

LEGISLATIVE PROPOSAL C

EXECUTIVE SUMMARY

Title

Disregarded Limited Partnerships (LPs)

Problem/Recommended Solution

Unlike the specified treatment of disregarded limited liability companies (LLCs), current state law lacks a provision expressly requiring disregarded LPs to annually file a return and pay the annual tax. Thus, resulting in disparate treatment of similarly-situated disregarded entities.

This proposal would amend the Revenue and Taxation Code (R&TC)¹ to expressly require disregarded LPs to pay the annual tax and file a return under the applicable statutes. This proposal, by amending the R&TC² in a manner substantially similar to the provisions that apply to disregarded LLCs, would provide similar treatment amongst disregarded entities.

Fiscal Impact

Staff estimates a cost of approximately \$75,000 for fiscal year 2020-2021 and \$71,000 for fiscal years 2021-2022 and thereafter for resources required to capture return data.

Economic Impact

Revenue Estimate

The population of disregarded LPs that would now be required to pay the annual tax cannot be determined with certainty. Using the Franchise Tax Board (FTB) and California Secretary of State (SOS) data, it is estimated that the revenue gain from requiring disregarded LPs to file and pay the annual tax would be between \$4.2 million and \$8.5 million in the 2020 taxable year.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

¹ R&TC section 23038(b)(2)(B)(iii).

² R&TC section 18633.

Revenue Discussion

Based on data from the SOS, it is estimated that 115,000 LPs would be formed in California or registered to do business in California in 2020. Using the FTB data, it is estimated that approximately 75 percent of registered LPs already file a tax return and would not be impacted by this proposal. Of the remaining 25,000 LPs, it is estimated that up to 40 percent would meet the definition of a disregarded LP and would be required to pay the \$800 annual tax. This would result in an estimated revenue gain of up to \$8.5 million in the 2020 taxable year.

The tax year estimate is converted to a fiscal year basis, and then rounded to arrive at the above amount.

Title

Disregarded Limited Partnerships (LPs)

Introduction

This proposal would provide statutory authority establishing filing and payment requirements for disregarded LPs.

Problem/Recommended Solution

Unlike the specified treatment of disregarded LLCs, current state law lacks a provision expressly requiring disregarded LPs to annually file a return and pay the annual tax. Thus, resulting in disparate treatment of similarly-situated disregarded entities.

This proposal would amend the R&TC³ to expressly require disregarded LPs to pay the annual tax and file a return under the applicable statutes. This proposal by amending the R&TC⁴ in a manner substantially similar to the provisions that apply to disregarded LLCs would provide similar treatment amongst disregarded entities.⁵

Program History/Background

California law in the 1990s conformed to the federal “check-the-box” entity classification regulations and generally disregards, for California income and franchise tax purposes, entities that are disregarded for federal purposes. California law also enacted specific exceptions to the disregarded entity rules relating to disregarded LLCs, such as requiring disregarded LLCs to file a return, and pay the annual tax and LLC fee.⁶ However, there were no exceptions enacted for disregarded LPs, as, at the time, disregarded LPs were not a recognized entity by the Internal Revenue Service (IRS).

Subsequent to California’s conformity to the “check-the-box” regulations, the IRS issued Rev. Rul. 2004-77 acknowledging the existence of disregarded LPs. However, California did not amend R&TC section 23038 to reflect the new entity type.

Current Federal Law

Under federal law and regulations (IRC section 7701), known as “check-the-box” regulations, an eligible entity may choose to be classified for tax purposes as a corporation (association) or a pass-through (partnership or an entity disregarded from its owner for income tax purposes.)⁷

Under federal law, a disregarded entity generally has no separate filing requirement. Federal law allows LLCs and also certain LPs to be eligible to be treated as a disregarded entity.⁸ Under IRS Rev. Rul. 2004-77, a disregarded LP exists in two specific circumstances. First, when an LP has multiple partners who are all disregarded and wholly owned by the same

³ R&TC section 23038(b)(2)(B)(iii).

⁴ R&TC section 18633.

⁵ R&TC section 18633.5(i).

⁶ R&TC section 23038(b)(2)(B)(iii).

⁷ U.S. Treasury Regulation section 301.7701. IRS Notice 95-14 simplified the entity classification process.

⁸ U.S. Treasury Regulation sections 301.7701-2 and 301.7701-3.

taxpayer. Second, when the owner taxpayer is a partner or member in the disregarded LP and the other partners are disregarded and owned by the taxpayer. These two structures make the LP disregarded for federal tax purposes.

Current State Law

Every LP doing business in this state (as defined by R&TC section 23101) and required to file a return under R&TC section 18633 generally must pay an annual tax equal to the amount prescribed by R&TC section 23153 (currently \$800). However, through California's conformity to the federal "check-the-box" regulations, if the separate existence of an eligible business entity is disregarded for federal tax purposes that business entity is also disregarded under state law for income and franchise tax purposes. Under this rule, a disregarded LP is not required to file a return or pay the annual tax.

State law, however, provides express exceptions to the "check-the-box" provisions relating to disregarded LLCs, thus requiring these entities to file a return, and pay the annual tax and LLC fee.⁹ State law lacks a similar exception for disregarded LPs.

Effective/Operative Date of Solution

If this proposal were enacted as a tax levy during the 2020 legislative session, it would be effective upon enactment and operative for taxable years beginning on or after January 1, 2020.

Justification

This proposal would provide similar filing and payment requirements for similarly-situated entities by requiring disregarded LPs to annually file and pay an annual tax similar to disregarded LLCs.

Implementation

The department currently accepts returns and payments from LPs, therefore the department anticipates that adoption of this proposal would not significantly increase the department workloads.

Implementing this proposal would require education and outreach and instructional form changes.

Fiscal Impact

Staff estimates a cost of approximately \$75,000 for fiscal year 2020-2021 and \$71,000 for fiscal years 2021-2022 and thereafter for resources required to capture return data.

⁹ See R&TC sections 17941, 17942, 18633.5, and R&TC sections 17039 and 23036 (relating to tax credits).

Economic Impact

Revenue Estimate

The population of disregarded LPs that would now be required to pay the annual tax cannot be determined with certainty. Using FTB and SOS data, it is estimated that the revenue gain from requiring disregarded LPs to file and pay the annual tax would be between \$4.2 million and \$8.5 million in the 2020 taxable year.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

Revenue Discussion

Based on data from the SOS, it is estimated that 115,000 LPs would be formed in California or registered to do business in California in 2020. Using FTB data, it is estimated that approximately 75 percent of registered LPs would not be impacted by this proposal because they already file a return. Of the remaining 25,000 LPs, it is estimated that up to 40 percent would meet the definition of a disregarded LP and be required to pay the \$800 annual tax. This would result in an estimated revenue gain of up to \$8.5 million in the 2020 taxable year.

The tax year estimate is converted to a fiscal year basis, and then rounded to arrive at the above amount.

Policy Considerations

This proposal would promote equitable treatment amongst similarly-situated business entities fostering a fair tax system.

Other States

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 law, until January 1, 2015, followed the federal "check-the-box" rules in determining an LLC's classification as a corporation, partnership, or disregarded entity. However, Florida law is silent as to whether it followed the federal "check-the-box" treatment in the case of partnerships. Effective January 1, 2015, Florida enacted "stand alone" law requiring all domestic and foreign LLCs authorized to do business in Florida to file an annual report with the Department of State, and pay an annual filing fee of \$50. In addition, each corporation, LLC, or LP authorized to transact business in Florida must pay an annual supplemental corporate fee of \$88.75.

Illinois law provides that an LLC is treated as a corporation or partnership based on its classification for federal tax purposes, and is subject to both the regular income tax and the replacement tax. However, Illinois law is silent as to whether it follows the federal "check-the-box" treatment in the case of partnerships.

Massachusetts law adopted the federal “check-the-box” rules for taxable years beginning on or after January 1, 2009, and requires that the Massachusetts filing status for business entities conform to their federal classification. Under Massachusetts law, an LLC treated as a corporation is subject to the corporate excise income tax and must file a return as a corporation. Massachusetts law is silent as to the filing requirements for disregarded LPs.

Michigan law provides that a disregarded entity under federal law is treated as a disregarded entity for purposes of the Michigan Single Business Tax (MBT). For purposes of the MBT, a disregarded entity for federal tax purposes, including a single member LLC must file as if it were a sole proprietorship if owned by an individual, or a branch or division if owned by another business entity. Michigan law is silent as to the filing requirements for disregarded LPs.

Minnesota law follows the federal “check-the-box” rules for taxable years beginning after December 31, 2012. An LLC treated as a corporation is subject to the corporation franchise (income) tax. An LLC treated as a partnership is subject to a minimum fee ranging from \$200 to \$9,960 determined based on the total of Minnesota property, payroll, and sales. Minnesota law is silent on the tax treatment and filing requirements for disregarded LPs.

New York law conforms to the federal “check-the-box” rules for entity classification. LLCs may be treated as corporations, partnerships, or disregarded entities. LLCs treated as partnerships for federal tax purposes will be treated as partnerships for New York tax purposes and will follow reporting requirements under personal income tax provisions. New York law is silent on the tax treatment and filing requirements for disregarded LPs.

Potential Compromises

None identified.

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Franchise Tax Board's Proposed Amendments for LP C

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Subject: Disregarded Limited Partnerships (LPs)

Amendment 1

Section 18633 of the Revenue and Taxation Code is amended to read:

18633 (a) (1) Every partnership, on or before the 15th day of the third month following the close of its taxable year, shall make a return for that taxable year, stating specifically the items of gross income and the deductions allowed by Part 10 (commencing with Section 17001). Except as otherwise provided in Section 18621.5, the return shall include the names, addresses, and taxpayer identification numbers of the persons, whether residents or nonresidents, who would be entitled to share in the net income if distributed and the amount of the distributive share of each person. The return shall contain or be verified by a written declaration that it is made under penalty of perjury, signed by one of the partners.

(2) In addition to returns required by paragraph (1), every limited partnership that is classified as a partnership pursuant to Section 23038 and which is subject to the tax imposed by subdivision (b) of Section 17935, on or before the 15th day of the third month following the close of its taxable year, shall make a return for that taxable year, containing the information identified in paragraph (1). In the case of a limited partnership not doing business in this state, the Franchise Tax Board shall prescribe the manner and extent to which the information identified in paragraph (1) shall be included with the return required by this paragraph.

(b) Each partnership required to file a return under subdivision (a) for any taxable year shall (on or before the day on which the return for that taxable year was required to be filed) furnish to each person who is a partner or who holds an interest in that partnership as a nominee for another person at any time during that taxable year a copy of the information required to be shown on that return as may be required by regulations.

(c) Any person who holds an interest in a partnership as a nominee for another person shall do both of the following:

(1) Furnish to the partnership, in the manner prescribed by the Franchise Tax Board, the name, address, and taxpayer identification number of that other person, and any other information for that taxable year as the Franchise Tax Board may by form and regulation prescribe.

(2) Furnish to that other person, in the manner prescribed by the Franchise Tax Board, the information provided by that partnership under subdivision (b).

(d) The provisions of Section 6031(d) of the Internal Revenue Code, relating to the separate statement of items of unrelated business taxable income, shall apply.

(e) The provisions of Section 6031(f) of the Internal Revenue Code, relating to electing investment partnerships, shall apply, except as otherwise provided.

(f) The amendments made to this section by the act adding this subdivision shall apply to returns for taxable years beginning on or after January 1, 2016.

(g) (1) Every limited partnership that has executed, acknowledged, and filed a certificate of limited partnership with the Secretary of State pursuant to Section 15621 or 15902.01 of the Corporations Code, and every foreign limited partnership that has registered with the Secretary of State pursuant to Section 15692 or 15909.01 of the Corporations Code, that is disregarded for tax purposes pursuant to Section 23038 shall file a return that includes information necessary to verify its liability under Section 17935, provides its sole owner's name and taxpayer identification number, and includes other information necessary for the administration of this part, Part 10 (commencing with Section 17001), or Part 11 (commencing with Section 23001).

(2) (A) Except as provided in subparagraph (B), the return required under paragraph (1) shall be filed on or before the 15th day of the fourth month after the close of the taxable year of the owner subject to tax under Part 10 (commencing with Section 17001) or Chapter 2 (commencing with Section 23101) of Part 11.

(B) In the event that the owner is an "S corporation," a partnership, or a limited liability company classified as a partnership for California tax purposes, the return required under paragraph (1) shall be filed on or before the 15th day of the third month after the close of the taxable year.

(3) For limited partnerships disregarded pursuant to Section 23038, "taxable year of the owner" shall be substituted for "taxable year" in Section 17935.

(h) The amendments made to this section by the act adding this subdivision shall apply to returns for taxable years beginning on or after January 1, 2020.

Amendment 2

Section 23038 of the Revenue and Taxation Code is amended to read:

23038 (a) "Corporation" includes every corporation except corporations expressly exempt from the tax by this part or the Constitution of this state.

(b) (1) For the purposes of the tax imposed under Chapter 3 (commencing with Section 23501), "corporation" also includes associations (including nonprofit associations that perform services, borrow money or own property), other than banking associations, and Massachusetts or business trusts. For the purposes of this part, a Massachusetts or business trust includes every business organization consisting essentially of an arrangement whereby property is conveyed to one, or more than one, trustee for purposes other than the mere conservation of assets, collecting and disbursing of fixed or periodic income, or the securing of an obligation. This paragraph shall apply for income or taxable years beginning before January 1, 1997.

(2) (A) For the purposes of the tax imposed under Chapter 3 (commencing with Section 23501), "corporation" also includes associations (other than banking associations but including nonprofit associations that perform services, borrow money or own property), business trusts, and other business entities classified as associations.

(B) (i) For purposes of the preceding subparagraph, the classification of a business entity (including a business trust) as an association taxable as a corporation (under Chapter 3 (commencing with Section 23501)) shall be determined under regulations of the Franchise Tax Board, that shall be consistent with federal regulations as in effect May 1, 2014, that classify a business entity as a partnership or an association taxable as a corporation or disregard the separate existence of certain business entities for tax purposes.

(ii) The classification of an eligible business entity as a partnership or an association taxable as a corporation for purposes of this part, Part 10 (commencing with Section 17001), and Part

10.2 (commencing with Section 18401) shall be the same as the classification of the entity for federal tax purposes.

(iii) If the separate existence of an eligible business entity is disregarded for federal tax purposes, the separate existence of that business entity shall be disregarded for purposes of this part, Part 10 (commencing with Section 17001), and Part 10.2 (commencing with Section 18401), other than Section 17935 (relating to the tax of a limited partnership), Section 17941 (relating to the tax of a limited liability company), Section 17942 (relating to the fee of a limited liability company), Section 18633 (relating to the return of a limited partnership), Section 18633.5 (relating to the return of a limited liability company), and Sections 17039 and 23036 (relating to tax credits).

(C) Notwithstanding clauses (ii) and (iii) of subparagraph (B), an eligible business entity that, for any income year beginning within the 60-month period preceding January 1, 1997, was properly classified as an association taxable as a corporation for California tax purposes shall continue to be an association taxable as a corporation until it elects, under regulations issued pursuant to subparagraph (B), to be classified or disregarded the same as the entity is classified or disregarded for federal tax purposes. The preceding sentence shall not apply to any entity that, during the 60-month period preceding January 1, 1997, was not doing business in this state, did not derive income from sources within this state, and had no owner who was a resident of this state.

(D) This paragraph shall apply for income or taxable years beginning on and after January 1, 1997.

(c) In addition to the above, for purposes of the tax imposed under Chapter 2 (commencing with Section 23101) for the purpose of exercising its franchise within this state, "corporation" also includes any limited liability company that is classified as an association for California tax purposes.

(d) "Corporation" includes any "corporation" operated by any receiver, liquidator, referee, trustee or other officers or agents appointed by any court, or an assignee for the benefit of creditors.

"Corporation" includes any professional corporation incorporated pursuant to Part 4 (commencing with Section 13400) of Division 3 of Title 1 of the Corporations Code.

(e) Notwithstanding the above, "corporation" also includes a trust organized and operated exclusively for purposes contained in Section 23701d.

(f) No provision of the act adding this subdivision shall be construed to alter existing law with respect to the civil liability of a limited liability company or its members.

(g) The amendments made to this section by the act adding this subdivision shall apply to returns for taxable years beginning on or after January 1, 2020.