Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Anderson	Analyst:	David Scott	Bill Number:	SB 641
Related Bills:	See Legislative History	Telephone:	845-5806	Introduced Date:	February 22, 2013
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Franchise Tax/Exempt Qualified New Corporations First Four Taxable Years

SUMMARY

This bill would exempt certain new corporations from paying the minimum franchise tax for its first four year taxable years.

RECOMMENDATION

No position.

REASON FOR THE BILL

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

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, 2013.

ANALYSIS

FEDERAL/STATE LAW

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 x 8.84% = $799).

Board Position:			Executive Officer	Date
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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, limited liability companies not classified as corporations, limited liability partnerships, 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 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.

<u>THIS BILL</u>

For taxable years beginning on or after January 1, 2013, this bill would exempt qualified new corporations, as defined, from the minimum franchise tax for its first four taxable years.

This bill would define the following terms:

- “Qualified new corporation” means a corporation that is incorporated under the laws of this state or has qualified to transact intrastate business in this state, that begins business operations at or after the time of its incorporation and that reasonably estimates that it will have gross receipts, less returns and allowances, reportable to this state for the taxable year of $10,000 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 nonbusiness income, as defined in subdivision (d) of Section 25120.[2]

The exemption would not apply to any corporation that reorganizes for the purpose of reducing its minimum franchise tax, limited partnerships, limited liability companies, limited liability partnerships, charitable organizations, regulated investment companies, real estate investment trusts, real estate mortgage investment conduits, Subchapter S subsidiaries, or to the formation of any subsidiary corporation.

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[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.

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.

Entities incorporated prior to the effective date of this bill that meet the definition of a qualified new corporation would be exempt from payment of the minimum franchise tax, therefore, existing corporations, not just new corporations, could qualify for this bill's exemption. If this is contrary to the author's intent, this bill should be amended.

The bill is silent in regards to whether the exemption would apply to a new corporation that takes over an existing business in this state and the corporation meets the gross receipts test for the exemption. The absence of clarification on this could lead to disputes with taxpayers and complicate the administration of the exemption.

The definition of "qualified new corporation" would limit the benefit to new corporations that "begin business operations at or after the time of its incorporation." Under this definition, it is unclear whether a business entity that was doing business as a partnership, limited liability company or sole proprietorship that later incorporates would be entitled to this exclusion because the language states that the entity must begin business operations "at or after" the time of incorporation. If it was intended to allow newly-incorporated existing businesses to receive this benefit, then it is unclear when the four-year period begins – on the date of incorporation or qualification, or when the business actually began operations, which would be sometime earlier.

It is unclear whether a corporation must meet the $10,000 gross receipts test in each of its first four taxable years or the initial taxable year only. Lack of clarity could lead to disputes between taxpayers and the department and would complicate administration of the exemption.

TECHNICAL CONSIDERATIONS

The nomenclature[3] of subdivision (j), beginning on page 5, is incorrect. Amendments should be made to correct this.

LEGISLATIVE HISTORY

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.

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[3] The system of using letters and numbers to designate or name something. In this case the separate subdivisions, paragraphs and subparagraphs in the Revenue and Taxation Code.

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 Limited Partnerships, Limited Liability Companies, and Limited Liability Partnerships 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, but anticipate the costs could be accomplished during the normal annual update.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of SB 641 As Introduced February 22, 2013 For Taxable Years Beginning On or After January 1, 2013 Enactment Assumed After June 30, 2013 ($ in Millions)				
2013-14	2014-15	2015-16	2016-17	2017-18
-$65	-$70	-$70	-$70	-$65

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 could argue that this bill would make California's business environment more competitive with other states for businesses.

Opponents: Some could argue that the minimum franchise tax and annual tax would be an insufficient incentive because businesses that would be eligible for the exemption are currently able to organize as sole proprietorships or general partnerships to avoid paying the minimum franchise tax or annual tax.

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