Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Garrick	Analyst:	Brian Werking	Bill Number:	AB 1605
Related Bills:	See Legislative History	Telephone:	845-6310	Introduced Date: Amended Date:	February 7, 2012 February 29, 2012
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Minimum Franchise Tax/Annual Tax/Reduce For Small Businesses That First Commence Business On Or After January 1, 2013

SUMMARY

This bill would exempt specified entities from the Minimum Franchise Tax (MFT) or annual tax and reduce the MFT or annual tax to $99 for specified entities that commence business on or after January 1, 2013.

RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

Summary of Amendments

This bill, as introduced February 7, 2012, would exempt specified entities that first commence business operations on or after January 1, 2013, from the MFT or the annual tax for the first taxable year. The bill would also reduce the MFT or annual tax to $99 for the second through tenth year of operation for specified entities that commence business on or after January 1, 2013, and before January 1, 2018.

The February 29, 2012, amendments expand the limited operation of this bill from specified entities that commence business on or after January 1, 2013, and before January 1, 2018, to all specified entities that commence business on or after January 1, 2013. The amendments also extend the period for which a specified entity may qualify for the reduced minimum franchise tax or annual tax, from the second through tenth years after commencing business to any year after the first year of commencing business provided that first year commences on or after January 1, 2013.

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

Summary of Suggested Amendments

Amendments have been provided to replace the MFT term with the term "annual tax" for relevant entities, and to clarify for what period the reduced annual tax may be available.

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PURPOSE OF THE BILL

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

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for businesses that first commence business operations on or after January 1, 2013.

ANALYSIS

FEDERAL/STATE LAW

Under existing state law, unless specifically exempted by statute, every corporation organized, qualified to do business, or doing business in this state (whether organized in-state or out-of-state), is subject 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 of existence. This exemption is inapplicable to any corporation that reorganizes or changes solely for the purpose of avoiding payment of the MFT. In addition, the first-year exemption is inapplicable to the annual taxes paid by limited partnerships (LPs), limited liability companies (LLCs) not classified as corporations, limited liability partnerships (LLPs), charitable organizations, regulated investment companies (RICs), real estate investment trusts (REITs), real estate mortgage investment conduits (REMICs), financial asset securitization investment trusts, or qualified Subchapter S subsidiaries (Q-Subs).

Corporate taxpayers must pay the greater of the measured franchise tax, herein "franchise tax," or the MFT. Currently, the franchise tax rate for corporate taxpayers (other than S corporations) is 8.84 percent. Corporate taxpayers with net income less than approximately $9,040 pay only the MFT because the amount of franchise tax owed would be less than $800 ($9,039 x 8.84% = $799).

REMICs are subject to and required to pay the MFT. RICs and REITs organized as corporations are also subject to and required to pay the MFT.

LPs, LLCs not classified as corporations, LLPs, and Q-Subs are required to pay an annual tax equal to the MFT, but are not subject to a franchise tax.

THIS BILL

This bill would exempt small business LPs, LLCs, LLPs, and corporations that first commence business operations on or after January 1, 2013, from the MFT or the annual tax for the first taxable year. Thereafter, the small business would pay a reduced MFT or annual tax of $99, instead of $800, as long as it remains a small business (as defined).

This bill would define the following terms:

- "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 purposes 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;
    - 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 LP, LLC, LLP, or corporation 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.

[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).

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

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

The term "first commences business operations" is undefined in the bill. As a result, the term could be broadly interpreted to include businesses that move from one location in California to another, move from outside of California into the state, or businesses that change their entity structure to qualify for the reduced MFT or annual tax. To avoid confusion, it is recommended that the author amend the bill to provide specific criteria that would define commencing business.

The bill is silent regarding the tax liability of REITs, RICs, REMICs, and Q-Subs. If it is the author's intent to exclude these types of entities from the reduced MFT, it is recommended that the bill be amended to include these exclusions.

The bill would define a small business as any specified entity, "that, for the previous taxable year, had gross receipts, less returns and allowances, reportable to the state of $1 million or less." This definition may be interpreted to include the subsidiaries of large corporate taxpayers that file a combined return as "small businesses." If the author's intent is to disallow this reduction specifically for the subsidiaries of large businesses, it is recommended the bill be amended to specify this disallowance.

TECHNICAL CONSIDERATIONS

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 Law sections should be changed to "annual tax."

- On page 3, line17; page 6, line 34; and page 9, lines 17, strikeout "the minimum franchise tax" and insert "an annual tax".

- On page 3, lines 18-19; page 6, lines 35-36; and page 9, lines 18-19, strikeout "a minimum franchise tax" and insert "an annual tax".

This bill does not provide that the reduced annual tax is available to eligible entities for each succeeding year after the first.

- On page 3, line 18; page 6, line 35; page 9, line 18, after "state" insert "for each succeeding taxable year".

LEGISLATIVE HISTORY

AB 166 (Cook, 2011/2012) would have eliminated the MFT. This bill failed passage out of the Assembly by the constitutional deadline.

AB 368 (Morrell, 2011/2012) would have reduced the MFT to $400 for qualified small businesses. This bill failed passage out of the Assembly by the constitutional deadline.

AB 821 (Garrick, 2011/2012) would have reduced the MFT from $800 to $100 for a small business for the first ten years of operation. AB 821 is similar to AB 1605 with the exception that AB 821 does not specify that the business remain a small business for all years. This bill failed passage out of the Assembly by the constitutional deadline.

AB 327 (Garrick, 2009/2010) would have reduced the MFT from $800 to $100. AB 327 failed passage out of the Assembly by the constitutional deadline.

AB 2126 (Garrick, 2009/2010) would have reduced the MFT to $100 for qualified small businesses. AB 2126 failed passage out of the Assembly Revenue and Taxation Committee.

AB 1179 (Garrick, 2007/2008) would have reduced the MFT from $800 to $100. AB 1179 failed passage out of the Assembly 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 *Arizona, Florida, Illinois, Massachusetts, Michigan, Minnesota, Nevada, New York, Oregon, and Utah.* These states were selected due to their geographic proximity to California or their similarities to California's economy, business entity types, and tax laws.

Florida, Michigan, and Minnesota do not impose a minimum tax on business entities.

Arizona imposes a $50 minimum tax on corporations.

Illinois imposes a $25 minimum tax on corporations.

Massachusetts imposes a $456 minimum tax on corporations.

Nevada does not impose income tax on business entities conducting business within the state. *Nevada* does require all businesses to pay an annual "business license fee" to the Nevada Department of Taxation for the privilege of doing business within the state. For the first year an entity does business within the state, the entity is required to pay a $200 license fee and is required to pay a $100 license fee for each subsequent year it does business within the state.

New York imposes a *minimum tax on corporations of $25 to $5,000* based on the corporation's in-state receipts. It also imposes a minimum tax of $25 to $4,500 for LPs, LLCs, and LLPs based on their in-state receipts.

Oregon imposes a $150 minimum tax on corporations, LPs, LLCs, and LLPs.

Utah imposes a $100 minimum tax on corporations.

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

This bill would result in the following revenue losses:

Estimated Revenue Impact of AB 1605 For Taxable Years Beginning On or After January 1, 2013 Enactment Assumed After June 30, 2012 ($ in Millions)			
2012-13	2013-14	2014-15	2015-16
-$0	-$50	-$120	-$170

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Pro: Some would argue that this bill would make California more competitive with other states for businesses.

Con: Some would argue that the MFT and annual tax do not discourage business because small businesses can organize as sole proprietorships or general partnerships to avoid paying the MFT or annual tax.

LEGISLATIVE STAFF CONTACT

Brian Werking	Patrice Gau-Johnson
Legislative Analyst, FTB	Asst. Legislative Director, FTB
(916) 845-5103	(916) 845-5521
brian.werking@ftb.ca.gov	patrice.gau-johnson@ftb.ca.gov