ASSESSING THE STATE REVENUE IMPLICATIONS OF LIMITED LIABILITY COMPANY LEGISLATION

March, 1993

CALIFORNIA FRANCHISE TAX BOARD

Research Bureau

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EXECUTIVE SUMMARY

In this report, we have examined the state revenue implications of a draft proposal sponsored by the Business Law Section of the State Bar of California Partnership Committee in October of 1992. This proposed California Limited Liability Company (LLC) statute would permit the formation of LLCs in California.

The analysis indicates that state revenue losses would result from LLC recognition with an order of magnitude impact in the $250 million range cumulatively over an initial five-year period beginning in 1993. The specific estimates are summarized below by year and by type of business entity considered in the analysis.

Estimated Revenue Effects
(Amounts in $ Millions)

	1993	1994	1995	1996	1997	Totals
Limited Partnerships	-2.5	-5.3	-10.9	-10.5	-11.1	-40.3
General Partnerships	5.4	21.0	28.1	34.5	41.7	130.7
Subchapter S-Corp.	-2.7	-7.9	-18.4	-32.1	-40.6	-101.7
New C Corporations	-4.8	-10.9	-22.4	-28.2	-33.7	-100.2
Professional Corp.	-1.1	-3.9	-10.2	-15.7	-17.0	-47.9
Closely-Held Corp.	-2.9	-8.3	-21.8	-30.0	-31.7	-94.6
GRANDTOTALS	-8.7	-15.4	-55.5	-82.0	-92.4	-253.9

Despite the imposition of the minimum tax on LLCs, net revenue losses result due to overriding impacts attributed to the loss of corporate tax revenues and operating loss deductions that would be available to members of LLCs. The report concludes that estimated revenue losses are probably conservative in that corporate conversions were addressed in a limited manner and the issue of joint venture activity between corporations was considered too speculative to quantify.

Finally, we have assumed in the analysis that some taxpayers will be reluctant to use the LLC option because of uncertainty regarding continuation of favorable treatment as partnerships at the federal level. If the future of LLCs becomes more secure in this regard under federal law and the list of states recognizing LLCs continues to expand, actual revenue losses may exceed the above estimates and continue to increase beyond 1997.

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INTRODUCTION

The Research Bureau has been asked to assess the revenue implications of state legislation that would recognize Limited Liability Companies (LLCs) as an alternative business entity form in California. Succinctly stated, LLCs combine the corporate characteristic of limited liability protection for its members (at least two) with the organizational flexibility and tax attributes of a partnership. In states where such entities currently exist, statutes have been carefully drafted which ensure that LLCs cannot be classified as corporations for tax purposes. That is, LLCs cannot possess more than two attributes of the four ascribed to corporations (i.e., continuity of life, centralized management, liability for corporate debts limited to corporate property, and free transferability of interests). This position has resulted in a partnership classification of the new entity for federal tax purposes.

In March of 1992, the Research Bureau completed a revenue analysis for LLC recognition that covered an initial two-year period (i.e., 1993 and 1994). That analysis was subsequently expanded (report dated June 1, 1992) to cover a five-year period (i.e., 1993 through 1997). Additional industries were included at that time, and some adjustments were made to underlying data.

The five-year analysis that follows represents our updated version of the June 1, 1992 report. Modifications include the following:

- A new base-year for tax data on business entities (1990) and revised growth rates for out-year projections.

- Imposition of the $800 minimum tax on LLCs.

- Inclusion of general partnerships due to applicability of the minimum tax.

- Extension of the LLC option to professional organizations.

- Consideration of other personal service and closely-held corporations converting to LLC status.

- Allowance for liquidation gain revenue that may result from corporate conversions.

- A modified assumption regarding additional deductions by owners for operating losses of limited partnerships converting to LLCs which has the effect of reducing revenue losses for this issue.

- Modified assumptions for LLC usage by newly formed C and S corporations.

ANALYSIS

Based on our understanding of the most significant tax and nontax features of LLC status, our revenue-estimating methodology included (1) evaluating current business entity types operating in California in terms of the likelihood of LLC usage either as a new, startup business or through a conversion of an existing operation; (2) creating statistical profiles of the net income/loss characteristics of these current business entities; (3) estimating utilization patterns of LLC status that might occur in 1993 through 1997; and (4) applying the tax data profiles to the projected group of LLCs and comparing the tax consequences before and after LLC treatment at both the entity and owner levels.

The following business entities were selected for the revenue analysis:

- Limited and General Partnerships
- Subchapter S corporations
- C corporations (specified categories)

General partnerships were not considered previously because we concluded that distributed income and losses reported by members would be virtually the same as LLC's, and limitations on the deductibility of losses due to basis and passive loss rules would be similar. However, since the minimum tax would now apply to LLC's,we have included these entities in this analysis since many would become LLC's because of limited liability protection and pay the minimum tax.

By considering Subchapter S entities (new and continuing) and new C corporations as possible candidates for LLC classification, we are acknowledging the organizational flexibility that can be applied to meet LLC specifications and avoid a corporate classification. The impact from preexisting C corporations reorganizing in a manner that fully meets LLC specifications and avoids the reporting of significant liquidation gains is more uncertain. In this updated analysis, we have included the potential for C corporate conversions by focusing on professional corporations and other closely-held corporations. While professional corporations can be identified on the tax return through industry codes, other closely-held corporations are not specifically identified. In order to approximate this universe for the analysis, we have selected corporations doing business only in California (i.e. nonapportioning) and classified in certain industries as explained in Section II. The other consideration pertaining to corporations is the use of LLCs for joint venture arrangements which is discussed in the Summary.

The analysis is divided into three sections:

- Section I provides net income/net loss tax profile data for current business entities (except general partnerships) arrayed by industry. These profiles reflect tax return characteristics for the 1990 base year and projections for 1993 through 1997. With regard to general partnerships, where the principal revenue issue is the minimum tax, a distribution of the number of such entities by industry and asset size is provided.

- Section II provides a summary of principal revenue issues and our assumptions regarding the rate of LLC usage for existing firms converting and new firms starting up as LLCs in 1993 through 1997.

- Section III shows the derivation of the estimated state revenue effects at both the entity and owner levels for the projected years. The revenue estimates are based on the projected net income and net loss profiles in Section I combined with the utilization assumptions in Section II. In addition, revenues derived from the minimum tax on general partnerships converting to LLC status are included. Footnotes follow the Section.

The revenue estimates resulting from the analysis are summarized on page 32. Despite the imposition of the minimum tax on LLC's, revenue losses are still projected over the five-year period although at lower levels. Assumptions regarding LLC usage in the first year (1993) allow for delayed enactment in 1993.

SECTION I

NET INCOME / NET LOSS PROFILES

SECTION I
LIMITED PARTNERSHIPS
NET INCOME/NET LOSS PROFILES
Base Year 1990 and Projections for 1993 - 1997

(Amounts in $ Millions)

INDUSTRIES		Oil and Gas	Manufactur.	Real Estate	Services	Subtotals	All Other	Totals
1990 - ACTUAL :								
NET INCOME	Number	321	131	1,611	1,079	3,142	2,029	5,171
	Amount	35	63	767	392	1,257	769	2,025
NET LOSS	Number	322	249	21,964	2,233	24,768	25,656	50,424
	Amount	20	66	677	664	1,427	878	2,305
Totals	Number	643	380	23,575	3,312	27,910	27,685	55,595
	Amount	16	-3	90	-272	-170	-110	-280
1993 - PROJECTION :								
NET INCOME	Number	256	105	1,286	862	2,509	1,620	4,129
	Amount	26	46	563	287	922	564	1,486
NET LOSS	Number	306	237	20,864	2,121	23,527	24,371	47,898
	Amount	15	48	497	487	1,047	645	1,692
Totals	Number	562	341	22,150	2,983	26,036	25,991	52,027
	Amount	11	-2	66	-200	-125	-81	-206
1994 - PROJECTION :								
NET INCOME	Number	264	108	1,325	887	2,583	1,669	4,252
	Amount	28	50	608	310	996	609	1,605
NET LOSS	Number	312	241	21,281	2,164	23,998	24,858	48,856
	Amount	16	51	529	519	1,114	686	1,800
Totals	Number	576	349	22,606	3,051	26,581	26,527	53,108
	Amount	13	-2	79	-208	-118	-77	-195

Note: - Projected income and losses for 1993 - 97 take into account the latest state forecasts of corporate and proprietor's income.
- Detail may not add to totals because of rounding.

SECTION I
LIMITED PARTNERSHIPS
NET INCOME/NET LOSS PROFILES
Base Year 1990 and Projections for 1993 - 1997

(Amounts in $ Millions)

INDUSTRIES		Oil and Gas	Manufactur.	Real Estate	Services	Subtotals	All Other	Totals
1995 - PROJECTION :								
NET INCOME -	Number	269	110	1,351	905	2,635	1,702	4,337
	Amount	31	55	668	342	1,096	670	1,766
NET LOSS -	Number	318	246	21,707	2,207	24,478	25,355	49,833
	Amount	17	56	573	562	1,207	743	1,949
Totals -	Number	588	356	23,058	3,112	27,113	27,057	54,170
	Amount	14	-1	96	-220	-111	-73	-184
1996 - PROJECTION :								
NET INCOME -	Number	275	112	1,378	923	2,688	1,736	4,424
	Amount	34	60	735	376	1,205	737	1,942
NET LOSS -	Number	325	251	22,141	2,251	24,967	25,862	50,830
	Amount	18	60	620	608	1,306	804	2,110
Totals -	Number	599	363	23,519	3,174	27,655	27,599	55,253
	Amount	16	0	115	-232	-101	-67	-168
1997 - PROJECTION :								
NET INCOME -	Number	280	114	1,406	942	2,742	1,771	4,513
	Amount	37	66	809	413	1,326	811	2,136
NET LOSS -	Number	331	256	22,584	2,296	25,467	26,380	51,846
	Amount	20	65	673	660	1,418	873	2,291
Totals -	Number	611	370	23,990	3,238	28,209	28,151	56,360
	Amount	18	1	136	-247	-92	-62	-155
GRAND TOTALS (1993-97) :								
NET INCOME -	Number	1,344	549	6,747	4,519	13,160	8,498	21,658
	Amount	156	278	3,383	1,728	5,545	3,391	8,936
NET LOSS -	Number	1,592	1,231	108,576	11,038	122,437	126,826	249,263
	Amount	85	281	2,891	2,836	6,093	3,751	9,843
Totals -	Number	2,936	151,860	115,323	15,558	135,596	135,324	270,921
	Amount	71	-3	492	-1107	-548	-360	-907

SECTION I
GENERAL PARTNERSHIPS
NUMBER by REPORTED ASSET SIZE
Base Year 1990 and Projection for 1993 - 1997

TOTAL ASSETS RANGES	LEGAL SERVICES	HEALTH & OTHER PROF.SERVICES	ALL OTHER SERV. & INDUSTRIES	TOTAL	% of TOTAL
1990 - ACTUAL :					
Less than $49,999	1,576	3,058	115,609	120,243	64.81
$50,000 to $99,999	417	808	11,109	12,334	6.65
$100,000 to $499,999	606	1,175	27,043	28,824	15.54
$500,000 to $999,999	98	189	9,227	9,514	5.13
$1,000,000 and over	117	227	14,262	14,606	7.87
Totals	2,814	5,457	177,250	185,521	100.00
1993 - PROJECTION :					
Less than $49,999	1,503	2,917	110,286	114,707	
$50,000 to $99,999	398	771	10,598	11,766	
$100,000 to $499,999	578	1,121	25,798	27,497	
$500,000 to $999,999	93	180	8,802	9,076	
$1,000,000 and over	112	217	13,605	13,934	
Totals	2,684	5,206	169,089	176,980	

NOTE : - HEALTH & OTHER PROF.SERVICES represent all health-related services and other professional services (accounting, auditing, consulting, engineering and architectural).
- Numbers, projected for 1993 - 1997, reflect a recession and recovery during period 1991 - 1995; the annual growth for 1996 and 1997 is 2%.
- Detail may not add to totals because of rounding.

SECTION I
GENERAL PARTNERSHIPS
NUMBER by REPORTED ASSET SIZE
Base Year 1990 and Projection for 1993 - 1997

TOTAL ASSETS RANGES	LEGAL SERVICES	HEALTH & OTHER PROF.SERVICES	ALL OTHER SERV. & INDUSTRIES	TOTAL
1994 - PROJECTION :				
Less than $49,999	1,534	2,976	112,492	117,001
$50,000 to $99,999	406	786	10,809	12,001
$100,000 to $499,999	590	1,143	26,314	28,047
$500,000 to $999,999	95	184	8,978	9,257
$1,000,000 and over	114	221	13,877	14,212
Totals	2,738	5,310	172,471	180,519
1995 - PROJECTION :				
Less than $49,999	1,564	3,035	114,742	119,341
$50,000 to $99,999	414	802	11,026	12,241
$100,000 to $499,999	601	1,166	26,840	28,608
$500,000 to $999,999	97	188	9,158	9,443
$1,000,000 and over	116	225	14,155	14,496
Totals	2,793	5,416	175,921	184,130
1996 - PROJECTION :				
Less than $49,999	1,595	3,096	117,037	121,728
$50,000 to $99,999	422	818	11,246	12,486
$100,000 to $499,999	613	1,190	27,377	29,180
$500,000 to $999,999	99	191	9,341	9,631
$1,000,000 and over	118	230	14,438	14,786
Totals	2,849	5,524	179,439	187,812
1997 - PROJECTION :				
Less than $49,999	1,627	3,158	119,378	124,163
$50,000 to $99,999	431	834	11,471	12,736
$100,000 to $499,999	626	1,213	27,925	29,764
$500,000 to $999,999	101	195	9,528	9,824
$1,000,000 and over	121	234	14,727	15,082
Totals	2,906	5,635	183,028	191,568

SECTION I
SUBCHAPTER S-CORPORATIONS
NET INCOME/NET LOSS PROFILES
Base Year 1990 and Projections for 1993 - 1997

(Amounts in $ Millions)

INDUSTRIES	Oil & Gas	Manufact.	Real Est.	Services	Subtotals	All Other	Totals
1990 - ACTUAL :							
NEW ENTITIES :							
Net Income - Number	8	222	305	1,083	1,619	1,132	2,751
- Amount	2	24	14	40	79	52	132
Net Loss - Number	13	596	863	1,905	3,377	2,644	6,021
- Amount	4	44	46	114	208	124	332
CONTINUING ENT.:							
Net Income - Number	101	4,008	4,011	12,958	21,078	16,036	37,114
- Amount	17	1,681	1,291	1,292	4,280	3,795	8,075
Net Loss - Number	94	2,919	4,608	9,384	17,005	12,939	29,944
- Amount	9	466	614	669	1,759	1,283	3,042
SUBTOTALS :							
Net Income - Number	110	4,230	4,316	14,042	22,697	17,168	39,865
- Amount	19	1,705	1,304	1,332	4,360	3,847	8,207
Net Loss - Number	107	3,514	5,471	11,289	20,382	15,583	35,965
- Amount	12	510	661	783	1,966	1,408	3,374
1993 - PROJECTION :							
NEW ENTITIES :							
Net Income - Number	9	244	335	1,188	1,775	1,241	3,016
- Amount	1	19	11	31	62	41	103
Net Loss - Number	16	718	1,039	2,294	4,068	3,184	7,252
- Amount	3	34	36	89	162	97	259
CONTINUING ENT.:							
Net Income - Number	111	4,394	4,397	14,208	23,111	17,582	40,693
- Amount	14	1,307	1,004	1,005	3,329	2,952	6,281
Net Loss - Number	114	3,515	5,551	11,304	20,484	15,586	36,070
- Amount	7	363	478	520	1,367	998	2,365
SUBTOTALS :							
Net Income - Number	120	4,638	4,732	15,396	24,886	18,823	43,709
- Amount	15	1,326	1,014	1,036	3,391	2,993	6,384
Net Loss - Number	130	4,233	6,590	13,598	24,552	18,770	43,322
- Amount	10	396	514	609	1,529	1,095	2,624

Note: - Projected income and losses for 1993 - 97 take into account the latest state forecasts of corporate and proprietor's income.
- Detail may not add to totals because of rounding.

SECTION I
SUBCHAPTER S-CORPORATIONS
NET INCOME/NET LOSS PROFILES
Base Year 1990 and Projections for 1993 - 1997

(Amounts in $ Millions)

INDUSTRIES	Oil & Gas	Manufact.	Real Est.	Services	Subtotals	All Other	Totals
1994 - PROJECTION :							
NEW ENTITIES :							
Net Income - Number	9	251	345	1,223	1,828	1,278	3,106
- Amount	1	20	12	33	66	44	110
Net Loss - Number	16	754	1,091	2,409	4,270	3,344	7,614
- Amount	3	34	36	89	163	97	260
CONTINUING ENT.:							
Net Income - Number	114	4,526	4,529	14,634	23,804	18,110	41,914
- Amount	15	1,398	1,074	1,076	3,562	3,158	6,721
Net Loss - Number	120	3,691	5,828	11,869	21,508	16,365	37,873
- Amount	8	453	597	650	1,708	1,246	2,954
SUBTOTALS :							
Net Income - Number	123	4,777	4,874	15,857	25,632	19,388	45,020
- Amount	16	1,419	1,085	1,109	3,629	3,202	6,831
Net Loss - Number	136	4,445	6,919	14,278	25,779	19,709	45,488
- Amount	11	487	633	739	1,870	1,343	3,214
1995 - PROJECTION :							
NEW ENTITIES :							
Net Income - Number	9	259	355	1,260	1,883	1,317	3,200
- Amount	1	22	13	36	72	48	120
Net Loss - Number	17	791	1,146	2,529	4,484	3,511	7,994
- Amount	3	37	39	96	176	105	281
CONTINUING ENT.:							
Net Income - Number	118	4,662	4,665	15,073	24,518	18,653	43,171
- Amount	16	1,524	1,170	1,173	3,883	3,442	7,326
Net Loss - Number	126	3,876	6,120	12,463	22,584	17,183	39,767
- Amount	9	504	664	724	1,901	1,387	3,288
SUBTOTALS :							
Net Income - Number	127	4,921	5,020	16,333	26,401	19,969	46,371
- Amount	17	1,547	1,183	1,209	3,955	3,490	7,446
Net Loss - Number	143	4,667	7,265	14,992	27,069	20,694	47,763
- Amount	12	541	703	820	2,076	1,492	3,569

SECTION I
SUBCHAPTER S-CORPORATIONS
NET INCOME/NET LOSS PROFILES
Base Year 1990 and Projections for 1993 - 1997

(Amounts in $ Millions)

INDUSTRIES	Oil & Gas	Manufact.	Real Est.	Services	Subtotals	All Other	Totals
1996 - PROJECTION :							
NEW ENTITIES :							
Net Income - Number	10	272	373	1,323	1,977	1,382	3,360
- Amount	1	24	14	39	79	52	131
Net Loss - Number	18	831	1,203	2,655	4,708	3,686	8,394
- Amount	3	40	42	104	189	113	302
CONTINUING ENT.:							
Net Income - Number	124	4,895	4,898	15,827	25,744	19,586	45,330
- Amount	17	1,661	1,276	1,278	4,233	3,752	7,985
Net Loss - Number	132	4,070	6,425	13,086	23,713	18,043	41,756
- Amount	11	566	746	813	2,135	1,558	3,693
SUBTOTALS :							
Net Income - Number	133	5,167	5,271	17,150	27,722	20,968	48,690
- Amount	18	1,686	1,290	1,317	4,311	3,804	8,116
Net Loss - Number	150	4,900	7,629	15,741	28,422	21,729	50,151
- Amount	14	606	788	916	2,324	1,671	3,995
1997 - PROJECTION :							
NEW ENTITIES :							
Net Income - Number	10	285	392	1,389	2,076	1,452	3,528
- Amount	1	27	15	43	86	57	143
Net Loss - Number	19	872	1,263	2,788	4,943	3,871	8,814
- Amount	4	42	45	111	202	121	323
CONTINUING ENT.:							
Net Income - Number	130	5,140	5,143	16,618	27,031	20,565	47,596
- Amount	19	1,811	1,391	1,393	4,613	4,090	8,703
Net Loss - Number	138	4,273	6,747	13,740	24,899	18,945	43,843
- Amount	12	640	843	918	2,413	1,761	4,174
SUBTOTALS :							
Net Income - Number	140	5,425	5,535	18,007	29,108	22,016	51,124
- Amount	20	1,837	1,406	1,436	4,699	4,147	8,846
Net Loss - Number	157	5,145	8,010	16,529	29,843	22,815	52,658
- Amount	15	682	888	1,029	2,615	1,882	4,497

SECTION I
NEW C CORPORATIONS (excl.Profess.)
NET INCOME/NET LOSS PROFILES
Base Year 1990 and Projections for 1993 - 1997

(Amounts in $ Millions)

INDUSTRIES	Oil and Gas	Manufactur.	Real Estate	Services	Subtotal	All Other	Totals
1990 - ACTUALS :							
Net Income - Number	15	479	464	1,482	2,440	1,855	4,295
- Amount	1	76	14	38	128	68	197
Net Loss - Number	66	2,345	2,327	6,122	10,860	25,366	36,226
- Amount	3	263	43	144	452	316	768
Totals - Number	81	2,824	2,791	7,604	13,300	27,221	40,521
- Amount	-3	-187	-29	-106	-324	-248	-571
1993 - PROJECTION :							
Net Income-Number	12	379	367	1,172	1,929	1,466	3,395
-Amount	0	64	11	32	107	57	164
Net Loss -Number	52	1,854	1,839	4,839	8,585	20,052	28,636
-Amount	3	218	36	120	376	263	639
Totals - Number	64	2,232	2,206	6,011	10,514	21,518	32,032
- Amount	-2	-155	-24	-88	-269	-206	-475
1994 - PROJECTION :							
Net Income-Number	12	382	370	1,183	1,948	1,481	3,429
-Amount	0	67	12	33	114	60	174
Net Loss -Number	53	1,872	1,858	4,888	8,672	20,252	28,924
-Amount	3	216	35	118	371	260	631
Totals - Number	65	2,255	2,228	6,071	10,620	21,733	32,353
- Amount	-2	-149	-23	-85	-258	-200	-457
1995 - PROJECTION :							
Net Income-Number	12	390	378	1,207	1,987	1,511	3,498
-Amount	0	73	13	37	124	66	190
Net Loss -Number	54	1,910	1,895	4,986	8,845	20,657	29,502
-Amount	3	233	38	127	400	280	680
Totals - Number	66	2,300	2,273	6,192	10,832	22,168	33,000
- Amount	-2	-159	-25	-90	-276	-214	-490

Note : - Projected income and losses for 1993 - 97 take into account the latest state forecasts of corporate and proprietor's income.
- Detail may not add to totals because of rounding.

SECTION I

NEW C CORPORATIONS (excl.Profess.)

NET INCOME/NET LOSS PROFILES

Base Year 1990 and Projections for 1993 - 1997

(Amounts in $ Millions)

INDUSTRIES	Oil and Gas	Manufactur.	Real Estate	Services	Subtotal	All Other	Totals
1996 - PROJECTION :							
Net Income-Number	12	398	385	1,231	2,027	1,541	3,568
-Amount	1	81	15	40	136	73	209
Net Loss -Number	55	1,948	1,933	5,085	9,021	21,070	30,091
-Amount	3	250	41	137	430	300	730
Totals - Number	67	2,346	2,318	6,316	11,048	22,611	33,659
- Amount	-2	-169	-26	-96	-293	-228	-521
1997 - PROJECTION :							
Net Income-Number	13	406	393	1,256	2,067	1,572	3,639
-Amount	1	89	16	44	150	80	230
Net Loss -Number	56	1,987	1,972	5,187	9,201	21,492	30,693
-Amount	3	266	43	146	459	321	779
Totals - Number	69	2,393	2,365	6,443	11,269	23,063	34,332
- Amount	-3	-177	-27	-101	-309	-241	-549

SECTION I
C-CORPORATIONS - PROFESSIONALS
NET INCOME/NET LOSS PROFILES
Base Year 1990 and Projections for 1993 - 1997

(Amounts in $ Millions)

	New Entities	Continuing Entities	Total		New Entities	Continuing Entities	Total
1990 - ACTUAL :				**1995 - PROJECTION:**			
Net Income - #	101	20,270	20,371	Net Income - #	82	16,507	16,589
- $	0.9	773.6	774.5	- $	0.8	747.1	747.8
Net Loss - #	145	13,188	13,333	Net Loss - #	118	10,740	10,858
- $	5.3	431.3	436.6	- $	5.5	451.5	457.0
1993 - PROJECTION:				**1996 - PROJECTION:**			
Net Income - #	80	16,023	16,103	Net Income - #	84	16,837	16,921
- $	0.7	646.8	647.5	- $	0.9	821.8	822.6
Net Loss - #	115	10,425	10,540	Net Loss - #	121	10,955	11,075
- $	4.4	360.6	365.0	- $	6.2	506.8	513.0
1994 - PROJECTION:				**1997 - PROJECTION:**			
Net Income - #	81	16,183	16,264	Net Income - #	86	17,174	17,260
- $	0.7	679.1	679.8	- $	0.9	903.9	904.9
Net Loss - #	116	10,529	10,645	Net Loss - #	123	11,174	11,297
- $	4.9	403.1	408.0	- $	7.0	571.0	578.0

Note: - Projected income and losses for 1993 - 97 take into account the latest state forecasts of corporate and proprietor's income.
- Detail may not add to totals because of rounding.

SECTION I

C-CORPORATIONS - CLOSELY-HELD (Approximated)

Continuing Non-Apportioning Entities(Excl.Profess.)

NET INCOME/NET LOSS PROFILES

Base Year 1990 and Projections for 1993 - 1997

(Amounts in $ Millions)

INDUSTRIES	Construct	Fin.&Ins. Services	Real Estate	Subtotal F.I.R.E.	Personal Services	Business Services	Other Services	Subtotal Services	Total
1990 - APPROX.:									
Net Income - #	9,000	2,500	7,800	10,300	900	7,500	5,000	13,400	32,700
- $	342	95	297	392	34	285	190	509	1,243
Net Loss - #	7,800	2,200	7,300	9,500	850	7,500	5,200	13,550	30,850
- $	255	72	239	311	28	246	170	444	1,010
1993 - PROJECTION:									
Net Income - #	7,114	1,976	6,166	8,142	711	5,929	3,952	10,593	25,849
- $	286	79	248	327	29	238	159	426	1,040
Net Loss - #	6,166	1,739	5,771	7,510	672	5,929	4,111	10,711	24,387
- $	213	60	200	260	23	205	142	371	844
1994 - PROJECTION:									
Net Income - #	7,186	1,996	6,227	8,223	719	5,988	3,992	10,698	26,108
- $	300	83	260	344	30	250	167	447	1,091
Net Loss - #	6,227	1,756	5,828	7,585	679	5,988	4,152	10,818	24,630
- $	229	64	214	278	25	220	152	397	904
1995 - PROJECTION:									
Net Income - #	7,329	2,036	6,352	8,388	733	6,108	4,072	10,912	26,630
- $	330	92	286	378	33	275	184	492	1,201
Net Loss - #	6,352	1,792	5,945	7,736	692	6,108	4,235	11,035	25,123
- $	253	71	236	308	28	243	168	439	999
1996 - PROJECTION:									
Net Income - #	7,476	2,077	6,479	8,556	748	6,230	4,153	11,131	27,162
- $	363	101	315	416	36	303	202	541	1,321
Net Loss - #	6,479	1,827	6,064	7,891	706	6,230	4,319	11,255	25,626
- $	280	79	262	341	31	269	187	486	1,107
1997 - PROJECTION:									
Net Income - #	7,625	2,118	6,609	8,727	763	6,354	4,236	11,353	27,706
- $	400	111	347	458	40	333	222	595	1,453
Net Loss - #	6,609	1,864	6,185	8,049	720	6,354	4,406	11,480	26,138
- $	310	88	290	378	34	298	207	539	1,227

Note: - Projected income and losses for 1993 - 97 take into account the latest state forecasts of corporate and proprietor's income.
Approximated data only based on assumptions described in Section II.
- Detail may not add to totals because of rounding.

SECTION II

IDENTIFIED REVENUE ISSUES

and

ASSUMPTIONS FOR LLC USAGE

SECTION II

IDENTIFIED REVENUE ISSUES AND ASSUMPTIONS FOR LLC USAGE

Limited Partnerships

Principal Revenue Effects

- Enhanced ability to qualify current-year distributive share losses as nonpassive and more fully deductible by members. Revenue losses attributed to this issue have been reduced relative to prior analyses as reflected in Section III.

- Distributive share net income /losses to members not materially different.

Assumptions for Utilization Rates

For industries specified in Section I, the assumed rates of LLC utilization over the five-year period beginning in 1993 are as follows: 10%; 20%; 40%; 45%; and 50%.

For all other industries, the assumed rates are:
1%; 5%; 10%; 15%; and 20%.

LLC status would permit a higher level of material participation on the part of members without the risk of forfeiting limited liability protection. For this reason, we are recognizing an increase in loss passthrough deductions by investors for the year of loss. In subsequent years, we have allowed for the eventual write-off of these same losses under current law by means of generated passive income or complete dispositions.

For converting entities reporting net income rather than net losses, we are assuming that the tax implications to the owners would not be materially different.

SECTION II

IDENTIFIED REVENUE ISSUES AND ASSUMPTIONS FOR LLC USAGE

General Partnerships

Principal Revenue Effects

- Subject to annual $800 minimum tax as LLC.
- Distributive share net income/losses to members not materially different.
- Limited liability protection for all members.

Assumptions for Utilization Rates

Section I tables provide distributions of general partnerships by asset category and industry. The use of asset categories provides an indicator of size and ability to absorb the minimum tax. While the value assigned to limited liability protection can vary by type of business due to differences in actual or perceived risks, the legal and other costs associated with converting and the annual minimum tax (currently $800) would discourage many smaller, lower income firms from converting. Conversely, the larger the business operation, the greater the probability of LLC usage to gain limited liability protection.

Whether the determinant for size is reported assets or gross receipts, the majority of general partnerships represent small-scale operations. The Section I table for 1990 (Actual) reveals that six out of every ten general partnerships have business assets of less than $50,000.

The assumed rates of LLC utilization over the five-year period beginning in 1993 are as follows:

Legal Services:	5%;	50%;	75%;	90%;	and 99%.
Health and **Other Prof.Services:**					
	1%;	5%;	5%;	10%;	and 20%.
Other Services and **Industries:**					
Assets < $50,000 ...	2.5%;	10%;	10%;	10%;	and 10%.
$50,000 - $99,999 ...	5%;	10%;	15%;	20%;	and 25%.
$100,000 - $499,999 ...	5%;	15%;	25%;	35%;	and 50%.
$500,000 - $999,999 ...	7.5%;	25%;	40%;	55%;	and 75%.
$1,000,000 and over ...	10%;	50%;	70%;	90%;	and 95%.

Regarding assumptions for professional entities, these levels of LLC usage allow for some delay and/or possible limitations regarding the LLC option in the Business and Professional Code or by professional regulatory authorities. For example, the issue of vicarious liability protection may not be forthcoming for medical-related and accounting professions.

Uncertainties regarding subsequent federal determinations pertaining to LLC's (e.g. recognition as corporations rather than partnerships) will, to some extent, limit the frequency of conversions.

SECTION II

IDENTIFIED REVENUE ISSUES AND ASSUMPTIONS FOR LLC USAGE

Subchapter S Corporations

Principal Revenue Effects

- Except for the minimum tax, avoidance of the corporate level tax (2.5 percent of taxable income) and the tax on net passive investment income and built-in gains (9.3 percent). Entities with operating losses would have qualified for NOL carryover deductions as S-corporations.

- Greater flexibility on the part of the entity to allocate income/losses among members of an LLC.

- For continuing entities contemplating conversion, the possible tax implications pertaining to realization of liquidation gains would be a factor.

Assumptions for Utilization Rates

The assumed rates of LLC utilization over the five-year period beginning in 1993 are as follows:

New Entities -	25%;	50%;	90%;	90%; and	90%.
Continuing Entities -					
Specified Industries	5%;	10%;	20%;	30%; and	30%.
All Other Industries (beginning in 1994)		1%;	5%;	10%; and	10%.

Rates for new entities are high to reflect several advantages of LLC status such as the ease of business formation and the flexibility regarding the number and type of owners (e.g. corporations, foreign investors).

For continuing entities the possibility of realizing significant liquidation gains and built-in gains are impediments to conversion. In this analysis we have made allowance for revenue gains resulting from liquidation gains for those entities that convert. For both new and continuing entities we have allowed for nonqualified, single-member operations.

SECTION II

IDENTIFIED REVENUE ISSUES AND ASSUMPTIONS FOR LLC USAGE

New C Corporations (excl.Profess.)

Principal Revenue Effects

- Except for the minimum tax, avoidance of the corporate level measured tax (9.3 percent of taxable income). Entities with operating losses would have qualified for NOL carryover deductions as corporations.

- Operating losses would flow through to owners rather than a 50 percent NOL to the entity.

- The issue of General Utilities repeal is avoided.

- For profitable entities, owners would have additional income to report, essentially what would have been retained earnings.

- Nonresident owners will have California-source income to report.

Assumptions for Utilization Rates

This category (newly-formed corporations) represents the only group of C corporations considered in prior analyses.

For all industries, the assumed rates of LLC utilization over the five-year period beginning in 1993 are as follows:

10%; 20%; 40%; 50%; and 60%.

Rates for the last three years are somewhat higher than prior analyses, and no distinction is made between industries. We have given more weight to the advantages listed above and additionally have allowed for the creation of separate entities as LLCs rather than as corporate subsidiaries.

We have also considered the issue of new entities not electing LLC status in California due to multistate operations in states where LLCs are not authorized.

SECTION II
IDENTIFIED REVENUE ISSUES AND ASSUMPTIONS FOR LLC USAGE
Professional C Corporations

Principal Revenue Effects

- Same as for new C corporations. An additional issue is introduced for continuing entities regarding the effects of possible taxation on liquidation gains.

Assumptions for Utilization Rates

Both new and continuing professional corporations are now considered in the analysis. LLC utilization rates were assigned after taking into account the issue of liquidation gains and the frequency of single-member corporations.

New firms - For all professional categories, the assumed rates are 10%, 20%, and 30% thereafter over the five-year period. The advantages listed for new C corporations have been considered in conjunction with the single-member issue. Based on limited information, we have assumed that 60% of professional corporations have a single-member practitioner.

Continuing firms - For all professional corporations conversion rates would range from 5% in the first year to 10% in the second and 25% in subsequent years to 1997. We have considered the issue of liquidation gains and single-member corporations.

SECTION II
IDENTIFIED REVENUE ISSUES AND ASSUMPTIONS FOR LLC USAGE
Other Closely-Held C Corporations

Principal Revenue Effects

- Same as for new C corporations. An additional issue is introduced for continuing entities regarding the effects of possible taxation on liquidation gains.

Assumptions for Utilization Rates

Since the analysis has been expanded to include professional corporations, we have also considered the appeal of LLC status to other closely-held corporations which were excluded previously (i.e. continuing entities).

In order to approximate this group of corporations, we have compiled data on nonapportioning corporations in the following industries: construction, financial services (other than institutions), services (other than professionals), and real estate. The data is for continuing firms only since the original analysis included all newly-formed corporations (except professionals). The occurrence of closely-held operations is probably more frequent in the above industries.

It is acknowledged that a significant number of firms in these industries are not closely-held. The statutory definition of a closely-held firm is stock ownership exceeding 50% by no more than five individuals.

For this analysis we have assumed that every other entity (50%) could qualify as closely-held and that average net income or losses would be the lesser of average income/loss for those industries or for professional corporations. This constraint on reported income allows for the control owners have in minimizing income exposure at the corporate level.

For continuing entities so approximated as closely-held, assumed conversion rates over the five-year period are as follows :

5%; 10%; 25%; 25%; and 25%.

These rates are identical to rates for continuing professional corporations over the time period. In this analysis we have allowed for revenue gains from reported liquidations by converting entities.

SECTION III

DERIVATION OF REVENUE ESTIMATES

SECTION III
LIMITED PARTNERSHIPS
Derivation of Revenue Estimates
Projections for 1993 - 1997

(Amounts in $ Millions)

	1993	1994	1995	1996	1997	Total
LLC Utilization (Sect.II)						
Group 1 Entities	10%	20%	40%	45%	50%	
Group 2 Entities	1%	5%	10%	15%	20%	
REVENUE EFFECTS (Comb.Sect.I & II):						
Additional loss deductions by owners (utilization rate x total net losses x 25% new deductions x marginal tax rate)						
Group 1	2.36	5.01	10.86	11.75	14.18	44.17
Offset *		0.47	1.47	3.24	5.59	10.77
Group 2	0.15	0.77	1.67	2.41	3.49	8.49
Offset *		0.03	0.18	0.46	0.94	1.61
TOTAL IMPACT (Loss)	2.50	5.28	10.88	10.47	11.14	40.28

Note : - The offset * represents the eventual write-off of these same losses under current law through generated passive income or complete dispositions.
- The utilization percentage for each year reflects the cumulative population of LLCs for that year.
- See footnotes on page 33 for other explanations.

SECTION III
GENERAL PARTNERSHIPS
Derivation of Revenue Estimates
Projections for 1993 - 1997

(Amounts in $ Millions)

	1993	1994	1995	1996	1997	Total
LLC Utilization (Sect.II)						
- Legal Services	5%	50%	75%	90%	99%	
- Health & Other Prof.Services	1%	5%	5%	10%	20%	
- All Other Services & Industr.						
with Assets < $49,999	2.5%	10%	10%	10%	10%	
$50,000 to $99,999	5%	10%	15%	20%	25%	
$100,000 to $499,999	5%	15%	25%	35%	50%	
$500,000 to $999,999	7.5%	25%	40%	55%	75%	
$1,000,000 and over	10%	50%	75%	90%	95%	
REVENUE EFFECTS (Comb.Sect.I & II):						
Gain from LLC minimum tax (Utilization rate x number of entities x $800)						
- Legal Services	0.11	0.38	0.60	0.76	0.88	2.71
- Health & Other Prof.Services	0.04	0.21	0.22	0.44	0.90	1.81
- All Other Services & Industr.						
with Assets < $49,999	2.21	9.00	9.18	9.36	9.55	39.30
$50,000 to $99,999	0.42	0.86	1.32	1.80	2.29	6.71
$100,000 to $499,999	1.03	3.16	5.37	7.67	11.17	28.39
$500,000 to $999,999	0.53	1.80	2.93	4.11	5.72	15.08
$1,000,000 and over	1.09	5.55	8.49	10.40	11.19	36.72
TOTAL IMPACT (Gain)	5.43	20.96	28.11	34.53	41.70	130.72

Note : - The utilization percentage for each year reflects the cumulative population of LLCs for that year.
- See footnotes on page 33.

SECTION III
SUBCHAPTER S-CORPORATIONS
Derivation of Revenue Estimates
Projections for 1993 - 1997

(Amounts in $ Millions)

	1993	1994	1995	1996	1997	Totals
LLC Utilization (Sect.II)						
- New Entities	25%	50%	90%	90%	90%	
- Continuing Ent.- Group 1	5%	10%	20%	30%	30%	
- Group 2	minor	1%	5%	10%	10%	
REVENUE EFFECTS (Comb. Sect I and II):						
1. Loss of corp. level tax (except min.tax): (Utilization rates for new and continuing firms x total net inc. x tax rate) - minimum tax						
- New Entities	0.04	0.13	0.40	0.53	0.68	1.77
- Continuing Ent.- Group 1	3.24	7.00	15.49	25.57	28.11	79.41
- Group 2		0.64	3.56	7.81	8.58	20.59
Liquidation Gains	1.76	2.41	6.22	7.78	1.63	19.80
NOL Offset		0.58	1.75	3.58	5.76	11.67
Subtotal	1.52	4.79	11.47	22.55	29.98	70.31
2. Additional loss deductions by owners due to more liberal basis and allocation rules (Utilization rates for new and continuing firms x total net losses x 10% new deduct. x margin.tax rate)						
- New Entities	0.58	1.46	2.86	3.19	3.41	11.50
- Continuing Ent.- Group 1	0.62	1.54	3.42	5.12	5.79	16.49
- Group 2		0.11	0.62	1.25	1.41	3.39
Subtotal	1.20	3.11	6.91	9.56	10.61	31.38
TOTAL IMPACT (Loss)						
- New Entities	0.62	1.59	3.26	3.71	4.09	13.28
- Continuing Ent.- Group 1	3.85	8.54	18.91	30.69	33.90	95.90
- Group 2	0.00	0.76	4.18	9.06	9.99	23.99
Liquidation Gains	1.76	2.41	6.22	7.78	1.63	19.80
NOL Offset		0.58	1.75	3.58	5.76	11.67
TOTAL	2.72	7.90	18.38	32.11	40.59	101.69

Note: - See footnotes on page 34.

SECTION III
NEW C-CORPORATIONS (excl. Profess.)
Derivation of Revenue Estimates
Projections for 1993 - 1997

(Amounts in $ Millions)

	1993	1994	1995	1996	1997	Total
LLC Utilization (Sect.II)	10%	20%	40%	50%	60%	
REVENUE EFFECTS (Comb. Sect.I and II) :						
1. Loss of corp.level tax (except min.tax) (Utilization rate x total net income x tax rate) - minimum tax	1.25	2.69	5.95	8.29	11.09	29.27
NOL Offset		0.58	1.71	3.70	6.62	12.61
Subtotal	1.25	2.11	4.24	4.59	4.47	16.66
2. Additional income reported by owners (Utilization rate x total net income from entities x 50% new distributions x marginal tax rate)	0.74	1.57	3.42	4.18	5.52	15.42
3. Operating losses reported by owners (Utilization rate x total net losses from entities x 0.75 x margin.tax rate)	4.31	10.68	22.62	30.06	38.99	106.66
Loss Carryover		0.29	1.00	2.23	4.23	7.75
Subtotal	4.31	10.39	21.62	27.83	34.76	98.91
TOTAL IMPACT (Loss)	4.83	10.93	22.44	28.24	33.71	100.15

Note: - The utilization percentage for each year applies to the projected new entities for that year.
- Calculated revenue effects for each year allow for the continuation of prior year new entities.
- See footnotes on pages 34 and 35.

SECTION III
C-CORPORATIONS - PROFESSIONALS
Derivation of Revenue Estimates
Projections for 1993 - 1997

(Amounts in $ Millions)

		1993	1994	1995	1996	1997	Totals
LLC Utilization (Sect.II) :							
	- New	10%	20%	30%	30%	30%	
	- Cont.	5%	10%	25%	25%	25%	
REVENUE EFFECTS (Comb. Sect I and II):							
1. Loss of corp.level tax (except min.tax) (Utilization rates for new and continuing firms x total net inc. x tax rate)							
- minimum tax	- New	*	*	*	*	*	*
	- Cont.	2.37	5.02	14.07	15.74	17.58	54.78
	Liquidation Gains	1.46	1.60	5.34	0.74	0.82	9.96
	NOL Offset		0.16	0.53	1.39	2.42	4.50
	Subtotal	0.91	3.26	8.20	13.61	14.34	40.32
2. Operating losses reported by owners (Utilization rates for new and continuing firms x total net losses x marg.tax rate)							
	- New	0.04	0.11	0.19	0.21	0.24	0.80
	- Cont.	1.62	3.63	10.16	10.14	11.42	36.97
	Subtotal	1.66	3.74	10.35	10.35	11.66	37.77
3. Additional income reported by owners (Utilization rates for new and continuing firms x total net income from entities x 50% new distribution x marginal tax rate)							
	- New	*	*	*	*	*	*
	- Cont.	1.46	3.06	8.40	8.22	9.04	30.17
	Subtotal	1.46	3.06	8.40	8.22	9.04	30.17
TOTAL IMPACT	- New	0.04	0.11	0.19	0.21	0.24	0.80
	- Cont.	1.07	3.83	9.95	15.53	16.72	47.11
	TOTAL (Loss)	1.11	3.94	10.15	15.74	16.97	47.91

Note: - Minor values are marked as * .
- See footnotes on pages 35 and 36.

SECTION III
C-CORPORATIONS - CLOSELY HELD
Derivation of Revenue Estimates
Projections for 1993 - 1997

(Amounts in $ Millions)

	1993	1994	1995	1996	1997	Totals
LLC Utilization (Sect.II) :						
Specified Industries	5%	10%	25%	25%	25%	
REVENUE EFFECTS (Comb. Sect I and II):						
1. Loss of corp.level tax (except min.tax): (Utilization rate x total net income x tax rate) - minimum tax						
CONSTRUCTION	1.05	2.22	6.22	6.96	7.77	24.21
FINANCIAL, INSURANCE, REAL ESTATE	1.20	2.54	7.12	7.96	8.89	27.71
SERVICES (Other than Professionals)	1.56	3.30	9.26	10.36	11.57	36.04
Liquidation Gains	2.34	2.57	8.60	1.20	1.32	16.03
NOL Offset		0.39	1.19	3.06	5.28	9.92
Subtotal	1.46	5.10	12.80	21.01	21.63	62.01
2. Operating losses reported by owners (Utilization rate x total net losses x x marginal tax rate)						
CONSTRUCTION	0.96	2.06	5.69	5.60	6.20	20.51
FINANCIAL, INSURANCE, REAL ESTATE	1.17	2.50	6.93	6.82	7.56	24.98
SERVICES (Other than Professionals)	1.67	3.57	9.88	9.72	10.78	35.62
Subtotal	3.80	8.14	22.50	22.14	24.54	81.11
3. Additional income reported by owners (Utilization rate x total net income x 50% new distributions x marginal tax rate)						
CONSTRUCTION	0.64	1.35	3.72	3.64	4.00	13.35
FINANCIAL, INSURANCE, REAL ESTATE	0.74	1.55	4.25	4.16	4.58	15.27
SERVICES (Other than Professionals)	0.96	2.01	5.54	5.41	5.95	19.87
Subtotal	2.34	4.91	13.51	13.21	14.53	48.49
TOTAL IMPACT (Loss)						
CONSTRUCTION	0.72	2.12	5.52	7.81	8.27	24.44
FINANCIAL, INSURANCE, REAL ESTATE	0.89	2.56	6.71	9.30	9.84	29.30
SERVICES (Other than Professionals)	1.31	3.64	9.56	12.83	13.54	40.88
Total Loss	2.92	8.33	21.79	29.95	31.65	94.63

Note: - The utilization percentage for each year reflects the cumulative population of LLCs for that year.
- See footnotes on pages 35 and 36.

SECTION III

SUMMARY of ESTIMATED REVENUE EFFECTS

Projection for 1993 - 1997

(Amounts in $ Millions)

	1993	1994	1995	1996	1997	Total
REVENUE EFFECTS :						
Limited Partnerships	-2.5	-5.3	-10.9	-10.5	-11.1	-40.3
General Partnerships	5.4	21.0	28.1	34.5	41.7	130.7
Subchapter S-Corporations	-2.7	-7.9	-18.4	-32.1	-40.6	-101.7
New C Corporations	-4.8	-10.9	-22.4	-28.2	-33.7	-100.2
Professional Corporations	-1.1	-3.9	-10.2	-15.7	-17.0	-47.9
Closely-Held Corporations	-2.9	-8.3	-21.8	-30.0	-31.7	-94.6
GRANDTOTALS	-8.7	-15.4	-55.5	-82.0	-92.4	-253.9

SECTION III

FOOTNOTES

Limited Partnerships

- Group 1 includes oil and gas, real estate, services, and manufacturing. Group 2 refers to all other industries.

- The assumption that 25 percent of projected losses of firms that become LLC's would represent new deductions for investors allows for those situations where members would increase their level of participation and qualify losses as nonpassive. A 50% assumption was used in prior analyses.

- The current law offset allows for the same losses being written-off over a five-year period by means of generated passive income or complete dispositions.

- The marginal tax rate used for the 1993-95 period is nine percent annually; for 1996-97 period, eight percent annually to allow for the five-year top rate increase enacted in SB 169 (Chapter 117, Stats. 1991).

General Partnerships

- Allowance was made for single-member law corporations that will be dissolved to avoid the minimum tax under current law. This loss in minimum tax is included in the revenue effects for legal services beginning in 1994, ranging from $0.7 million that year to $1.4 million by 1997.

Subchapter S-Corporations

- Group 1 reflects industries used previously; i.e., oil and gas, manufacturing, real estate, and services. Group 2 refers to all other industries.

- Revenue effects for new entities include impacts for both new entities forming that year and prior year new entities. Allowance was made for business failures over the five-year period.

- Under #1 of the Table, allowance was made for NOL carryover deductions for loss entities that would have reduced corporate tax liabilities in subsequent years under current law. Revenue gains from reported liquidations were assumed to equal half of the loss of corporate tax revenue for non-service industries and 25% for the service industry.

- The assumption (under #2 of the Table) that only 10 percent of projected entity losses would represent new deductions for owners acknowledges the high rate of current writeoffs by Subchapter S owners.

- The marginal tax rate used for the 1993-95 period is nine percent annually; for the 1996-97 period, eight percent annually to allow for the five-year top rate increase enacted in SB 169 (Chapter 117, Stats. 1991).

New C Corporations

- Revenue effects include impacts for both new entities forming that year and prior year new LLC entities. Allowance was made for business failures for the continuing group over the five-year period.

- Under #1 of the Table, allowance was made for the minimum tax that would apply. In addition, allowance was made for NOL carryover deductions for loss entities that would have reduced corporate tax liabilities in subsequent years under current law.

- The assumption (under #2 of the Table) that 50 percent of projected entity income would represent new income reported by owners reflects a corporate dividend payout rate slightly above 50 percent and allows for the reporting of income by nonresident LLC members.

- The assumption (under #3 of the Table) that 75 percent of the loss would qualify as deductions by owners allows for some limitations that would apply under the passive loss rules. The remaining 25 percent that would be carried-over was assumed to be applied ratably over five years.

- The marginal tax rate used for the 1993-95 period is nine percent annually on income and losses. For years 1996 and 1997, the rate is eight percent annually. This allows for the five-year top rate increase enacted in SB 169 (Chapter 117, Stats, 1991).

Professional and Closely-Held Corporations

- Under #1 of the Table, allowance was made for the minimum tax that would apply. In addition, allowance was made for NOL carryover deductions of loss entities that would have reduced corporate tax liabilities in subsequent years under current law. Revenue gains from reported liquidations were assumed to equal 25% of the loss of corporate tax revenue for the service industry and 50% for all other industries.

- For new professional entities, revenue effects include impacts for both new entities forming that year and prior year new LLCs. Allowance was made for business failures.

- The marginal tax rate used for the 1993-95 period is nine percent annually on income and losses. For years 1996 and 1997, the rate used is eight percent annually. This allows for the five-year top rate increase enacted in SB 169 (Chapter 117, Stats, 1991).

CONCLUSIONS

The preceding analysis indicates that state revenue losses would result from LLC recognition in California. The order of magnitude impact is projected to be in the $250 million range cumulatively over the five-year period, ranging from $9 million in 1993 to $92 million in 1997.

We acknowledge that the estimates are based on many assumptions and, therefore, are subject to error. However, we feel that revenue losses are probably conservative for reasons discussed below.

The analysis has addressed the issue of C corporation conversions in a limited manner by focusing on professional corporations and other closely-held corporations. These corporate types were selected because controlling stock ownership is highly concentrated and the small number of owners permits a higher degree of flexibility over organizational structure. However, in reality many other existing corporations will weigh the one-time costs of converting (e.g. tax on liquidation gains) against the longer-run benefits and decide to reorganize as LLCs.

In addition, we are not able to isolate the impact LLC recognition might have on joint-venture activity between corporations in California. In cases where the joint-venture operation would have otherwise taken place under current law as a general partnership with special purpose subsidiary structures that can limit liability exposure for the parent corporations, the state tax implications under an LLC arrangement instead would probably not be materially different.

However, in cases where the joint venture would have been structured under current law as a separate corporation rather than as a general partnership, the state tax implications would be more significant. One possible explanation for a corporate preference under current law would center on the legal issue of greater liability protection for the corporate owners. In any event, if such corporate joint ventures elect LLC status instead, a number of revenue issues surface. For example, in those cases where the entity incurs losses initially, the losses can be applied by the corporate members to offset other income; in cases where the entity produces net income (less likely over the initial startup years), the corporate level tax would not apply to the entity, and members would have net income to report if their other business operations are profitable. The point for the latter joint ventures is that, to the extent the LLC form is used but the general partnership option would not have been used, additional revenue losses would emerge in the future.

Finally, the analysis has assumed that some taxpayers will be reluctant to use the LLC option because of uncertainty regarding continuation of favorable treatment as partnerships at the federal level. If the future of LLCs becomes more secure in this regard under federal law and the list of states recognizing LLCs continues to expand, actual revenue losses may exceed the above estimates and continue to increase beyond 1997.