

Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Patterson, et al. Analyst: Jessica Deitchman Bill Number: AB 2428
 Related Bills: See Legislative History Telephone: 845-6310 Introduced Date: February 21, 2014
 Amended Date: April 10, 2014
 Attorney: Bruce Langston Sponsor: _____

SUBJECT: Minimum Franchise Tax/Exempt New Corporations, LLCs, LPs & LLPs First Consecutive Five Taxable Years/New Qualified Business Deduction

SUMMARY

This bill would, under the Personal Income Tax Law (PITL) and Corporation Tax Law (CTL), provide tax relief to new corporations, Limited Liability Companies (LLCs), Limited Partnerships (LPs), Limited Liability Partnerships (LLPs) and tax relief for certain other taxpayers.

RECOMMENDATION

No position.

Summary of Amendments

The bill as introduced February 21, 2014, added provisions that would provide tax relief for new corporations, LLCs, LPs, LLPs, and tax relief certain other taxpayers.

The April 10, 2014, amendments added co-authors, modified the operative date, and extended the sunset for provisions related to deployed veterans.

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

REASON FOR THE BILL

The reason for this bill is to reduce the financial burden that new businesses face by exempting them from the annual or minimum tax and annual fee for the first five years.

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.

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ANALYSIS

FEDERAL/STATE LAW

Minimum or Annual Tax

Federal Law

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

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.

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 LPs, LLCs not classified as corporations, and LLPs is set at \$800 by reference to the minimum franchise tax.

A corporation and an LLC (not classified as 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 or the annual 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.

These provisions cease to be operative for taxable years beginning on or after January 1, 2018.

LLC Fee

Federal Law

Federal law does not charge annual fees on LLCs.

State Law

State law currently requires LLCs taxed as partnerships, organized or operating in the state to pay an annual fee to the state 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

Business Income

Federal and State Law

There is no current federal or state law that allows shareholders or members to deduct all income received from a qualified business from their gross income.

Under current federal and state law, a partnership computes its income, gain, loss, deduction, and credit at the partnership level and allocates these items among its partners. The partners report their distributive share of these items on their own tax returns to be included in taxable income.

Partners are generally allowed to allocate partnership items of income, gain, loss, deduction, or credit among themselves based on their partnership agreement. Allocation of the partnership tax items must be consistent with the underlying economic arrangement among the partners.

THIS BILL

For taxable years beginning on or after January 1, 2015, this bill would do the following:

1. Allow as a deduction all qualified income earned or received by a taxpayer from a qualified business. The deduction would be available for the first five consecutive taxable years that a business is a qualified business.

For purposes of this provision, the bill defines the following terms:

- "Qualified Business" means a business that, on or after January 1, 2015, is either a sole proprietorship, a general partnership that commences business within this state, a LP, or a LLP, that files the applicable document or form with the Secretary Of State (SOS) and does business in the state after January 1, 2015.
- "Qualified Income" means any income attributable to the taxpayer's status as a partner in or sole proprietor of a qualified business.

2. Exempt all LPs, LLCs (not taxed as corporations), and LLPs that file certificates of limited partnership, articles of organization, or certificates of limited liability partnership with the SOS on or after January 1, 2015, from the annual tax for the first five consecutive taxable years that it does business in the state.
3. Exempt all LLCs that file articles of organization with the SOS on or after January 1, 2015, from all LLC fees¹ for its first five consecutive taxable years that it does business in the state.
4. Exempt all corporations incorporated in this state on or after January 1, 2015, from the corporation income tax and the minimum franchise tax for its first five consecutive taxable years.
5. Extend the sunset date of the provision in current law related to exemptions from the minimum franchise tax for a corporation wholly owned by a deployed member of the Armed Forces from taxable years beginning on or after January 1, 2018, to taxable years beginning on or after January 1, 2019. It does not, however, modify the sunset date for the exemption from the annual tax for an LLC (not classified as a corporation) owned by a deployed member of the Armed Forces.

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 uses terms and phrases that are undefined, i.e., "business", "commences business within the state," and "applicable document or form." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of these deductions. It is recommended the bill be amended to define these terms.

Partnerships compute income, gain, loss, deduction, and credit at the partnership level and allocate these items among its partners. With the exception of income, the bill is silent on the treatment of flow through losses, credits and other tax items on a partner's return. If the author intends to eliminate all pass through items from the calculation of income, the bill should be amended to clarify how and what items should or should not be included on a partner's return.

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 tax, annual tax, or annual fee, would be eligible for the reduction of the applicable minimum or annual tax or annual fee. 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.

¹ As defined in California Revenue & Taxation Code Section 17942

TECHNICAL CONSIDERATIONS

The CTL section of this bill specifies that the exemption from minimum franchise tax would be allowed for every corporation that “incorporates” in this state on or after January 1, 2015. Because LLCs “organize” and do not “incorporate” it is unclear if the exemption would apply to those LLCs that elect to be taxed as a corporation. If it is the author’s intent to allow LLCs taxed as corporations to be allowed the exemption, the bill should be amended to include those that “incorporate” or “organize.”

On page 9, line 25, after “limited” insert “liability”

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.

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 LPs, LLCs, and LLPs based on their in-state receipts.

FISCAL IMPACT

Department staff is unable to determine the costs to administer this bill until the implementation concerns have been resolved. As the bill continues to move through the legislative process and the implementation concerns are resolved, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 2428 As Amended April 10, 2014 Assumed Enactment After June 30, 2014 (\$ in Billions)		
2014-15	2015-16	2016-17
- \$6	- \$13	- \$15

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

LEGAL IMPACT

This bill provides an exemption for entities created under the laws of California, but not for the same entities organized under the laws of another state and registered in California. This bill could raise constitutional concerns under the Commerce Clause of the United States Constitution because it could appear to improperly favor in-state activity.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

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

Opponents: Some may argue that providing a tax benefit only to newly formed business entities may be overly narrow and inadvertently exclude other businesses that need tax assistance.

POLICY CONCERNS

This bill would provide a tax benefit for PIT taxpayers that own sole proprietorships, are partners in general partnerships, limited partnerships, and limited liability partnerships. This benefit would not be provided to partners (shareholders/members) in other business entities such as S-corporations. Thus, this bill would provide differing treatment for taxpayers based solely on the classification of business that they have ownership in.

The bill allows all qualified income, as defined, earned or received by a shareholder/member from a qualified business, as defined, to be deducted from income for the first five consecutive taxable years. This bill would provide a 100 percent deduction of all income received, which would be unprecedented.

The bill extends the sunset for the exemption from the minimum franchise tax for a corporation wholly owned by a deployed member of the armed forces but does not extend the sunset date for the exemption from the annual tax for an LLC wholly owned by a deployed member of the armed forces.

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