

ANALYSIS OF ORIGINAL BILL

Author: Allen, et al. Analyst: Jessica Deitchman Bill Number: AB 2544
 See Legislative
 Related Bills: History Telephone: 845-6310 Introduced Date: February 19, 2016
 Attorney: Bruce Langston Sponsor _____

SUBJECT:	LLCs/Qualified Investment Partnerships File Return as Partnership
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SUMMARY

This bill would, under the Personal Income Tax Law (PITL), exempt certain Limited Liability Companies (LLC) from the annual tax and fee.

RECOMMENDATION

No position.

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, 2016.

FEDERAL LAW

Federal law has no annual tax or fee on LLCs comparable to state law discussed below.

STATE LAW

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.

¹ Chapter 10.6 of Part 10.

Board Position:	Executive Officer	Date
_____ S _____ NA _____ X _____ NP	Selvi Stanislaus	3/9/16
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The annual fee is based on the LLC's total income from all sources derived from or reportable to this state for the taxable year as follows:

2001 & Future Fees	Total Income
\$ 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.

THIS BILL

This bill would provide an exemption from the annual tax and fee for LLCs that are classified as qualified investment partnerships.

"Qualified investment partnership" would mean an LLC that meets all of the following requirements:

- The LLC is classified as a partnership for California income tax purposes.
- No less than 90 percent of the costs of its total assets consist of qualifying investment securities, deposits at banks or other financial institutions, interest or investments in a partnership, or office space and equipment reasonably necessary to carry on its activities as a qualified investment partnership.
- No less than 90 percent of its gross income consists of interests, dividends, and gains from the sale or exchange of qualifying investment securities or investments in a partnership.

"Qualifying investment securities" would have the same meaning as that term is described in Section 17955 (c)(3)(A)² of the Revenue and Taxation Code (R&TC).

Additionally, this bill would require:

- A qualified investment partnership that is required to file a federal return,³ to file a state partnership return⁴ for that taxable year.

² R&TC section 17955(c)(3)(A) provides a list of securities that are considered "qualified investment securities," which include securities such as common stock, bonds, foreign and domestic currency deposits, and repurchase agreements.

³ Pursuant to Section 6031 of the Internal Revenue Code (IRC).

⁴ Pursuant to section 18633 of the R&TC.

- A qualified investment partnership that is not required to file a federal return,⁵ to file an information return as prescribed by the Franchise Tax Board (FTB) for that taxable year.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require changes to existing tax forms and instructions, and information systems.

LEGISLATIVE HISTORY

AB 799 (Allen, et al., 2015/2016) substantially similar to this bill, would have exempted LLCs that are qualified investment partnerships from the annual tax and fee. AB 799 failed to pass out of the first house by the constitutional deadline.

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 and 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 thereof, 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.

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 have not yet determined 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.

⁵ Pursuant to Section 6031 of the IRC.

ECONOMIC IMPACT

This bill will result in the following revenue loss:

Estimated Revenue Impact of AB 2544 As Introduced February 19, 2016 Assumed Enactment After June 30, 2016 (\$ in Millions)		
2016-17	2017-18	2018-19
- \$1.7	- \$1.8	- \$1.9

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

Revenue Discussion:

The revenue impact would consist of the following: the revenue loss due to the annual tax exemption of \$800 per LLC, the revenue loss due to the LLC fee exemption, and the revenue gain from LLC fees that would no longer be deducted at the individual taxpayer level.

Based on the Franchise Tax Board (FTB) data, it was determined that there were approximately 5,300 LLCs that were holding companies in California in 2015. For purposes of this estimate, it was assumed that 20 percent of these LLCs would qualify and be exempt from tax. Based on the FTB historical tax filing data, it was assumed that the number of qualifying LLCs would increase at the rate of 6 percent per year. This would result in a revenue loss of approximately \$900,000 in 2016.

The fee portion of the revenue impact was estimated using the percentages of qualifying LLCs at each fee level based upon 2015 tax data, resulting in a revenue loss of approximately \$800,000. Because the LLC fee would no longer be a deduction from tax liabilities at the individual levels, assuming an average individual tax rate of 5 percent, the estimated revenue gain would be approximately \$40,000.

This bill would result in a total estimated loss for 2016 of \$1.7 million.

The tax year estimates are converted to fiscal year estimates, and then rounded to arrive at the estimates shown in the table above.

SUPPORT/OPPOSITION⁶

Support: 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 Bernstein, Assistant Professor of Finance at Stanford Graduate School of Business; Dave McClure, 500 Startups Founder; Naval Ravikant, CEO AngelList.

Opposition: None provided.

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 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 that would not be provided to other business entities. Thus, this bill would provide differing treatment based solely on business type.

LEGISLATIVE STAFF CONTACT

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⁶ As indicated on author provided fact sheet.