ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	Skinner	Analyst:	Jane Raboy	Bill Number:	AB 1143
Related Bills:	See Legislative History	Telephone:	845-5718	Amended Date:	June 9, 2014
		Attorney:	Bruce Langston	Sponsor:	Franchise Tax Board

SUBJECT: Equal Tax Treatment of Nonqualified Foreign Limited Liability Companies for Contract Voidability/Check-the-box Regulations

SUMMARY

This bill would amend the definition of taxpayer as it relates to suspension, forfeiture, revivor, and contract voidability, to specifically include all limited liability companies (LLCs) and allow certain state regulations to be updated.

This analysis will not address the bill's changes relating to property valuation date, as they do not impact the department or state income tax revenue.

RECOMMENDATION

Support.

On December 5, 2012, the three-member Franchise Tax Board voted 2-0 to sponsor the language related to contract voidability, with the representative from the Department of Finance abstaining.

On December 4, 2013, the three-member Franchise Tax Board voted 2-0, with the Director of Finance abstaining, to sponsor the language related to the check-the-box regulations.

Summary of Amendments

The June 9, 2014, amendments added a provision that would allow the Franchise Tax Board (FTB) to update the check-the-box regulations. This analysis replaces the department's analysis of the bill as introduced February 22, 2013, and amended April 22, 2013.

REASON FOR THE BILL

The reason for the bill is to provide equitable tax treatment between foreign non-qualified LLCs and all other LLCs and corporations and provide consistency between the state and federal check-the-box regulations.

Board Position:			Executive Officer	Date
X S	NA	NP		
SA	O	NAR	Selvi Stanislau	6/19/14
N	OUA			

EFFECTIVE/OPERATIVE DATE

As an urgency measure, this bill would be effective and operative immediately upon enactment. Contract voidability for foreign nonqualified LLCs lacking an FTB-assigned account number would be specifically operative for contracts entered into during the period beginning on the later of January 1, 2014, or the first day of the taxable year for which the taxpayer has failed to file a return.

ANALYSIS

FEDERAL/STATE LAW

Contract Voidability

Under existing federal law, business entities are not subject to contract voidability for failure to pay taxes, penalties, fees, or interest, or for failure to file required tax returns with the Internal Revenue Service (IRS). Nor does the IRS offer relief from contract voidability for any business entities.

Under existing state law, domestic or foreign registered (qualified) LLCs or domestic or foreign qualified corporations may be subject to suspension or forfeiture for failure to file a tax return or for failure to pay delinquent taxes, penalties, fees, or interest within 60 days of the FTB mailing a final notice. One consequence of suspension or forfeiture is being subject to contract voidability for the period in which the entity is suspended or forfeited.

Foreign nonqualified corporations may be subject to contract voidability in two ways depending on whether or not the corporation has an FTB-assigned account number. The two ways are as follows:

- Foreign nonqualified corporations that do not have an FTB-assigned account number, because the FTB is unaware of the entities' business activities within the state, may be subject to contract voidability beginning on the first day of the taxable year for which the taxpayer has failed to file a required return
- Foreign nonqualified corporations that have an FTB-assigned account number may be subject to contract voidability for failure to file a tax return or for failure to pay delinquent taxes, penalties, fees, or interest within 60 days of the FTB mailing a final notice before contract voidability.

Unlike, foreign nonqualified corporations, foreign nonregistered (nonqualified) LLCs are not subject to contract voidability for failure to file tax returns or for failure to pay taxes, penalties, fees, or interest. Consequently, foreign nonqualified LLCs do not need to obtain relief from contract voidability.

All business entities that enter into a contract while subject to contract voidability may have the contract voided by another party to the contract. The third party may exercise the right to declare a contract void only in a lawsuit brought by either party with respect to the contract. A court shall not issue a final judgment rescinding the contract unless the taxpayer subject to contract voidability is provided a reasonable opportunity to cure the voidability. In no event shall a court order a contract rescinded without providing the taxpayer full restitution of the benefits provided by the taxpayer under the contract.

Entities that are subject to contract voidability may elect to obtain relief from contract voidability. If obtained during the revivor process, the entity may choose relief for a portion of the time in which the entity was subject to contract voidability by choosing the starting tax year for which the relief period will begin. If an entity elects to obtain relief from contract voidability outside of the revivor process, the entity must choose relief for the entire period for which the entity was subject to contract voidability. Relief from contract voidability is granted at a cost of $100 a day for the period of relief granted. The amount cannot exceed the amount of tax due for the relief period. When a return is not due, the minimum franchise tax is considered the tax due for that period.

Check-the-box

Federal check-the-box regulations,[1] effective January 1, 1997, provide that an entity may elect how it will be classified for federal tax purposes, as a corporation, a partnership, or an entity disregarded as separate from its owner. In the absence of an election, default classifications are provided. A taxpayer generally may not change its classification for 60 months.

Under general provisions of state law, the classification of an entity for state tax purposes must be the same as the classification for federal tax purposes.

With regard to check-the-box regulations, current state law provides that the classification of a business entity is determined under regulations of the FTB, that are required to be consistent with federal regulations as in effect January 1, 1997.

Background

The federal check-the-box regulations, effective January 1, 1997, have subsequently been updated over 10 times, yet the state's check-the-box regulations may not be updated because state law specifically requires that the state check-the-box regulations be consistent with the the January 1, 1997, version of the federal regulations. Although the federal changes have not been substantive, differences between the federal and state check-the-box regulations cause taxpayer confusion and increase inquiries from taxpayers to the department. Examples of the subsequent federal changes to the check-the-box regulations include modifications to the 1) definition of a corporation for entities formed in certain countries, 2) classification of an entity as an association, 3) rules when an entity classified as a partnership has its membership reduced to one, and 4) treatment of a partnership that elects to be classified as an association.

THIS BILL

This bill would include foreign nonqualified LLCs within the definition of taxpayer as it relates to contract voidability. As a result, foreign nonqualified LLCs would be subject to the same terms of contract voidability as currently applies to foreign nonqualified corporations, as follows:

- Foreign nonqualified LLCs without an FTB-assigned account number that fail to file a required tax return would be subject to contract voidability during the period beginning on the later of the first day of the taxable year for which the LLC failed to file a required tax return, or January 1, 2014, and ending when the LLC qualifies with the Secretary of State or obtains an FTB account number.

[1] Treasury regulations sections 301.7701-1 through 301.7701-3.

- Foreign nonqualified LLCs with an FTB-assigned account number that fail to file a tax return or fail to pay delinquent taxes, penalties, fees, or interest within 60 days of the FTB mailing a final notice would be subject to contract voidability during the period beginning with the end of the 60-day demand notice and ending on the earlier of (1)the date relief from contract voidability is granted or (2)the date the LLC qualifies with the Secretary of State.

In addition, this bill would modify the date the state check-the-box regulations are required to be consistent with the federal check-the-box regulations to May 1, 2014.

IMPLEMENTATION CONSIDERATIONS

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

LEGISLATIVE HISTORY

AB 318 (Skinner, Chapter 313, Statutes of 2012), among other things, expanded the imposition of the non-qualified, suspended, or forfeited failure to file penalty to include LLCs.

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. None of the states reviewed impose contract voidability, nor do they offer relief from contract voidability. In addition, these states generally follow the federal check-the-box regulations.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 1143 As Amended June 9, 2014		
2014-15	2015-16	2017-18
+ $50,000	+ $30,000	+ $50,000

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

SUPPORT/OPPOSITION[2]

Support: Franchise Tax Board (Sponsor), California Assessors' Association, California Federation of Teachers, California Tax Reform Association, and SEIU California

Opposition: None provided

ARGUMENTS

Proponents: Supporters could argue that this bill would provide greater protection to California consumers when contracting with foreign nonqualified LLCs and, by reducing differences between state and federal check-the-box regulations, reduce taxpayer confusion.

Opponents: Some could argue that this bill would place an additional burden on specified LLCs, thus discouraging economic activity within the state.

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[2] As provided in the Senate Floor Analysisdated June 11, 2014.