

Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Silva Analyst: David Scott Bill Number: AB 831

Related Bills: None Telephone: 845-5806 Introduced Date: February 17, 2011

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Single Member Limited Liability Companies/Exemption From Annual Tax and Annual Fee/ Filing Info Return

SUMMARY

This bill would exempt a single member limited liability company (SMLLC), from paying the annual tax or annual fee; and filing certain information returns.

RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

PURPOSE OF THE BILL

According to the author, the purpose of this bill is to conform California tax law to federal tax law with regard to the tax-exempt treatment of an SMLLC whose sole member is a tax-exempt organization. This benefit would eliminate the costs and filing burden that exempt SMLLCs currently have in order to receive the same treatment. This provision would benefit the Franchise Tax Board's (FTB) administration of tax-exemption acknowledgments by making the process more efficient.

EFFECTIVE/OPERATIVE DATE

This bill would become effective on January 1, 2012. The exemption from the annual tax and fee and the additional requirement for obtaining tax exemption would be operative for taxable years beginning on or after January 1, 2012. The provision regarding returns would be operative as of January 1, 2012.

ANALYSIS

FEDERAL/STATE LAW

For federal and California tax purposes, a limited liability company (LLC) will be generally classified as a partnership if it has more than one owner and will be disregarded as separate from its owner if it has only one owner. However, federal and California tax law allows an LLC to elect to be taxed as a corporation.

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An SMLLC that is not taxable as a corporation is generally disregarded¹ for income tax purposes. The owner of a disregarded SMLLC reports all income, loss, deductions, and credits of the entity on the single member's income tax return. SMLLCs do not file a separate return for federal tax purposes.

CALIFORNIA LAW

An LLC's California filing requirements and method of taxation depend on whether it is classified as a partnership, corporation, or a disregarded entity for federal income tax purposes.

For California purposes, a disregarded SMLLC must file FTB Form 568, *Limited Liability Company Return of Income*, and is subject to the annual tax, LLC fee, and non-consenting nonresident member tax (if applicable).

An LLC treated as a corporation for federal purposes is subject to California corporation tax law. The LLC would file a California Form 100 and would not be subject to California LLC fees, although it would be subject to the minimum franchise tax.

An LLC that is not taxed as a corporation must pay an annual tax if they are any of the following:

- Formed in California.
- Registered with the California Secretary of State (SOS).
- Doing business in this state.

The tax is equal to the current corporate minimum franchise tax, \$800. The annual tax is not deductible. The annual tax is imposed for the privilege of doing business in California with limited liability and to offset the administrative costs of the SOS.

For tax years beginning on or after January 1, 2007, every LLC subject to the LLC annual tax also pays an annual fee based on total income from all sources derived from or attributable to California and applies only to LLCs that are any of the following:

- Formed in California.
- Doing business in California.
- Registered with the California SOS.

"Total income from all sources derived from or attributable to California" is determined by applying existing rules for assigning sales to California for income apportionment purposes. The assignment of sales to California is determined using the numerator assignment rules for the sales factor in the R&TC².

Exempt organizations are subject to tax on any unrelated business income under the Personal Income Tax Law and Corporate Tax Law. Credits used by an exempt organization are limited to the tax on the unrelated business income. Credits earned by disregarded entities would be limited to the amount of tax on the unrelated business income of the disregarded entity.

¹ If it is disregarded as an entity separate from its owner, it is treated in the same manner as a sole proprietorship, branch, or division of the owner.

² R&TC section 25134

An LLC's powers, rights, and privileges may be suspended (domestic) or forfeited (foreign) for failure to file a return or nonpayment of amounts due.

THIS BILL

This bill would exempt an SMLLC, for California purposes, whose sole member is a tax-exempt organization, from having to pay the annual tax, currently \$800. This bill would also exempt SMLLCs, whose sole member is a tax-exempt organization, from having to pay the annual fee, which is based on total income from all California sources. Additionally, the bill would not require SMLLCs (treated as a disregarded entity) to file an annual statement of information to verify its liabilities, provide sole owner's information, and the consent of the owner to California tax jurisdiction.

Additionally, a corporation may not receive exempt status, if at the time of application it is in suspended or forfeited status.

LEGISLATIVE HISTORY

(AB 831, Leach, Stats. 1999, Ch. 490) allowed LLCs to have one member. Prior to this enactment, LLCs were required to have at least two members.

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 does not require an SMLLC treated as a disregarded entity to file a return, but the income must be included in the return of the single member parent. Illinois follows federal rules for SMLLCs treated as a disregarded entity. Massachusetts follows federal rules for the taxation of SMLLCs treated as a disregarded entity. Michigan requires that an SMLLC treated as a disregarded entity can file a separate Michigan Business Tax return or file as part of a unitary group return. Minnesota treats the income from an SMLLC, treated as a disregarded entity, as if it received directly by the single member owner. New York conforms to federal rules, but requires that the SMLLC file a separate information return for New York.

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 credit use of a disregarded entity whose sole owner is an exempt organization is limited to the unrelated business income. This bill would eliminate the filing requirement for the disregarded entity. It could complicate the administration of computing the correct amount of tax because without filing a return, it would be difficult to determine the credit use.

- The operative date of the changes to returns is one year earlier than the operative date for the exemption from the tax and fee. If this is not the author's intent, then it should be amended to provide an operative date for returns for taxable years beginning on or after January 1, 2012.
- Currently, the FTB uses information received from the SOS to determine if an LLC is incorrectly claiming to be an exempt entity. If the requirement to file is removed, it would be difficult for the FTB to regulate these false claims and the FTB could expect additional protests and appeals from LLCs that incorrectly claim to fall under this exemption.

TECHNICAL CONSIDERATIONS

The only LLCs liable for an annual fee are those that are "subject to the annual tax." Because Section 1 makes these entities "not subject to the annual tax," the amendment to R&TC section 17942 is unnecessary. Amendment 1 would eliminate the unnecessary language.

Insurers are exempt by the California Constitution, not by any provision of Part 11 of the R&TC. If the intent of the bill is to allow disregarded LLCs owned by entities exempt from tax (other than Unrelated Business Taxable Income) to be exempt from the LLC tax and fee, the language regarding insurers should be deleted.

FISCAL IMPACT

This bill would require system changes and changes to existing forms. As a result, this bill would impact the department's printing, processing, and storage costs. The additional costs have not been determined at this time. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 831 For Taxable Years Beginning On or After January 1, 2012 Enactment Assumed After June 30, 2011 (\$ in Millions)		
2011-12	2012-13	2013-14
-\$7	-\$8	-\$9

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: Exempt organizations do not pay the annual corporate minimum tax, so this would equalize the treatment of subsidiaries set up as corporations and as LLCs.

Con: Some may argue that the annual tax is designed to cover the administrative expenses incurred by the state for entities operating as LLCs. If the fee were eliminated, these expenses would still exist for these LLCs; however, the state would have to absorb the costs associated with the administration of these entities.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 831
As Introduced on February 17, 2011

AMENDMENT 1

On page 4, strikeout lines 25 through 39, inclusive; strikeout page 5; and on page 6, strikeout lines 1 through 29, inclusive.