

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Alejo Analyst: Jessica Deitchman Bill Number: AB 1645
Related Bills: See Legislative History Telephone: 845-6310 Amended Date: April 21, 2014
Attorney: Bruce Langston Sponsor: _____

SUBJECT: Annual Tax & Minimum Franchise Tax/Exempt New Corporations, LLCs, LPs, & LLPs 1st & 2nd Taxable Years

SUMMARY

This bill would, under the Corporation Tax Law (CTL) and Personal Income Tax Law (PITL), eliminate the minimum franchise tax or annual tax for new business entities for the first two taxable years.

RECOMMENDATION

No position.

Summary of Amendments

The April 21, 2014, amendments added language to include Limited Liability Companies (LLCs), Limited Liability Partnerships (LLPs), and Limited Partnerships (LPs) in the exemption from the annual tax. This analysis replaces the department's analysis of the bill as amended March 20, 2014.

REASON FOR THE BILL

The reason for this bill is to provide tax relief for new corporations doing business in California by eliminating the minimum franchise tax for their first two years.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for new corporations that incorporate or qualify to do business in this state on or after January 1, 2015.

ANALYSIS

FEDERAL/STATE LAW

Federal law has no minimum franchise tax or annual tax on business entities comparable to the California minimum franchise tax.

Board Position:

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Executive Officer

Date

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STATE LAW

Unless specifically exempted by statute, every corporation that is organized or qualified to do business or doing business in this state (whether organized in state or out-of-state) is subject to the minimum franchise tax. Taxpayers must pay the minimum franchise tax only if it is more than their measured franchise tax. For taxable years beginning on or after January 1, 1997, only taxpayers whose net income is less than approximately \$9,040 pay the minimum franchise tax because their measured tax would be less than \$800 ($\$9,039 \times 8.84\% = \799).

Every corporation that incorporates or qualifies to do business in this state on or after January 1, 2000, is exempt from the minimum franchise tax for its first taxable year. This exemption does not apply to any corporation that reorganizes solely for the purpose of avoiding payment of its minimum franchise tax. It also does not apply to LPs; LLCs not classified as corporations, LLPs, charitable organizations, regulated investment companies, real estate investment trusts, real estate mortgage investment conduits, financial asset securitization investment trusts, and qualified Subchapter S subsidiaries.

Under existing state law, the annual tax on LPs, LLCs not classified as corporations, and LLPs is set at \$800 by reference to the minimum franchise tax.

A corporation wholly owned by an individual that is a member of the U.S. Armed Forces is exempt from paying the minimum franchise tax for any taxable year if both of the following apply:

- The owner is deployed during that taxable year, and
- The corporation operates at a loss or ceases operation in that taxable year.

Doing Business

Section 23101 defines "doing business" as actively engaging in any transaction for the purpose of financial or pecuniary gain or profit.

Furthermore, a taxpayer will also be considered to be doing business in California if any of the following conditions are satisfied:

- The taxpayer is organized or commercially domiciled in California.
- Sales, as defined in subdivision (f) of Revenue & Taxation Code (R&TC) Section 25120, of the taxpayer in California, including sales by the taxpayer's agents and independent contractors, exceed the lesser of \$500,000 or 25 percent of the taxpayer's total sales.
- Real and tangible personal property of the taxpayer in California exceed the lesser of \$50,000 or 25 percent of the taxpayer's total real and tangible personal property.
- The amount paid in California by the taxpayer for compensation, as defined in subdivision (c) of R&TC Section 25120, exceeds the lesser of \$50,000 or 25 percent of the total compensation paid by the taxpayer.

THIS BILL

This bill would exempt new corporations that incorporate or register with the secretary of state after January 1, 2015, from the minimum franchise tax for the first two taxable years.

This bill would also exempt LLPs, LPs and LLCs, that do business in the state¹ after January 1, 2015, from the annual tax for the first two taxable years.

Charitable Corporations, Regulated Investment Companies, Real Estate Investment Trusts, Real Estate Mortgage Investment Conduit, or qualified subchapter S subsidiaries would be ineligible for the minimum franchise tax exemption that this bill would establish.

IMPLEMENTATION CONSIDERATIONS

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

Because the bill fails to specify otherwise, any business entity that began business operations as a sole proprietorship, a partnership, an LLC, a corporation, or any other form of business entity prior to its organization, and reorganizes solely for the purpose of reducing its minimum or annual tax, would be eligible for the exemption of the applicable minimum or annual tax. If it is the author's intention to disallow an exemption for these types of reorganizations, the bill should be amended to specifically exclude these types of reorganizations.

TECHNICAL CONSIDERATIONS

Because the bill fails to specify otherwise, the changes made to the LLC annual tax law² may be interpreted to exclude an LLC from paying the fee because the LLC fee law³ applies to LLCs subject to the annual tax. It is recommended the bill be amended to clarify that the exclusion from the annual tax does not exclude an LLC from the annual fee.

LEGISLATIVE HISTORY

AB 1769 (Dababneh, 2013/2014) would exempt certain small business LLCs from the minimum franchise tax for up to two taxable years. AB 1769 is pending before the Assembly Revenue and Taxation Committee.

AB 1889 (Hagman, 2013/2014) would exempt certain small business entities from the minimum franchise tax for up to the first two taxable years. AB 1889 is pending before the Assembly Revenue and Taxation Committee.

AB 2466 (Nestande, 2013/2014) would either exempt or reduce certain, veteran owned small business entities from the minimum franchise tax. AB 2466 is pending before the Assembly Revenue and Taxation Committee.

¹ As defined in Section 23101.

² R&TC Section 17941.

³ R&TC Section 17942.

AB 2495 (Melendez, 2013/2014) would eliminate the minimum franchise tax for new business entities for up to five taxable years. AB 2495 is pending before the Assembly Revenue and Taxation Committee.

AB 2428 (Patterson, 2013/2014) would eliminate the minimum franchise tax for new business entities for up to five taxable years. AB 2428 is pending before the Assembly Revenue and Taxation Committee.

SB 641 (Anderson, 2013/2014) would eliminate the minimum franchise tax for certain new corporations for the first four taxable years. SB 641 is currently in the Senate Appropriations Committee.

AB 166 (Cook, 2011/2012) would have eliminated the minimum franchise tax. AB 166 failed passage out of the Assembly by the constitutional deadline.

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

AB 821 (Garrick, 2011/2012) would have reduced the minimum franchise tax from \$800 to \$100 for a small business for the first ten years of operation. AB 821 failed passage out of the Assembly by the constitutional deadline.

AB1605 (Garrick, 2011/2012) would have exempted specified entities from the minimum franchise tax or annual tax and reduced the minimum franchise tax or annual tax to \$99 for specified entities that commence business on or after January 1, 2013. AB 1605 failed passage out of the Assembly by the constitutional deadline.

AB 327 (Garrick, 2009/2010) would have reduced the minimum franchise tax 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 minimum franchise tax 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 minimum franchise tax 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 minimum franchise tax from \$800 to \$200. AB 2178 failed passage out of the Assembly Revenue and Taxation 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, Michigan, and Minnesota do not impose a minimum tax on business entities.

Illinois imposes a \$25 minimum tax on corporations.

Massachusetts imposes a \$456 minimum tax on corporations.

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.

FISCAL IMPACT

This bill would impact the department's printing, processing and programming costs. 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

Estimated Revenue Impact of AB 1645 As Amended April 21, 2014 Assumed Enactment After June 30, 2014 (\$ in Millions)		
2014-15	2015-16	2016-17
- \$36	- \$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

Proponents: Some may argue that providing an exemption from the minimum franchise or annual tax would give a needed tax break to newly formed entities in California and therefore encourage them to stay in business.

Opponents: Some may argue that exempting any group of business entities from the minimum franchise or annual tax would be an inequitable shifting of the burden of paying for state services and benefits to taxpayers ineligible for the exemption that this bill would provide.

POLICY CONCERNS

The bill would allow an exemption from the minimum franchise tax for any corporation that incorporates or registered with the secretary of state after January 1, 2015. The bill fails to provide the same treatment for LLPs, LPs, and LLCs because it would only allow an exemption from the annual tax for the first two taxable years if the LLP, LP or LLC were doing business in the state. If this is contrary to the author's intent, the bill should be amended.

LEGISLATIVE STAFF CONTACT

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