Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Dababneh	Analyst:	Jessica Deitchman	Bill Number:	AB 1769
Related Bills:	See Legislative History	Telephone:	845-6310	Introduced Date:	February 14, 2014
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Exempt New LLC Small Business From The Annual Fee For First Two Taxable Years

SUMMARY

This bill would under Personal Income Tax Law (PITL), exempt small business Limited Liability Companies (LLCs) from the annual fee for up to the first two taxable years.

RECOMMENDATION

No position.

REASON FOR THE BILL

The reason for this bill is to provide tax relief for new, small business, LLCs doing business in California.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2015, and specifically operative for taxable years beginning on or after January 1, 2015.

ANALYSIS

FEDERAL/STATE LAW

Federal Law

Current federal law requires that an LLC with more than two members be classified as a partnership for federal tax purposes unless it specifically elects to file as a corporation. Federal law has no requirement for partnerships to pay fees or minimum tax.

State Law

LLC Tax and Fee

State law currently requires LLCs not classified as corporations that are organized, registered, or doing business in the state to pay an annual tax, in an amount equal to the minimum franchise tax, which is currently $800. Every LLC subject to the annual tax is also required to pay an annual fee based on the total income from all sources derived from or attributable to the state.

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The fee is determined as follows:

- If total income is more than $250,000, but less than $500,000, the fee is $900
- If total income is more than $500,000, but less than $1 million, the fee is $2,500
- If total income is more than $1 million, but less than $5 millions, the fee is $6,000
- If total income is more than $5 million, the fee is $11,790

The fee must be estimated and paid no later than the 6th month of the taxable year. A penalty of 10 percent of the amount of underpayment will be added to any fee paid late.

THIS BILL

For taxable years beginning on or after January 1, 2015, this bill would exempt qualified new LLCS not classified as corporations from the annual fee for up to its first two taxable years; as long as the LLC remains a small business.

This bill would define the following terms:

- "New Limited Liability Company" means an LLC that is organized under the laws of the state or qualified to transact intrastate business in the state and begins business operations at or after the time of its organization.
- "Small Business" means an LLC that reasonably estimates that it will have gross receipts, less returns and allowances, reportable to this state for the taxable year of $5,000 or less.
- "Gross receipts, less returns and allowances reportable to this state," means the sum of the gross receipts from the production of business income, as defined in subdivision (a) of Section 25120[1] and the gross receipts from the production of non-business income, as defined in subdivision (d) of Section 25120.[2]

The exemption would not apply to any LLC that either; began business operations as a sole proprietorship, a partnership, a corporation, or any other form of business entity prior to its organization, or; that reorganizes solely for the purpose of reducing its annual fee.

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.

This bill defines small businesses as those that have below $5,000 in gross receipts and specifically exempts these businesses from the annual fee. However, the annual fee for LLCs applies only to those entities with over $250,000 in total income. Because the definition of gross receipts includes the sale or exchange of property, the performance of services, or the use of property or capital, it would be impossible for an entity to have below $5,000 in gross receipts and

[1] "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.
[2] "Non-business income" means all income other than business income.

still be above the $250,000 total income threshold. If it is the author's intent to exempt new small businesses LLCs from the annual tax and not the LLC fee, the bill should be amended to clarify this exemption.[3]

This bill would eliminate the annual fee for LLCs that estimate their gross receipts to be less than $5,000. Under current law, an LLC is required to estimate and pay the fee on the 15th day of the sixth month of the taxable year – well before the fee is due and payable. A penalty is imposed on a taxpayer that underpays the estimate payment of the fee. If the LLC taxpayer incorrectly estimates the gross receipts when paying the estimated payment for the annual tax and it is later determined that the gross receipts were in excess of $5,000, it is unclear if the taxpayer would be subject to the underpayment penalty. Department staff recommends the bill be amended to clarify how the author would like the penalty to be assessed.

It is unclear if the exemption from the annual fee should be allowed for the first two taxable years an LLC is organized or for the first two years that the LLC is a small business. Because of this, LLCs that organized prior to the effective date of this bill that meet the definition of a "new limited liability company" would be exempt from payment of the annual fee, therefore, existing LLCs, not just new LLCs, could qualify for this bill's exemption. If this is contrary to the author's intent, this bill should be amended.

TECHNICAL CONSIDERATIONS

Because an LLC pays its annual fee at the time the LLC files its return, it would be unnecessary for a LLC to "reasonably estimate" its gross receipts reportable to the state for the taxable year.

On page 4, line 20, before "that" strike out "reasonably estimates"

LEGISLATIVE HISTORY

AB 1889 (Hagman, 2013/2014) would exempt certain small business entities from the minimum franchise tax for up to the first 2 years. AB 1889 was introduced on February 19, 2014.

AB 2495 (Melendez, 2013/2014) would eliminate the minimum franchise tax for new business entities for up to five years. AB 2495 was introduced on February 21, 2014.

AB 2466 (Nestande, 2013/2014) would either exempt or reduce certain small, veteran owned business entities from the minimum franchise tax. AB 2466 was introduced on February 21, 2014.

AB 2428 (Patterson, 2013/2014) would eliminate the minimum franchise tax for new business entities for up to five years. AB 2428 was introduced on February 21, 2014.

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.

[3] California Revenue and Taxation Code Section 17941

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.

Annual Fee

All the states surveyed, except Minnesota, do not charge an annual fee to LLCs.

In Minnesota, an LLC is subject to a minimum fee if the sum of its Minnesota source property, payroll, and sales is at least $50,000 (unless that LLC derives over 80 percent of its income from farming). The maximum fee imposed on an LLC is $5,000.

Minimum Tax

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 limited partnerships, LLCs, and limited liability partnerships based on their in-state receipts.

FISCAL IMPACT

This bill would impact the department's programming costs to automate the verification of the gross receipts for qualified taxpayers. 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

The proposed legislation would exempt new LLCs that have gross receipts of $5,000 or below from the annual LLC fee. The amount of annual fee is based on total income; an LLC with income below $250,000 is not subject to this fee. Because gross receipts include total income from all sources, it would not be possible for a taxpayer to have only $5,000 in total income and still be subject to the fee. Therefore, this bill has no impact on revenue.

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

Proponents: Some may argue that the bill would give a needed tax break to small LLCs in California and therefore encourage them to stay in business.

Opponents: Some may argue that this fee exemption offers an incentive to only LLCs and not other entity types and this may be viewed as an unfair practice.

LEGISLATIVE STAFF CONTACT

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