Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Leach	Analyst:	Roger Lackey	Bill Number:	AB 19
Related Bills:	See Legislative History	Telephone:	845-3627	Introduced Date:	12-07-98
		Attorney:	Doug Bramhall	Sponsor:	

SUBJECT: Minimum Franchise Tax/Exempts Corporations Incorporated For Less Than 5 Years

SUMMARY

This bill would provide that every corporation that during the income year has been incorporated for less than five years shall be exempt from the minimum franchise tax.

EFFECTIVE DATE

This bill would apply to income years beginning on or after January 1, 1999.

LEGISLATIVE HISTORY

AB 10, AB 40, SB 42 (1999), AB 2798 (Stats. 1998, Ch. 323), AB 27 (1998), SB 842 (1997), SB 510 (1997), AB 8 (1997), AB 27 (1997), SB 38 (Stats. 1996, Ch. 954), AB 546, AB 3298, AB 3010, AB 3394 (1996); AB 647, AB 744, AB 1098 (1995); AB 411, AB 977, AB 1721, AB 2886, AB 3807 (1993/94); AB 3506, SB 1453 (1992); AB 4275 (1989/90); SB 572 (Stats. 1987, Ch. 1139); AB 1 (Stats. 1971, Ch.1); AB 1175 (Stats. 1957, Ch. 1127).

PROGRAM HISTORY/BACKGROUND

The minimum franchise tax was established to ensure that all corporations pay at least a minimum amount of franchise tax for the privilege of doing business in this state, regardless of the corporation's level of income (or loss). The minimum franchise tax has varied over the years. For income years ending before June 25, 1959, the minimum franchise tax is $25. For income years ending after June 25, 1959, and beginning before January 1, 1972, the minimum franchise tax is $100. For income years beginning after December 31, 1971, and before January 1, 1987, the minimum franchise tax is $200. For income years beginning after December 31, 1986, and before January 1, 1989, the minimum franchise tax is $300 (SB 572, Stats. 1987, Ch. 1139). This tax was increased to $600 for income years beginning on or after January 1, 1989, and before January 1, 1990, and to $800 for income years beginning on or after January 1, 1990. Beginning on January 1, 1999, a "qualified new corporation," as defined, pays a $300 minimum franchise tax for its first and $500 for its second taxable years. The minimum franchise tax is $25 for certain gold and quicksilver mining corporations. Credit unions, certain nonprofit cooperative associations, and exempt organizations are not subject to the minimum franchise tax.

Corporations prepay the minimum franchise tax to the Secretary of State (SOS) at the time they incorporate (California corporation) or initially qualify (non-California corporation) with that office to do business in this state. This

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initial payment constitutes the taxpayer's initial franchise tax return. For income years beginning on or after January 1, 1997, and before January 1, 1999, the prepayment to the SOS is reduced to $600 for a "qualified new corporation," as defined. For income years commencing on or after January 1, 1999, the prepayment to the SOS for a "qualified new corporation," definition revised, is reduced to $300. If a non-California corporation commences to do business in this state without qualifying with the SOS, the FTB assesses the initial minimum franchise tax.

Under the rules for payment of estimated taxes, four equal payments are to be made during the current year for the privilege of exercising a corporate franchise in the subsequent year, but the first payment cannot be less than the minimum tax. At the end of the first year, even if it is not a full 12 months, taxpayers are required to compute their franchise tax for the privilege of conducting business during the second taxable year based on a measurement of the first year's net income. The taxpayer must file a corporate franchise tax return within two months and 15 days after the end of the first year and include payment of the taxes due for the second taxable year. The franchise tax for each subsequent taxable year is computed based on a measurement of the preceding year's net income.

SPECIFIC FINDINGS

Under existing state law, unless specifically excepted by statute, every corporation that is organized or qualified to do business or is 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 income 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).

Existing state law provides that real estate mortgage investment conduits (REMICs) are subject to and required to pay the minimum franchise tax. Regulated investment companies (RICs) and real estate investment trusts (REITs) organized as corporations also are subject to and required to pay the minimum franchise tax.

Under existing state law, the tax on limited partnerships (LPs), limited liability companies (LLCs), and limited liability partnerships (LLPs) is set at $800 by reference to the amount provided in the minimum franchise tax statute.

Existing state law requires nonprofit charitable organizations to file periodic reports with the Attorney General. For any year that a nonprofit charitable organization does not file with the Attorney General and the Attorney General notifies the department of this failure, the nonprofit charitable organization is assessed and required to pay the minimum franchise tax.

Existing state law provides for income years commencing on or after January 1, 1997, and before January 1, 1999, a reduced prepayment of tax to the SOS of $600 for a "qualified new corporation" with gross receipts, less returns and allowances, reportable to this state of less than $1 million. The reduced tax applies only to the prepayment payable to the SOS in connection with incorporation or registration with the SOS.

For income years beginning on or after January 1, 1999, the prepayment to the SOS for the first income year of a "qualified new corporation," definition revised, is $300, and the minimum franchise tax for its second taxable year is $500. A "qualified new corporation" for income years beginning on or after January 1, 1999, does not include any corporation that began business operations as a single proprietorship, a partnership, or any other form of business entity prior to its incorporation. To be eligible for the reduced prepayment and minimum franchise tax, the qualified new corporation must be incorporated on or after January 1, 1999.

Also, **existing state law** provides that the determination of whether a corporation meets the gross receipts criterion is based on the aggregate gross receipts of the members of a commonly controlled group. The law defines "gross receipts less returns and allowances reportable to this state" as including both business and non-business receipts.

The reduced minimum franchise tax does not apply to any corporation if 50% or more of its stock is owned by another corporation. In addition, it does not apply to certain entities such as limited partnerships, limited liability companies, and charitable corporations required to pay the minimum franchise tax as a result of failure to file with the Attorney General.

For income years beginning on or after January 1, 1997, and before January 1, 1999, a corporation that paid $600 to the SOS must pay an additional tax of $200 on the due date of its first return, without regard to extension, if its gross receipts exceed $1 million or its tax liability exceeds $800. For income years beginning on or after January 1, 1999, a corporation that paid $300 to the SOS must pay an additional $500 if it does not meet the requirements of a "qualified new corporation," in its first income year. If it paid $500 minimum franchise tax for its second taxable year, the corporation must pay an additional $300 if it fails to meet the requirements in its second taxable year.

This bill would provide that every corporation that during the income year has been incorporated for less than five years shall be exempt from the minimum franchise tax.

Policy Considerations

Prior legislation has focused on providing relief from the minimum franchise tax for new small corporations, such as those with gross receipts of $1 million or less. However, this bill would not focus its benefit on the basis of size, but would rather provide relief for every corporation on the basis of age, regardless of its income level.

This bill would extinguish the prepayment to the SOS for all California corporations and corporations organized under the laws of another state, so long as the corporation had been incorporated less than five years. Out-of-state corporations that had been incorporated more than five years prior to qualification to do business with the SOS might argue that this change makes the prepayment to the SOS unconstitutionally discriminatory against out-of-state corporations. However, because the exemption is based on date of incorporation rather than place of incorporation, this change would likely survive constitutional challenge.

Implementation Considerations

It is unclear if it is the author's intent to have this benefit available to only corporations that incorporate after the effective date of this bill or for corporations that incorporated prior to, but have been incorporated for less than five years. As written, the department would interpret this bill to provide a benefit to all corporations that have been incorporated for less than five years from the effective date of this bill.

The bill would not reduce the tax of other business entities (i.e., limited partnerships, certain limited liability companies, etc.) that are liable for a tax in an amount equal to the minimum franchise tax.

Also, this bill would provide that a corporation "during the income year [be] incorporated for less than five years." The term "five years" could lead to confusion since calendar years, taxable years, and income years are all terms used in tax law. The franchise tax liability of a corporation is measured by income received during the preceding income year and is paid for the following taxable year.

A California corporation pays the minimum franchise tax for its first taxable year at the same time it files for incorporation with the SOS. Therefore, it could be inferred that that payment would equate to one year, leaving the corporation with four additional years. It also could be interpreted so that a corporation may receive as many exemptions as available in five calendar years. As a result, a corporation could receive six exemptions from the minimum franchise tax. This ambiguity would make it difficult for the department and a corporation to determine whether the corporation was entitled to an exemption from the minimum franchise tax in a particular year. These issues need to be resolved before the department could effectively implement this bill.

As this bill is written, it unclear whether the prepayment upon incorporation or qualification to do business in California would still be required since the code section requiring the prepayment is left intact.

In addition, legislation was enacted in 1998 that reduced the commencing corporation prepayment to the Secretary of State for the first taxable year from $600 to $300 and the minimum franchise tax for the second taxable year from $800 to $500 for qualified new corporations. If the exemption extends to all corporations, regardless of gross receipts, consideration should be given to repealing the reduced minimum franchise tax program to clarify the law.

Because the minimum franchise tax exemption would apply to income years beginning on or after January 1, 1999, refunds would need to be made to any eligible corporations that prepaid the minimum franchise tax to the SOS or paid the minimum franchise tax to the FTB between January 1, 1999, and the enactment date of this bill. These refunds should not significantly impact the department.

FISCAL IMPACT

Departmental Costs

Approximately 89,000 existing corporations would be eligible for this bill's exemption. Therefore, implementation of this bill would require moderate changes for the annual updates for the 2000 process year.

Tax Revenue Estimate

Revenue losses under the Bank & Corporation Tax Law are as follows:

Effective for Income Years Beginning January 1, 1999 Enactment Assumed After June 30, 1999 (in millions		
1999-0	2000-1	2001-2
($157)	($105)	($108)

Tax Revenue Discussion

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue losses would depend on the number of corporations that are new corporations that have been incorporated less than five years.

It is projected that for income years beginning in 1999 approximately 89,000 corporations less than five years old would benefit from the minimum tax repeal. Estimates above also include the repeal of the Secretary of State fee at the time of incorporation for approximately 55,000 corporations each year.

BOARD POSITION

Pending.