Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Garrick, et al.	Analyst:	Angela Raygoza	Bill Number:	AB 2126
Related Bills:	See Legislative History	Telephone:	845-7814	Amended Date:	May 18, 2010
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Minimum Franchise Tax/Small Businesses That First Commence Business On Or After January 1, 2011, Exempt First Taxable Year And $100 Succeeding 9 Taxable Years

SUMMARY

This bill would exempt small businesses from the minimum franchise tax (MFT) for the first taxable year, and reduce the MFT for nine years thereafter.

SUMMARY OF AMENDMENTS

The May 18, 2010, amendments added language that would make changes to the MFT for small businesses, added definitions, co-authors, and a repeal date.

This analysis replaces the department's analysis of the bill as amended April 5, 2010.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to: (1) encourage small businesses to comply with laws governing businesses, (2) make California more competitive with other states for business, and (3) reduce costs for businesses so they may reinvest in their business.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and operative for small businesses that first commence business operation on or after January 1, 2011, and before January 1, 2016.

POSITION

Pending.

ANALYSIS

STATE LAW

Under existing state law, unless specifically exempted by statute, every corporation organized or qualified to do business or that is doing business in this state, whether organized in state or out-of-state, is subject to the MFT. Taxpayers must pay the MFT only if it is more than their measured franchise tax. For taxable years beginning on or after January 1, 1997, only taxpayers with net income less than approximately $9,040 pay the MFT because the amount of measured tax owed would be less than $800 ($9,039 x 8.84% = $799).

Board Position:			Department Director	Date
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Real estate mortgage investment conduits (REMICs) are subject to and required to pay the MFT. Regulated investment companies (RICs) and real estate investment trusts (REITs) organized as corporations are also subject to and required to pay the MFT.

The annual tax on limited partnerships (LPs), limited liability companies (LLCs) not classified as corporations, limited liability partnerships (LLPs), and qualified Subchapter S subsidiaries (QSSSs) is set at $800 by reference to the MFT.

Every corporation that incorporates or qualifies to do business in this state is exempt from the MFT for the first taxable year. This exemption is inapplicable to any corporation that reorganizes solely for the purpose of avoiding payment of the MFT. In addition, the exemption does not apply to LPs, LLCs not classified as corporations, LLPs, charitable organizations, RICs, REITs, REMICs, financial asset securitization investment trusts, and QSSSs.

PROGRAM BACKGROUND

The MFT was established to ensure that all corporations pay at least a minimum amount of franchise tax for the privilege of doing business in this state, regardless of the corporation's income or loss.

THIS BILL

This bill would exempt small business LPs, LLCs, LLPs, and corporations that first commence business operations on or after January 1, 2011, and before January 1, 2016, from the MFT for the first taxable year. Thereafter, the small businesses would pay the reduced MFT of $100, instead of $800, for each of the next nine taxable years the business was a small business.

This bill defines the following:

- "Gross Receipts" means the gross amounts realized (the sum of money and the fair market value of other property or services received) on the sale or exchange of property, the performance of services, or the use of property or capital, including rents royalties, interest, and dividends, in a transaction that produces business income, in which the income, gain, or loss is recognized or would be recognized if the transaction were in the United States under the Internal Revenue Code (IRC), as applicable for purposed of this part. Amounts realized on the sale or exchange of property shall not be reduced by the cost of goods sold or the basis of property sold. Gross receipts, shall not include the following items:[1]
    - Repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, certificate of deposit, or similar marketable instrument;
    - The principal amount received under a repurchase agreement or other transaction property characterized as a loan;
    - Proceeds from issuance of a the taxpayer's own stock or from sale of treasury stock;

[1] Gross receipts would not include the items listed in this bill, even if the items were business income under Part 11 (commencing with Section 23001).

- Damages and other amounts received as the result of litigation;
- Property acquired by an agent on behalf of another;
- Tax refunds and other tax benefit recoveries;
- Pension reversions;
- Contributions to capital, except for sales of securities by securities dealers;
- Income from discharge of indebtedness;
- Amounts realized from exchange of inventory that are not recognized under the IRC;
- Amounts received from transactions in intangible assets held in connection with a treasury function of the taxpayer's business and the gross receipts and overall net gains from the maturity, redemption, sale, exchange, or other disposition of those intangible assets; and
- Amounts received from hedging transactions involving intangible assets.

- "Small Business" means any taxpayer that, for the previous taxable year, had gross receipts, less returns and allowances reportable to this state of $1 million or less.

- "Treasury Function" means the pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the taxpayer's trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, and business acquisitions, and also includes the use of futures contracts and option contracts to hedge foreign currency fluctuations.

- "Hedging Transaction" means a transaction related to the taxpayer's trading function involving futures and options transactions for the purpose of hedging price risk of the products or commodities consumed, produced, or sold by the taxpayer.

This bill would not apply to any LP, LLC, LLP, or corporation that reorganizes solely for the purpose of reducing its MFT.

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.

TECHNICAL CONSIDERATION

This bill uses the term "minimum franchise tax" for LPs, LLCs, and LLPs. The term for LPs, LLCs, and LLPs in the Personal Income Tax section should be changed to "annual tax." It is recommended the bill be amended to use the term "annual tax" when referencing LPs, LLCs, and LLPs.

LEGISLATIVE HISTORY

AB 327 (Garrick, 2009/2010) would have reduced the MFT from $800 to $100. AB 327 died pursuant to the constitutional deadline.

AB 1179 (Garrick, 2007/2008) and AB 1419 (Campbell, 1997/1998) would have reduced the MFT from $800 to $100. AB 1179 failed passage out of the Assembly Revenue and Taxation Committee; AB 1419 failed passage out of the Senate Revenue and Taxation Committee.

AB 2178 (Garrick, 2007/2008) would have reduced the MFT from $800 to $200. AB 2178 failed passage out of the Assembly Revenue and Taxation Committee.

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 has a corporate income tax of 5.5 percent with no minimum tax.

Illinois has an annual franchise tax of 1 percent of the tax base. The tax base is calculated by using the shares of stock issued by the corporation as disclosed in the annual statement reported to the *Illinois* Secretary of State. The tax ranges from a minimum of $25 to a maximum of $1 million.

Massachusetts imposes the greater of a corporate excise tax of 9.5 percent based on taxable income or a minimum tax equal to $456. In lieu of the corporate excise tax, the corporate franchise tax is imposed on cemetery companies, crematory companies, canal companies, and safe deposit companies.

Michigan replaced the Single Business Tax with the Michigan Business Tax (MBT) that includes a business income tax and a gross receipts tax, for taxable years beginning on or after January 1, 2008. *Michigan* does not have a minimum tax. All persons engaged in a "business activity" and that have "gross receipts" in *Michigan* are subject to the MBT. The business income tax is 4.95 percent and the gross receipts tax is .080 percent.

Minnesota has a franchise tax that is imposed on a corporation's taxable income at the rate of 9.8 percent. An additional franchise tax is imposed, ranging from zero to $5,000, based on the sum of the property determined by property, payroll, and sales in the state.

New York imposes a franchise tax of 7.1 percent based on net income plus a fixed dollar minimum tax based on gross payroll. The fixed dollar minimum tax ranges from $100 to $1,500.

ECONOMIC IMPACT

Revenue Estimate

FISCAL IMPACT

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.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue losses:

Estimated Revenue Impact of AB 2126 As Amended May 18, 2010 Effective For Taxable Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2010 ($ in Millions)		
2010-11	2011-12	2012-13
-$11	-$60	-$90

LEGISLATIVE STAFF CONTACT

Legislative Analyst
Angela Raygoza
(916) 845-7814
angela.raygoza@ftb.ca.gov

Revenue Manager
Monica Trefz
(916) 845-4002
monica.trefz@ftb.ca.gov

Asst. Legislative Director
Patrice Gau-Johnson
(916) 845-5521
patrice.gau-johnson@ftb.ca.gov