Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Morrell	Analyst:	Jessica Matus	Bill Number:	AB 368
Related Bills:	See Legislative History	Telephone:	845-6310	Introduced Date:	February 14, 2011
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Minimum Franchise Tax/Small Businesses That First Commence Business On Or After January 1, 2012, & Before January 1, 2018, Exempt First Taxable Year And $400 Succeeding 5 Taxable Years

SUMMARY

This bill would reduce the Minimum Franchise Tax (MFT) to $400 for the 2nd through 6th years of operation for specified entities that commence business on or after January 1, 2012.

RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

Summary of Suggested Amendments

Amendments have been provided to replace MFT with annual tax for certain entities.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to encourage small businesses to form in California by reducing the mandatory fees to do so.

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, 2012, and before January 1, 2018.

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 LPs, LLCs not classified as corporations, LLPs, charitable organizations, RICs, REITs, REMICs, financial asset securitization investment trusts, or Q-Subs.

Board Position:			Executive Officer	Date
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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 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).

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.

Limited partnerships (LPs), limited liability companies (LLCs) not classified as corporations, limited liability partnerships (LLPs), and qualified Subchapter S subsidiaries (Q-Subs) are required to pay an annual tax equal to the MFT, but are not subject to a “franchise” income tax.

THIS BILL

This bill would exempt small business LPs, LLCs not classified as a corporation, LLPs, and corporations that first commence business operations on or after January 1, 2012, and before January 1, 2018, from the MFT for the first taxable year. Thereafter, the small businesses would pay the reduced MFT of $400, instead of $800, for each of the next five taxable years.

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;
    - 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;

[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).

   - 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.

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

<u>IMPLEMENTATION CONSIDERATIONS</u>

The term "commencing 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, or businesses that change entity structure. To avoid confusion, it is recommended that the author amend the bill to provide specific criteria that would define commencing business.

<u>TECHNICAL CONSIDERATIONS</u>

This bill uses the term "minimum franchise tax" for LPs, LLCs, and LLPs. LPs, LLCs, and LLPs in the Personal Income Tax section pay an "annual tax" equal to MFT. It is recommended that the bill be amended to use the term "annual tax" when referencing LPs, LLCs, and LLPs.

To address this concern, the following amendment has been provided.

On page 3, line 13; page 6, line 2; page 9, line 8, strikeout "minimum franchise tax" and insert "annual tax".

LEGISLATIVE HISTORY

AB 166 (Cook, 2011/2012) would eliminate the MFT. This bill is currently in the Assembly Revenue and Taxation Committee.

AB 821 (Garrick, 2011/2012) would change the MFT to $100 for qualified small businesses. This bill is currently in the Assembly Rules Committee.

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 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.

AB 1419 (Campbell, 1997/1998) would have reduced the MFT from $800 to $100. AB 1419 failed passage out of the Senate 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 minimum tax of $456 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

Revenue Estimate

Estimated Revenue Impact of AB 368 For Taxable Years Beginning On or After January 1, 2012 Enactment Assumed After June 30, 2011 ($ in Millions)			
2011-12	2012-13	2013-14	2014-15
-$0	-$45	-$100	-$150

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 simply organize as sole proprietorships to avoid paying the MFT or annual tax.

POLICY CONCERNS

This bill would allow a small business to pay a reduced MFT in the succeeding five years after the first year of operation. It is unclear if the author intends for a determination to be made annually that an entity is a small business or if the determination would be made at the beginning of the period and apply for all five years. For clarity, it is recommended the bill be amended to specify whether the business must remain a small business to qualify for the reduction.

The bill would define a small business as, "any taxpayer that for the previous taxable year had gross receipts, less returns and allowances, reportable to the state of one million dollars 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.

LEGISLATIVE STAFF CONTACT

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