLC v. Franchise Tax Board*, Case No. CGC-05-437721, the San Francisco Superior Court held in its Statement of Decision that the LLC fee could not be applied constitutionally to the Plaintiff because the LLC fee is an unapportioned tax and thus violates the Commerce Clause of the United States Constitution and the Due Process Clauses of the California and United States Constitution. The Plaintiff is an LLC that registered with the California Secretary of State and its income was derived solely from sources outside of California. FTB has appealed this decision to the California Court of Appeal. The department will continue to enforce current law unless a final appellate decision is rendered to the contrary. In *Ventas Finance I, LLC v. Franchise Tax Board*, Case No. CGC-05-440001, the San Francisco Superior Court held in its Statement of Decision that the LLC fee imposed on the Plaintiff is an unapportioned tax that violates the Commerce Clause of the United States Constitution and the Due Process Clauses of the California and United States Constitution. The Court also held that the statutory language of Revenue & Taxation Code (R&TC) section 17942 could not be judicially reformed. The Plaintiff is an LLC that registered with the California Secretary of State and its income was derived from sources within and outside California.

² R&TC Section 25120(a) defines business income as income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

³ R&TC Section 25120(d) defines nonbusiness income as all income other than business income.

FTB has appealed this decision to the California Court of Appeal. The department will continue to enforce current law unless a final appellate decision is rendered to the contrary.

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 for taxable years beginning on or after January 1, 2001.

THIS BILL

This bill would determine an LLC's fee based on the 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

R&TC section 17942

(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

R&TC section 17942

(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 11.⁴

LEGISLATIVE HISTORY

AB 1546 (Calderon, 2007/2008) has identical provisions to this bill except the operative date for AB 1546 would be for taxable years on or after January 1, 2007, which makes application of the bill prospective only.

AB 1614 (Ruskin, 2005/2006) had identical provisions to this bill. The Governor vetoed AB 1614 and provided the following veto message:

"This bill would impact how fees are collected from businesses choosing to operate as limited liability companies. As litigation is currently pending regarding this matter, it is premature to take legislative action at this time. For this reason, I am returning the bill without my signature."

⁴ References Sections 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.

SB 469 (Stats. 1994, Ch. 1200), known as the Beverly-Killea 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, and Michigan lack provisions requiring an LLC to pay an annual fee.

Minnesota requires a limited liability partnership and an LLC treated as a partnership to pay an annual entity level fee that ranges from \$0 to \$5,000. The fee is based on the sum of an entity's *Minnesota* property, payroll, and sales.

New York requires every domestic and foreign LLC that is treated as a partnership and has any income, gain, loss, or deduction from *New York* sources to pay 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.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

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

Estimated Revenue Impact Enactment Assumed After June 30, 2007 Accrual Basis (In \$ Millions)				
	2006/07	2007/08	2008/09	2009/10
Refunds	-\$145	-\$10	\$0	\$0
Reduction in Deposits	\$0	-\$40	-\$45	-\$50
Total Revenue Loss	-\$145	-\$50	-\$45	-\$50

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

Revenue Discussion

Reduction In Deposits. 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. LLC fees are projected to grow to \$415 million in 2009. A representative sample of more than 1,800 LLC returns for fee year 2004 were 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. It is estimated that this bill would have decreased the amount of fees received in 2004 by just under 12% or \$30 million (\$246 million x 12% rounded to \$30 million). These results were extrapolated from the sample to the entire projected LLC population and grown to \$40 million for 2007/2008.

Refunds. This bill would allow refunds for taxpayers whose fees would have been reduced by applying the apportionment and allocation rules. Estimates of refund amounts use the methodology described above and are based on the actual number of LLC returns filed during the eligible years. Fees paid in the period 2001-2006, were estimated at \$1.4 billion. Based on data on the amount of fees for which refund claims have been made to date, an estimated 78% of the potential fee refunds from 2001 through 2006 will be claimed. Based on those refund claims, it is estimated that interest due averages about 19% of the total fee refund. The estimated fee refund is slightly more than \$155 million (\$1.4 billion x 12% (reduction in fee) x 78% (refund claims) x 1.19 (for interest owed).

Assuming this bill becomes law in the second half of 2007, \$145 million would be paid out in 2007-08 and the remaining \$10 million would be paid out in 2008-09. In the table above, both of these amounts are accrued back one year to 2006-07 and to 2007-08

The existing structure of LLC fees is being challenged in court (see Background section of analysis). The estimate above is based on the assumption that the fees will ultimately be upheld. Should the courts reject the fees entirely, and no legislative alternative such as this bill is adopted, the potential revenue loss is estimated to be about \$1.3 billion for open tax years plus an ongoing cost that reaches over \$400 million per year by 2009-10.

LEGISLATIVE STAFF CONTACT

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