ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	Hagman, et al.	Analyst:	Jessica Deitchman	Bill Number:	AB 1889
Related Bills:	See Legislative History	Telephone:	845-6310	Introduced Date Amended Date:	February 19, 2014 and April 3, 2014
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Minimum or Annual Franchise Tax/$400 for New Small Business Corporation, Limited Partnership, Limited Liability Partnership, & Limited Liability Company

SUMMARY

This bill would, under the Corporation Tax Law (CTL) and Personal Income Tax Law (PITL), reduce the minimum franchise or annual tax for certain new, small business entities.

RECOMMENDATION

No position.

Summary of Amendments

The bill as introduced February 19, 2014, would reduce the minimum franchise or annual tax for certain small business entities.

The April 3, 2014, amendments added a number of co-authors, corrected a reference to the annual tax and corrected several technical errors.

This is the department's first analysis of the bill.

REASON FOR THE BILL

The reason for this bill is to provide tax relief for new, small businesses doing business in California, by reducing the minimum or annual tax for the first or second taxable year.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2015.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

<u>Federal Law</u>

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

Board Position:			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 x 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 limited partnerships (LPs), limited liability companies (LLCs) not classified as corporations, limited liability partnerships (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.

Real estate mortgage investment conduits are subject to and required to pay the minimum franchise tax. Regulated investment companies and real estate investment trusts organized as corporations also are subject to and required to pay the minimum franchise tax.

Under existing state law, the annual tax on limited partnerships, limited liability companies not classified as corporations, and limited liability partnerships 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.

THIS BILL

For taxable years beginning on or after January 1, 2015, this bill would reduce the minimum franchise or annual tax, as applicable, to $400 as follows:

- For the first taxable year of a new LP, new LLP, or new LLC, provided that it was a small business for its first taxable year.
- For the second taxable year of a new corporation, provided that the entity is a small business in both of its first two taxable years.

This bill would define the following terms:

- “New LP, LLP, LLC or new corporation” means an LP, LLP, LLC, or corporation 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 either:
  - An LP, LLP, that that will have gross receipts, less returns and allowances, reportable to this state for the taxable year of $5,000 or less, or
  - An LLC or Corporation 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 reduction of the minimum franchise or annual tax would be unavailable to any new LP, LLC, LLP or corporation that either; began business operations, or acquired its business operations as follows:

- New LP: from a sole proprietorship, LLC, general partnership, corporation, or any other business entity prior to its organization or that acquired its business operations from a partnership.
- New LLC: from a sole proprietorship, a partnership, a corporation, or any other form of business entity prior to its organization or that acquired it business operations from an LLC.
- New LLP: from a sole proprietorship, an LLC, a corporation, a partnership, or any other form of business entity prior to its organization or that acquired its business operations from an LLP.
- New Corporation: from a sole proprietorship, a partnership, LLC, or any other form of business entity prior to its incorporation or that acquired its business operations from a corporation.

The reduction would not apply to any LP, LLC, LLP or corporation that reorganized solely for the purpose of reducing its minimum tax.

To receive the reduction of the minimum franchise or annual tax, the LP, LLP, LLC or corporation must file a timely return.

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.

[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] "Nonbusiness income" means all income other than business income.

An LP, LLP, LLC or corporation that organized prior to the effective date of this bill that meets the definition of a “new LP, LLP, LLC or corporation” would qualify for a reduced minimum franchise tax, therefore, existing business entities, not just new business entities, could qualify for this bill’s exemption. If this is contrary to the author’s intent, this bill should be amended.

TECHNICAL CONSIDERATIONS

The references to the Corporations Code sections in current law, 15623 and 15696 are obsolete and should be deleted.

On page 7, line 7, delete “corporation” and insert “limited liability company”.

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 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.

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

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

<u>Revenue Estimate</u>

Estimated Revenue Impact of AB 1889 As Amended April 3, 2014 Assumed Enactment After June 30, 2014 ($ in Millions)		
2014-15	2015-16	2016-17
- $2.7	- $6.8	- $9.7

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 reduction to small businesses in California and therefore encourage them to stay in business.

Opponents: Some may argue that providing a reduction to newly formed business entities may be overly narrow and inadvertently exclude other businesses that may also be struggling.

LEGISLATIVE STAFF CONTACT

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