

Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Morrell Analyst: Jessica Deitchman Bill Number: SB 248
Related Bills: See Legislative History Telephone: 845-6310 Introduced Date: February 7, 2017
Attorney: Bruce Langston Sponsor: _____

SUBJECT: Annual Tax & Minimum Franchise Tax/Exempt New Small Businesses

SUMMARY

This bill would, under the Corporation Tax Law and Personal Income Tax Law, modify the minimum franchise or annual tax due from certain small businesses.

RECOMMENDATION – NO POSITION

REASON FOR THE BILL

The reason for the bill is to provide tax relief to small businesses by reducing the minimum franchise or annual tax for the first six years.

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, and before January 1, 2024.

FEDERAL/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 (MFT). Taxpayers must pay the MFT only if it is more than their measured franchise tax. For taxable years beginning on or after January 1, 1997, only corporate taxpayers whose net income is less than approximately \$9,040 pay the MFT because their measured tax would be less than \$800 ($\$9,039 \times 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 MFT 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 (LP); limited liability companies (LLC) not classified as corporations, limited liability partnerships (LLP), 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 LPs, LLCs not classified as corporations, and LLPs is set at \$800 by reference to the minimum franchise tax.

A corporation wholly owned by an individual that is a member of the U.S. Armed Forces is exempt from paying the MFT for any taxable year if both of the following apply:

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

THIS BILL

For each LP, LLP, LLC or corporation that is a small business and that first commences business operations on or after January 1, 2018, and before January 1, 2024, this bill would eliminate the minimum franchise or annual tax for the first taxable year. This bill would also reduce the minimum franchise or annual tax, as applicable, to \$400 for the 2nd through 6th taxable years.

This bill would define the following terms:

- “Gross receipts” means the gross amounts realized (the sum of money and the fair market value of other property or services received) on the sale or exchange of property, the performance of services, or the use of property or capital, including rents, royalties, interest, and dividends, in a transaction that produces business income, in which the income, gain, or loss is recognized or would be recognized if the transaction were in the United States under the Internal Revenue Code (IRC), as applicable for purpose of this part. Amounts realized on the sale or exchange of property sold would not be reduced by the cost of goods sold or the basis of the property sold. Gross receipts, even if business income under part 11 (commencing with Section 23001), would specifically exclude the following items:
 - Repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, certificate of deposit, or similar marketable instrument.
 - The principal amount received under a repurchase agreement or other transaction properly characterized as a loan.
 - Proceeds from issuance of the taxpayer’s own stock or from sale of treasury stock.
 - Damages and other amounts received as the result of litigation.
 - Property acquired by an agent on behalf of another.
 - Tax refunds and other tax benefit recoveries.
 - Pension reversions.
 - Contributions to capital, except for sales of securities by securities dealers.
 - Income from discharge of indebtedness.
 - Amounts realized from exchanges of inventory that are not recognized under the IRC.

- Amounts received from transactions in intangible assets held in connection with a treasury function of the taxpayer's business and the gross receipts and overall net gains from the maturity, redemption, sale, exchange, or other disposition of those intangible assets.
 - "Treasury function" means the pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the taxpayer's trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, and business acquisitions, and also include the use of futures contracts and options contracts to hedge foreign currency fluctuations. A taxpayer principally engaged in the trade or business of purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function, such as a registered broker-dealer, is not performing a treasury function, with respect to income so produced.
- Amounts received from hedging transactions involving intangible assets.
 - "Hedging transaction" means a transaction related to the taxpayer's trading function involving futures and options transactions for the purpose of hedging price risk of the products or commodities consumed, produced, or sold by the taxpayer.
- "Small business" means any taxpayer that, for the previous taxable year, had gross receipts, less returns and allowances, reportable to this state of one million dollars (\$1,000,000) or less.

The reduction or elimination of the minimum franchise or annual tax would be unavailable to any LP, LLC, LLP or corporation that reorganizes solely for the purpose of reducing its minimum tax.

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 term "commencing business operations" is undefined in the bill. As a result, the term could be broadly interpreted to include businesses that move from one location in California to another, or businesses that change entity structure (e.g. Addition of plant in the same line of business, expansion into another line of business). To avoid confusion, it is recommended that the author amend the bill to provide specific criteria that would define commencing business.

Because the bill fails to state otherwise, a taxpayer whose total gross receipts less returns and allowances exceeded one million dollars would qualify for the reduction this bill would allow so long as the amount reportable to California was on million dollars or less. If this is contrary to the author's intent, the bill should be amended.

This bill would allow a small business to pay a reduced minimum franchise or annual tax in the succeeding five years after the first year of operation. It is unclear if the author intends for a determination to be made annually that an entity is a small business or if the determination would be made at the beginning of the period and apply for all five years. For clarity, it is recommended the bill be amended to specify whether the business must remain a small business to qualify for the reduction.

Further, the bill would define a small business as “any taxpayer that for the previous taxable year had gross receipts, less returns and allowances, reportable to the state of one million dollars or less.” This definition may be interpreted to include the subsidiaries of large corporate taxpayers that file a combined return as “small businesses.” If the author’s intent is to disallow this reduction specifically for the subsidiaries of large businesses, it is recommended the bill be amended to specify this disallowance.

TECHNICAL CONSIDERATIONS

This bill uses the term “minimum franchise tax” for LPs, LLCs, and LLPs. LPs, LLCs, and LLPs in the Personal Income Tax section pay an “annual tax” equal to the MFT. It is recommended that the bill be amended to use the term “annual tax” when referencing LPs, LLCs, and LLPs.

LEGISLATIVE HISTORY

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

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 1769 (Dababneh, 2013/2014) would have exempted certain small business LLCs from the MFT 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 MFT 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 MFT 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 MFT 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 MFT 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 MFT 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 MFT. AB 166 failed passage out of the Assembly by the constitutional deadline.

AB 368 (Morrell, 2011/2012) would have reduced the MFT 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 MFT 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 MFT or annual tax and reduced the MFT 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, Massachusetts, and New York do impose a minimum tax on corporations, but they lack a reduction schedule similar to the one proposed in this bill.

FISCAL IMPACT

Department costs have yet to be determined. 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 SB 248 As Introduced February 7, 2017 Assumed Enactment After June 30, 2017 (\$ in Millions)		
2017-18	2018-19	2019-20
- \$21	- \$60	- \$110

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 LLPs, LPs, and LLCs would register and be doing business per the limitations specified in the bill.

The estimated revenue loss for 2018 does not include corporations because under current law they are not subject to the MFT in their first year of operation. However, approximately 45,000, LPs, LLPs, and LLCs would be subject to the annual tax and benefit from the reduced tax in tax year 2018, resulting in an estimated revenue loss of \$36 million. For the 2019 tax year, it is estimated that 90,000 first- and second-year LPs, LLPs, and LLCs, and 80,000 second-year corporations would benefit from the reduced MFT and annual tax for a total estimated revenue loss of \$85 million.

The revenue loss would be phased in over a five-year period, reaching \$210 million in 2023 and would continue to increase (until the sunset of the bill) with the establishment of new small 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 may argue that the bill would give a needed tax reduction to small businesses in California and therefore encourage them to remain in business.

Opponents: Some may argue that the bill would provide a reduction to potentially large businesses and not capture the true “small business.”

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