

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Allen Analyst: Jessica Deitchman Bill Number: AB 1778
Related Bills: See Legislative History Telephone: 845-6310 Amended Date: April 1, 2014
Attorney: Bruce Langston Sponsor: _____

SUBJECT: Annual Tax/Exempt LLCs Formed Exclusively to Acquire & Hold Intangible Personal Property

SUMMARY

This bill would, under the Personal Income Tax Law (PITL) relating to the taxation of limited liability companies (LLCs), modify the definition of an LLC (LLC).

RECOMMENDATION

No position.

Summary of Amendments

The April 1, 2014, amendments removed provisions of the bill related to property taxation, and replaced them with the provisions discussed in this analysis. This is the department's first analysis of the bill.

REASON FOR THE BILL

The reason for the bill is to encourage LLCs that are formed exclusively to acquire and hold certain intangible personal property to form or register in California, and invest in start up businesses anywhere, by exempting them from the \$800 annual tax.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2014.

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 an annual tax.

Board Position:

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Executive Officer

Date

Selvi Stanislaus

5/14/14

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.

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.

Every LLC that is doing business in this state, organized in this state, or registered with the Secretary of State is required to file its return on or before the 15th day of the fourth month following the close of its taxable year.

THIS BILL

This bill would amend the description of an LLC for state tax purposes to exclude an LLC that is formed for the exclusive purpose of acquiring and holding title to intangible personal property constituting equity or debt interests, or both, in a single other corporation, LLC; or partnership, collecting income there from, and turning over the entire amount thereof, less expenses to its members

IMPLEMENTATION CONSIDERATIONS

Department staff has identified the following implementation considerations for purposes of a high-level discussion; additional concerns may be identified as the bill moves through the legislative process. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

By changing the description of an LLC to exclude "an LLC that is formed for the exclusive purpose of acquiring and holding title to intangible personal property constituting equity or debt interests, or both," this bill would exempt an LLC that meets this description from the requirement to pay the annual \$800 tax and the LLC fee. If this is not the intent of the author, amendments would be necessary.

It is unclear how an LLC and the FTB would verify that the LLC was formed for the “exclusive purpose” the exemption would require.

Further it is unclear what effect, if any, that (1) the performance of activities other than the exclusive purpose or (2) modification of the articles to include something other than the exclusive purpose would have on an LLCs exemption from the annual tax. If the author intends for the exemption to be limited to LLCs that are formed and operate solely for the exclusive purpose, this bill should be amended.

The term “expenses” may be broadly interpreted to include expenses other than ordinary and necessary business expenses. It is recommended that the bill be amended to more clearly express the author’s intent as to the character of the expenses that could reduce an LLCs income.

The bill’s exemption from the annual tax would have no impact on the filing requirement for LLCs classified as a partnership that are organized, registered, or doing business in the state. Additionally, the bill would have no impact on the requirement for an LLC with non-resident members to file a combined non-resident return reporting those members’ income. If this is contrary to the author’s intent, this bill should be amended.

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 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.

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.

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.

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.

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, Illinois, Massachusetts and Minnesota generally do not impose a minimum tax on LLCs.

New York imposes a minimum tax \$25 to \$4,500 for LLCs based on their in-state receipts.

FISCAL IMPACT

The costs to administer this bill have yet to be determined. 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 1778 As Amended April 1, 2014 Assumed Enactment After June 30, 2014 (\$ in Millions)		
2014-15	2015-16	2016-17
- \$2.6	- \$2.9	- \$3.1

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

SUPPORT/OPPOSITION

Support: National Federation of Independent Businesses and Silicon Valley Chamber of Commerce

Opposition: None provided.

ARGUMENTS

Proponents: Some may argue that the bill would provide a needed tax exemption to LLCs that acquire and hold intangible personal properties in California and therefore encourage them to open and operate in California.

Opponents: Some may argue that providing a tax exemption only to LLCs that acquire and hold intangible personal property may be overly narrow and inadvertently exclude other business owners that need assistance as well.

POLICY CONCERNS

This bill would provide a tax benefit for certain types of LLCs that would not be provided to other business entities. Thus, this bill would provide differing treatment based solely on business type.

LEGISLATIVE STAFF CONTACT

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