

Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Florez Analyst: Angela Raygoza Bill Number: SB 392
 Related Bills: See Legislative History Telephone: 845-7814 Amended Date: February 26, 2009, April 20, 2009, and April 21, 2009
 Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Limited Liability Companies/Contractors

SUMMARY

This bill would allow contractors to form limited liability companies (LLCs).

This analysis will not address the bill's changes to the Business and Professions Code and Corporation Code, except to the extent those provisions affect the department.

SUMMARY OF AMENDMENTS

The April 20, 2009, amendments would specify an operative date of July 1, 2011.

The April 21, 2009, amendments would make changes to the aggregate dollar amount for liability insurance and provide that LLCs with suspended contractor's licenses would be subject to certain penalties under the Business and Professions Code. The April 21, 2009, amendments do not impact the department and they will not be addressed in the department's analysis.

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

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to provide contractors with the benefit of flexibility in estate planning, profit sharing, and liability protection for their personal assets.

EFFECTIVE/OPERATIVE DATE

This bill would be effective on January 1, 2010, and specifically operative for taxable years beginning on or after July 1, 2011.

POSITION

Pending.

ANALYSIS

Board Position:	Department Director	Date
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FEDERAL/STATE LAW

The Beverly-Killea Limited Liability Company Act (LLC Act) first authorized the organization of LLCs in California in 1994 and also recognized LLCs organized under the laws of other states. An LLC is a hybrid form of an unincorporated business entity affording its members certain benefits, such as the following:

- ◆ Limited liability to the extent of a member's equity investment;
- ◆ Flexible management alternatives; and
- ◆ Liberal membership qualification requirements.

Members of an LLC are afforded the same advantage of limited liability as shareholders of a corporation. If an LLC is classified as a partnership for income tax purposes, the income of the LLC is generally subject to only one level of income tax, as are the partners of a partnership.

LLCs treated as partnerships for income tax purposes are not subject to the membership restrictions or the two levels of income tax imposed on S corporations.

Current federal and state law allows eligible business entities including LLCs to be treated as partnerships, corporations, or entities that are disregarded for federal tax purposes. Generally, the classification of a business entity for California purposes is required to be the same as the entity's federal classification. LLCs not classified as a corporation that are organized, registered, or doing business in California are required to pay an annual tax of \$800 and a fee measured by total income attributable to California.

Current state law allows domestic or foreign LLCs to engage in any lawful business except banking, insurance, trust company business, or the offering of professional services for which a license, certification or registration is required, unless expressly authorized under provisions of the Business and Professions Code or the Chiropractic Act.

"Professional services" is defined in the Moscone-Knox Professional Corporation Act (Corporation Act) as any type of professional services that may be lawfully rendered only pursuant to a license, certification, or registration authorized by the Business and Professions Code, the Chiropractic Act, or the Osteopathic Act. "Professional services" also means any type of professional services that may be lawfully rendered pursuant to a license, certification, or registration authorized by the Yacht and Ship Brokers Act.

PROGRAM BACKGROUND

Until 2004, the Office of the Secretary of State (SOS) prohibited businesses licensed under the Business and Professions Code from forming LLCs. In 2004, SOS requested an Attorney General (AG) opinion asking if "a business that provides services requiring a license, certification, or registration pursuant to the Business and Professions Code [could] conduct its activities as [an LLC]." AG Opinion 04-103 concluded that a business could "conduct its activities as an LLC if the services rendered require only a nonprofessional, occupational license." The AG declined to determine if each licensed activity specified in the Business and Professions Code was a professional or a nonprofessional occupational activity. SOS no longer denies any application, professional or non-professional, on the basis that the business is licensed under the Business and Professions Code.

THIS BILL

Beginning on or after July 1, 2011, this bill would allow an individual or a business providing services as a contractor to form and operate as an LLC. In addition, this bill would authorize the State Contractors' License Board to issue a contractor's license to an LLC under the Business and Professions Code.

Under this bill, any LLC would be treated in the same manner as a corporation relative to the issuance, renewal, suspension, re-issuance, or termination of a contractor's license.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs and operations.

LEGISLATIVE HISTORY

SB 1337 (Correa, 2007/2008) would have allowed a contractor to form an LLC and authorize the issuance of a contractor's license to an LLC under the Business and Professions Code. This bill failed passage out of the Senate Judiciary Committee.

AB 2235 (Parra, 2005/2006) would have expanded the definition of "person" under the Real Estate Law to include an LLC. This bill failed passage in the Senate Judiciary Committee without being heard.

SB 1022 (Campbell, 2005/2006) sought to authorize the formation of professional LLCs to provide professional services, as defined. This bill failed passage in the Senate Judiciary Committee.

AB 2724 (Runner, 2001/2002) would have authorized a contractor's license to be issued to an LLC that met certain requirements. That bill failed passage out of the Assembly Business and Professions 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, Illinois, Massachusetts, Michigan, Minnesota, and New York allow contractors to form an LLC if the members are registered, licensed, or certified by that state or local licensing entity.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue gains:

Estimated Revenue Impact of SB 392 Effective For Taxable years Beginning On and After July 1, 2011 Enacted After June 1, 2009 (\$ in Millions)			
2009-10	2010-11	2011-12	2012-13
\$0	\$0	+\$7	+\$11

Revenue Discussion

The revenue impact of this bill would be estimated as the difference in the tax revenue collected under existing and proposed laws. Under existing law, nearly all licenses issued by the Contractors' State License Board are for individuals. Individual contractors must file returns with the FTB to pay taxes on their contracting business income. If this bill is enacted, some individual contractors may decide to convert to LLC's. An LLC often elects treatment as a partnership for tax purposes. As such, an LLC must pay a minimum tax of \$800, an LLC fee that would be based on the LLC's total income, and must pass through all the profit or loss to its owners. Pass-through profits or losses are taxable to the individual owners. It is assumed if the individual contractor converts to an LLC that the taxes on an individual contractor's business income under existing law would be equal to the taxes on an owner's pass-through profits. Thus, the revenue impact of this bill would be equal to the taxes and fees paid by the new LLCs that would be created by this bill. The impact was estimated in the following steps.

First, data from the Contractors' State License Board was merged with 2005 tax return samples to identify individual contractors with income reported on a Schedule C. Only building and specialty trade contractors were considered for this analysis.

Next, the potential LLC taxes and fees to be collected would be estimated assuming that all individual contractors would convert into LLCs. Based on the above data from the Contractors' State License Board and FTB tax returns, the gross impact would be estimated at \$111 million for 2005. The estimated 2005 revenue impact was extrapolated for future years, assuming an annual growth rate of 2 percent. For example, the 2005 gross impact of \$111 million was extrapolated to \$125 million for the 2011 taxable year. The \$125 million would be further adjusted to account for (1) the conversion rate from individual contractors to LLC, (2) missing data, (3) contractors other than building and specialty trade contractors may convert to LLC, (4) the \$1 million insurance requirement, (5) not all individual contractors are aware of this program, and (6) the program is operative for only half of the 2011 taxable year. For the 2011 taxable year, it was assumed that approximately 3,745 individual contractors would convert into an LLC, resulting in a revenue gain of approximately \$4.5 million.

(\$125 million gross impact x 7% conversion rate x 1.45% for missing data x 1.05% for other contractors x 90% for \$1 million insurance requirement x 75% awareness in 2011 x 50% for being effective on or after July 1, 2011 ≈ \$4.5 million)

Finally, the taxable-year estimates were converted to fiscal-year estimates that are shown in the above table. For example, the revenue impact of \$7 million for the 2011-12 fiscal year consists of \$4 million from the 2011 taxable year and \$3 million from the 2012 taxable year.

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