SUBJECT: Minimum Franchise and Annual Tax/Reduce to $100 for 1st or 2nd Taxable Year

SUMMARY

This bill would, under the Personal Income Tax Law and the Corporation Tax Law, reduce the minimum franchise or annual tax for new entities in California.

RECOMMENDATION – NO POSITION

REASON FOR THE BILL

The reason for this bill is to provide tax relief for entities forming in California, by reducing the minimum franchise or annual tax.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2018.

FEDERAL/STATE LAW

Federal law lacks a corporation minimum tax

Unless specifically exempted by statute, every corporation that is organized or qualified to do business or 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 taxable 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).

Every corporation that incorporates or qualifies to do business in this state on or after January 1, 2000, is exempt from the minimum franchise tax for its first taxable year. This exemption does not apply to any corporation that reorganizes solely for the purpose of avoiding payment of its minimum franchise tax. It also does not apply to limited partnerships (LPS), limited liability companies (LLCs) not classified as corporations, limited liability partnerships (LLPs), charitable organizations, regulated investment companies, real estate investment trusts, real estate mortgage investment conduits, financial asset securitization investment trusts, and qualified Subchapter S subsidiaries.

Real estate mortgage investment conduits are subject to and required to pay the minimum franchise tax. Regulated investment companies and real estate investment trusts organized as corporations also are subject to and required to pay the minimum franchise tax.
Under existing state law, the annual tax on LP's, LLC's not classified as corporations, and LLP's is set at $800 by reference to the minimum franchise tax.

**THIS BILL**

For taxable years beginning on or after January 1, 2018, this bill would allow every:

- New LLC, LLP, and LP that is a small business to pay an annual tax of $100 for its first taxable year.
- New corporation that is a small business to pay a minimum franchise tax of $100 for its second taxable year.

The bill provides the following definitions:

- “New Limited Liability Company,” “New Limited Liability Partnership,” “New Partnership,” or “New Corporation” means an LLC, LLP, LP or corporation that on or after January 1, 2018, is organized under the laws of this state or has qualified to transact intrastate business in this state that begins business operations at or after the time of its organization. “New LLC, LLP, LP, or Corporation” does not include any LLC, LLP, LP or corporation that began business operations as, or acquired its business operations from, a sole proprietorship, an LLC, LLP, LP or corporation, or any other form of business entity prior to its organization.
- “Gross receipts, less return and allowances reportable to this state,” means the sum of the gross receipts from the production of business income,\(^1\) and the gross receipts from the production of nonbusiness income.\(^2\)
- “Small business” means an LLP or LP that has, or an LLC or corporation that reasonably estimates it will have, gross receipts, less returns and allowances, reportable to this state for the taxable year of $5,000 or less. If the gross receipts, less returns and allowances, of an LLC or corporation for a taxable year exceeds $5,000, an additional tax of $100 is due and payable on the due date for the return, without regard to extension.

The bill states that the reduction would be unavailable to any LLC, LLP, LP or corporation that:

1. fails to file a return on the due date of its return, without regard to extension, for that year; or
2. reorganizes solely for the purpose of reducing its annual tax.

**IMPLEMENTATION CONSIDERATIONS**

The department has identified the following implementation concern. Department staff is available to work with the author’s office to resolve this and other concerns that may be identified.

\(^1\) As defined in Section 25120(a).
\(^2\) As defined in Section 25120(d).
An LLC, LLP, LP or corporation that organized prior to the effective date of this bill that meets the definition of a “New LLC, LLP, LP or Corporation” would qualify for a reduced minimum franchise tax; therefore, existing business entities, not just new business entities, could qualify for this bill’s exemption. If this is contrary to the author’s intent, this bill should be amended.

TECHNICAL CONSIDERATIONS

On page 6, line 34, in the LLC provisions, the word “corporation” should be replaced by the phrase “limited liability company”.

On page 8, line 13, the phrase “limited partnership” should be replace by the phrase “limited liability partnership”.

LEGISLATIVE HISTORY

AB 1432 (Melendez, 2017/2018) would eliminate the minimum franchise tax for every new corporation for the first five taxable years. AB 1432 was introduced on February 17, 2017.

SB 248 (Morrell, 2017/2018) would eliminate the annual tax for the first taxable year and reduce the minimum franchise or annual tax to $400 for new, small business corporations, LLCs, LLP, and LPs. SB 248 was introduced on February 7, 2017.

AB 612 (Patterson, 2015/2016) would have reduced the annual tax to $400 for new, small business LLCs, LLPs, and LPs. AB 612 failed passage out of the Assembly by the constitutional deadline.

AB 328 (Grove, 2015/2016) would have eliminated the minimum franchise tax or annual tax for new veteran-owned small corporations and LLCs. AB 328 failed passage out of the Assembly by the constitutional deadline.

AB 1769 (Dababneh, 2013/2014) would have exempted certain small business LLCs from the minimum franchise tax for up to two taxable years. AB 1769 failed passage out of the Assembly by the constitutional deadline.

AB 1889 (Hagman, 2013/2014) would have exempted certain small business entities from the minimum franchise tax for up to the first two taxable years. AB 1889 failed passage out of the Assembly by the constitutional deadline.

AB 2428 (Patterson, 2013/2014) would have eliminated the minimum franchise tax for new business entities for up to five taxable years. AB 2428 failed passage out of the Assembly by the constitutional deadline.
AB 2466 (Nestande, et al., 2013/2014) would have reduced or eliminated the annual fee or minimum franchise tax for certain veteran-owned small business LLCs and corporations. AB 2466 failed passage out of the Assembly by the constitutional deadline.

AB 2495 (Melendez, 2013/2014) would have eliminated the minimum franchise tax for new business entities for up to five taxable years. AB 2495 failed passage out of the Assembly by the constitutional deadline.

SB 641 (Anderson, 2013/2014) would have eliminated the minimum franchise tax for certain new corporations for the first four taxable years. SB 641 failed passage out of the Senate by the constitutional deadline.

AB 166 (Cook, 2011/2012) would have eliminated the minimum franchise tax. AB 166 failed passage out of the Assembly by the constitutional deadline.

AB 368 (Morrell, 2011/2012) would have reduced the minimum franchise tax to $400 for qualified small businesses. AB 368 failed passage out of the Assembly by the constitutional deadline.

AB 821 (Garrick, 2011/2012) would have reduced the minimum franchise tax from $800 to $100 for a small business for the first ten years of operation. AB 821 failed passage out of the Assembly by the constitutional deadline.

AB1605 (Garrick, 2011/2012) would have exempted specified entities from the minimum franchise tax or annual tax and reduced the minimum franchise tax or annual tax to $99 for specified entities that commence business on or after January 1, 2013. AB 1605 failed passage out of the Assembly by the constitutional deadline.

OTHER STATES’ INFORMATION

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, Michigan, and Minnesota do not impose a minimum tax on business entities.

Illinois imposes a $25 minimum tax on corporations.

Massachusetts imposes a $456 minimum tax on corporations.

New York imposes a minimum tax on corporations of $25 to $5,000 based on the corporation’s in-state receipts.

FISCAL IMPACT

The department’s costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.
ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

<table>
<thead>
<tr>
<th>Estimated Revenue Impact of AB 1256</th>
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<tbody>
<tr>
<td>As Introduced February 17, 2017</td>
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<tr>
<td>Assumed Enactment After June 30, 2017</td>
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<tr>
<td>($ in Millions)</td>
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<tr>
<td>2017-18</td>
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<tr>
<td>- $14</td>
</tr>
<tr>
<td>2018-19</td>
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<tr>
<td>- $47</td>
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<tr>
<td>2019-20</td>
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<td>- $70</td>
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</tbody>
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This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

Based on new business registration data from the Secretary of State and data from the Franchise Tax Board for years 2009-2016, it is estimated that in 2018 approximately 85,000 corporations, and 45,000 new LLCs, LLPs, and LPs would register and be doing business per the limitations specified in this bill.

The estimated revenue loss for 2018 does not include corporations because they are not subject to minimum franchise tax in their first year of operation under current law. However, approximately 35,000 LLCs, LLPs and LPs would be subject to the annual tax and benefit from the reduced tax in tax year 2018, resulting in an estimated revenue loss of $25 million. For the 2019 tax year, it is estimated that 40,000 first year LLCs, LLPs and LPs and 60,000 second year corporations would benefit from the reduced minimum franchise tax and annual tax for a total estimated revenue loss of $70 million.

This estimate includes an increase for existing LLCs, LLPs, LPs or corporations organized prior to the effective date of this bill as addressed in the implementation concern above.

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

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may argue that the bill would give much needed tax relief to newly established small businesses in California and thus assisting them to remain in business.
Opponents: Some may argue that reducing the minimum tax due from a small business for the first or second taxable year is inadequate to relieve the financial stress faced by new businesses and would overly complicate tax administration.

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