

ANALYSIS OF AMENDED BILL

Author: Allen Analyst: Jessica Deitchman Bill Number: AB 799
 See Legislative
 Related Bills: History Telephone: 845-6310 Amended Date: March 26, 2015
 Attorney: Bruce Langston Sponsor _____

SUBJECT:	Exempt Limited Liability Company Holding Companies/Modify the Definition of Doing Business
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SUMMARY

This bill would under the Corporation Tax Law (CTL):

- Exempt limited liability companies (LLCs), classified as holding companies, from the definition of doing business in the state.
- Modify the definition of doing business in the state for Corporations and LLCs that are classified as holding companies.

RECOMMENDATION

No position.

Summary of Amendments

The March 26, 2015, amendments removed provisions of the bill related to non-substantive changes imposing an annual tax and replaced them with the provisions discussed in this analysis. This is the department’s first analysis of the bill.

REASON FOR THE BILL

The reason for the bill is to encourage the formation of investment LLCs by exempting them from the annual taxes and fees associated with 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, 2015.

FEDERAL LAW

Federal law treats an LLC as an eligible entity that may be classified as a partnership, corporation, or a disregarded entity depending on the number of owners and is based on an entity election or default classification rules in the absence of an election.

Board Position:	Executive Officer	Date
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STATE LAW

Current law (Revenue and Taxation Code (R&TC) section 23102) provides that a corporation is not doing business in this state under certain conditions. This exemption is provided when the corporation is holding or organized to hold stock or bonds of any other corporation or corporations, and not trading in stock or bonds or securities held, and engages in no activities other than the receipt and disbursement of dividends from stock or interest from bonds.

Every corporation and every LLC taxable as a corporation that is either organized, qualified to do business, or doing business in this state is subject to the corporate franchise tax, which is imposed for the privilege of doing business in California.

Existing state law¹ requires an LLC (not classified as a corporation) that is doing business in this state to pay both an annual tax and an annual fee. The annual tax is an amount equal to the minimum franchise tax (\$800) and is paid annually until the effective date of cancellation by the LLC, or, if later, the date the LLC ceases to do business within the state.

The annual fee is based on the LLC's total income from all sources reportable to this state for the taxable year as follows:

<u>2001 & Future Fees</u>	<u>Total Income</u>
\$ 900	\$250,000 or more, but less than \$500,000
\$2,500	\$500,000 or more, but less than \$1,000,000
\$6,000	\$1,000,000 or more, but less than \$5,000,000
\$11,790	\$5,000,000 or more.

For purposes of the fee, total income does not include income of a subsidiary LLC subject to a fee.

“Doing business”² for income and franchise tax purposes means either of the following:

- Actively engaging in any transaction for the purpose of financial or pecuniary gain or profit, or;
- If any of the following conditions have been satisfied:
 - The taxpayer is organized or commercially domiciled in this state;
 - Sales³ of the taxpayer within this state exceed the lesser of \$500,000 or 25 percent of the taxpayer's total sales;
 - Sales of the taxpayer include sales by an agent or independent contractor of the taxpayer.⁴

¹ Chapter 10.6 of Part 10.

² Revenue and Taxation Code section 23101.

³ As defined in subdivision (e) or (f) of Section 25120.

- The real property and tangible personal property of the taxpayer in this state exceed the lesser of \$50,000 or 25 percent of the taxpayer's total real property and tangible personal property;⁵
- The amount paid in this state by the taxpayer for compensation⁶ exceeds the lesser of \$50,000 or 25 percent of the taxpayer's total real property and tangible personal property;⁷ and
- The amount paid in this state for compensation⁸ exceeds the lesser of \$50,000 or 25 percent of the total compensation paid by taxpayer.⁹

The sales, property, and payroll of the taxpayer include the taxpayer's pro rata or distributive share of pass-through entities.¹⁰

THIS BILL

This bill would add LLCs as entities that could be considered, under R&TC section 23102, as "not doing business in the state" for purposes of the chapter this bill amends¹¹ or Chapter 10.6 (See Technical Considerations). As a result, these LLCs not classified as corporations would no longer be subject to the annual tax, annual fee, or both, under the Personal Income Tax Law.

In addition, this bill would also expand the activities that would be considered "not doing business in the state" to include activities exempted under subdivision (c) of Section 191 of the Corporations Code. Those activities are:

- Maintaining or defending any action or suit or any administrative or arbitration proceeding, or effecting the settlement thereof or the settlement of claims or disputes.
- Holding meetings of its board or shareholders or carrying on other activities concerning its internal affairs.
- Maintaining bank accounts.
- Maintaining offices or agencies for the transfer, exchange, and registration of its securities or depositaries with relation to its securities.

⁴ Sales in this state shall be determined using the rules for assigning sales under Section 25135 and subdivision (b) of Section 25136 and the regulations there under, as modified by regulation under Section 25137.

⁵ The value of the real and tangible personal property and the determination of whether property is in this state shall be determined using the rules contained in Section 25129 and 25131 and the regulations thereunder, as modified by regulation under Section 25137.

⁶ As defined in subdivision (c) of Section 25120.

⁷ The value of the real and tangible personal property and whether property is in the state shall be determined using the rules contained in Sections 25129 and 25131, inclusive, and the regulations thereunder, as modified by regulation under Section 25137.

⁸ As defined in subdivision (c) of Section 25120.

⁹ Compensation in this state shall be determined using the rules for assigning payroll contained in Section 25133 and the regulations thereunder, as modified by regulations under Section 25137.

¹⁰ "Pass-through entities" means a partnership or an "S" corporation.

¹¹ Chapter 2 of the Corporation Franchise Tax.

- Effecting sales through independent contractors.
- Soliciting or procuring orders, whether by mail or through employees or agents or otherwise, where those orders require acceptance outside this state before becoming binding contracts.
- Creating evidences of debt or mortgages, liens or security interests on real or personal property.
- Conducting an isolated transaction completed within a period of 180 days and not in the course of a number of repeated transactions of like nature.

IMPLEMENTATION CONSIDERATIONS

This bill would add corporations and LLCs engaged solely in the activities listed in Corporations Code section 191(c) as entities excluded from the definition of "doing business" for tax purposes, significantly expanding the activities a holding company may engage in and remain exempt from the otherwise applicable minimum tax, or annual tax, annual fee, or both. These additional activities are internally inconsistent with the allowable activities an entity may engage in and be considered a holding company for tax purposes and could result in an entity meeting both the definition of "doing business" and an exclusion that this bill would add. If this is not the intention of the author, the bill should be amended.

TECHNICAL CONSIDERATIONS

The reference to Chapter 10.6 should be modified to read, Chapter 10.6 of Part 10¹² (commencing with section 17001).

LEGISLATIVE HISTORY

AB 1769 (Dababneh, 2013/2014) would have exempted small business LLCs from the annual fee for up to the first two taxable years. AB 1769 failed to pass the Assembly Revenue Taxation Committee.

AB 1778 (Allen, 2013/2014) would have amended the description of an LLC for state tax purposes to exclude an LLC that is formed for the exclusive purpose of acquiring and holding title to intangible personal property constituting equity or debt interests, or both, in a single other corporation, LLC; or partnership, collecting income there from, and turning over the entire amount thereof, less expenses to its members. AB 1778 failed to pass out of the Assembly Revenue and Taxation Committee.

¹² Tax and Fees on LLCs.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states lack laws that would allow "holding companies" to transact business activities this bill would allow. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

FISCAL IMPACT

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

ECONOMIC IMPACT

This bill would allow certain corporate taxpayers to be exempt from the franchise tax and certain LLC taxpayers to be exempt from paying the LLC annual tax and fee should they engage in the activities outlined in this bill. Based on the Franchise Tax Board data, it was estimated that approximately \$25 million in minimum franchise tax was paid by corporations that are not registered with the Secretary of State. It was assumed that half of these taxpayers would be exempt from tax under the provisions of this bill. It was further assumed that there would be an equal amount of LLCs that would be exempt from paying the annual tax and fee. It is unknown how many of the corporate taxpayers affected currently pay more than the minimum tax or how many more entities would be able to restructure their operations to take advantage of this exemption. It was assumed that these factors would increase the revenue loss from this bill by 60 percent to approximately \$40 million per year.

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

SUPPORT/OPPOSITION

Support¹³: Angel Capital Association; National Federation of Independent Business (NFIB); San Jose Silicon Valley Chamber of Commerce; Arthur Korteweg, Associate Professor of Finance at Stanford University School of Business; Dr. Shai Berstein, Assistant Professor of Finance at Stanford Graduate School of Business; Dave McClure, 500 startups founder; Naval Ravikant, CEO AngelList.

Opposition: None provided.

¹³ Taken from the Fact Sheet provided by the author's office.

ARGUMENTS

Proponents: Some may argue that this bill would treat holding companies organized as LLCs similarly to holding companies that are organized as corporations, thus encouraging capital investment in the state.

Opponents: Some may argue that the minimum or annual tax, and annual fee are obligations imposed in exchange for the benefits and protections of the state that should be borne by all business entities.

POLICY CONCERNS

This bill would provide a tax benefit for certain types of LLCs and corporations that would not be provided to other business entities. Thus, this bill would provide differing treatment based solely on business type.

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