Franchise Tax Board **ANALYSIS OF ORIGINAL BILL**

Author:	Melendez	Analyst:	Janet Jennings	Bill Number:	AB 1432
Related Bills:	See Legislative History	Telephone:	845-3495	Introduced Date:	February 17, 2017
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Annual Tax and Minimum Franchise Tax/Exempt New Corporations, LLC's, LP's, LLP's First Consecutive Five Taxable Years

SUMMARY

This bill would, under both the Corporation Tax Law (CTL), and Personal Income Tax Law (PITL), exempt newly organized or registered business entities from the minimum tax or annual tax for the first five taxable years and remove outdated references and language.

RECOMMENDATION – NO POSITION

REASON FOR THE BILL

The reason for this bill is to provide tax relief for newly formed business entities doing business in California, by exempting them from the minimum franchise or annual tax for the first five years.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for specified business entities that organize or register on or after January 1, 2018.

FEDERAL LAW

Federal law has no minimum franchise tax or annual tax on business entities comparable to the California minimum franchise tax or annual tax.

STATE LAW

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 liability companies (LLCs), limited partnerships (LPs); 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.

Under existing state law, the annual tax on LLCs, LPs not classified as corporations, and LLPs is set at $800 by reference to the minimum franchise tax. In addition, every LLC not classified as a corporation that is subject to the annual tax is also subject to an annual fee, varying from $900 to $11,790, based on its total income derived from or attributable to this state.

For taxable years beginning before January 1, 2018, a corporation or a LLC not classified as a corporation that is a small business, as defined, and is wholly owned by an individual that is a member of the U.S. Armed Forces is exempt from paying the minimum franchise tax for any taxable year if both of the following apply:

- The owner is deployed during that taxable year, and
- The LLC operates at a loss or ceases operation in that taxable year.

Doing Business

Revenue & Taxation Code (R&TC) section 23101 defines "doing business" as actively engaging in any transaction for the purpose of financial or pecuniary gain or profit.

Furthermore, a taxpayer will also be considered to be doing business in California if any of the following conditions are satisfied:

- The taxpayer is organized or commercially domiciled in California.
- Sales, as defined in subdivision (f) of R&TC section 25120, of the taxpayer in California, including sales by the taxpayer's agents and independent contractors, exceed the lesser of $500,000 or 25 percent of the taxpayer's total sales.
- Real and tangible personal property of the taxpayer in California exceed the lesser of $50,000 or 25 percent of the taxpayer's total real and tangible personal property.
- The amount paid in California by the taxpayer for compensation, as defined in subdivision (c) of R&TC Section 25120, exceeds the lesser of $50,000 or 25 percent of the total compensation paid by the taxpayer.

THIS BILL

This bill would for taxable years beginning on or after January 1, 2018, exempt the following entities from the annual tax[1] for the first five consecutive taxable years that it is doing business[2] in the state:

- LLCs that file articles of organization or a certificate of registration with the Secretary of State (SOS) on or after January 1, 2018.
- LPs that file a certificate of limited partnership or an application of registration with the SOS on or after January 1, 2018.
- LLPs that register as limited liability partnerships with the SOS on or after January 1, 2018.

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[1] In an amount equal to the minimum franchise tax ($800).
[2] R&TC section 23101.

The exemption would specifically exclude any LLCs, LPs, or LLPs that reorganize solely for the purpose of avoiding payment of its annual or minimum franchise tax.

In addition, this bill would for taxable years beginning on or after January 1, 2018, exempt a qualified new corporation from the minimum franchise tax for its first five consecutive taxable years.

"Qualified new corporation" would mean a corporation that is incorporated under the laws of this state or has qualified to transact business in this state on or after January 1, 2018, and that begins business operations at or after the time of its incorporation. "Qualified new corporation" would specifically exclude any corporation that began business operations as a sole proprietorship, a partnership, or any other form of business entity prior to its incorporation.

IMPLEMENTATION CONSIDERATIONS

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

The specified business entities that organized prior to the effective date of this bill, but do not qualify to do business in the state until after January 1, 2018, would be exempt from payment of the minimum franchise tax or annual tax, as applicable. Therefore, existing corporations, LLCs, LPs, and LLPs, not just new specified entities, could qualify for this bill's exemption. If this is contrary to the author's intent, this bill should be amended.

It is unclear as to how the exemption from the annual tax would be applied for qualified entities that merge or convert their entity type. The bill should be amended to provide clear direction for qualified entities that merge or convert their entity type.

Because the bill fails to specify otherwise, the changes made to the LLCs annual tax law[3] may be interpreted to exclude LLCs from paying the fee because the LLCs fee law[4] applies to LLCs subject to the annual tax. It is recommended the bill be amended to clarify that the exclusion from the annual tax does not exclude LLCs from the annual fee.

POLICY CONSIDERATION

This bill lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of the credit by the Legislature.

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[3] R&TC section 17941.
[4] R&TC section 17942.

LEGISLATIVE HISTORY

AB 1256 (Brough, 2017/2018) would under the PITL and the CTL, reduce the minimum franchise or annual tax for new entities in California. AB 1256 has been referred to the Assembly Revenue and Taxation Committee.

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 1889 (Hagman, Chapter 700, Statutes of 2014) exempted certain small business entities from the minimum franchise tax for up to the first two taxable years.

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 from the Assembly Revenue and Taxation Committee.

AB 2495 (Melendez, 2013/2014) was substantially similar to this bill. AB 2495 failed passage from the Assembly Revenue and Taxation Committee.

AB 1769 (Dababneh, 2013/2014) would exempt certain small business LLCs from the minimum franchise tax for up to two taxable years. AB 1769 failed passage from the Assembly Revenue and Taxation Committee.

AB 2466 (Nestande, 2013/2014) would have either exempted, in total or in part, certain small, veteran-owned business entities from the minimum franchise tax. AB 2466 failed passage from the Assembly Appropriations Committee.

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 from the Senate Appropriations Committee.

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.

AB 327 (Garrick, 2009/2010) would have reduced the minimum franchise tax from $800 to $100. AB 327 failed passage out of the Assembly by the constitutional deadline.

AB 2126 (Garrick, 2009/2010) would have reduced the minimum franchise tax to $100 for qualified small businesses. AB 2126 failed passage 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 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. It also imposes a minimum tax of $25 to $4,500 for LPs, LLCs, and LLPs based on their in-state receipts.

FISCAL IMPACT

This bill would require changes to the department's forms and instructions, processing, and programming. As the bill continues to move 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:

Estimated Revenue Impact of AB 1432 As Introduced February 17, 2017 Assumed Enactment After June 30, 2017 ($ in Millions)		
2017-18	2018-19	2019-20
- $22	- $90	- $190

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 SOS and data from the Franchise Tax Board for years 2009-2016, it is estimated that in 2018 approximately 87,000 corporations, and 46,000 new LLCs, LLPs, and LPs would register and be doing business per the limitations specified in the 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 46,000 LLCs, LLPs, and LPs would be subject to the annual tax and benefit from the exemption in tax year 2018, resulting in an estimated revenue loss of $37 million. For the 2019 tax year, it is estimated that 91,000 first- and second-year LLCs, LLPs and LPs and 86,000 second-year corporations would benefit from the minimum franchise tax and annual tax exemption for a total estimated revenue loss of $140 million.

The revenue loss would be phased in over a five-year period, reaching $400 million in 2023 and would continue to increase with the establishment of new businesses in California.

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

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some taxpayers may argue that providing a limited term exemption from the minimum tax or annual tax would give a needed tax break to newly formed entities in California and therefore encourage them to stay in business.

Opponents: Some taxpayers may argue that providing a limited term exemption to only newly formed entities may be overly narrow and inadvertently exclude other businesses that also need assistance.

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