
SENATE COMMITTEE ON REVENUE AND TAXATION

Senator Jerry McNerney, Chair
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MINIMUM FRANCHISE TAX

Alters the annual tax on partnerships and limited liability companies to \$200.

Background

Minimum Franchise Tax. State law imposes an annual franchise tax on corporations (C Corps and S Corps) for the privilege of doing business in California. The measured franchise tax rate is 8.84% for C Corps and 1.5% for S Corps, and it applies to corporations' California apportioned net income, although higher rates apply to financial corporations. State law also imposes a Minimum Franchise Tax (MFT) of \$800 on all corporations, which corporations must pay if their amount of measured franchise tax is below the annual tax amount. The MFT ensures that business taxpayers who do not show a profit in a taxable year bear some of the cost of public services. Generally, C-Corps with a net income of less than \$9,049.32 and S-Corps with a net income of less than \$53,333.34 will pay the MFT, since their measured franchise tax would be less than \$800.

The Legislature has enacted several general or specific exemptions from the MFT. Credit unions are exempt from the MFT, and certain nonprofit cooperative associations are exempt for up to 5 years. Additionally, beginning January 1, 2000, newly incorporated or qualified C-Corporations and S-Corporations are not required to pay the minimum franchise tax in their first taxable year (AB 10, Correa, 1998). Additionally, corporations are exempt from the MFT if they did not conduct business in California during the tax year and their tax year was 15 days or fewer. This exemption does not apply to any corporation that reorganizes solely to avoid MFT payments.

The Legislature also exempts corporations and limited liability corporations (LLCs) solely owned by a deployed United States Armed Forces member from the MFT and the Annual Tax (AB 2671, Cook, 2010, extended by AB 308, Muratsuchi, 2019). To qualify for this exemption, the corporation or LLC had to be a small business, which is defined as having \$250,000 or less in total apportioned state income. This exemption will expire January 1, 2030, unless extended.

Pass-Through Entities. S-corporations, LLCs, Limited Liability Partnerships (LLP), and Limited Partnerships (LP) are business entities set up to distribute net income generated from the business to their owners (called shareholders, members, or owners). The owners report the income on their personal income tax returns and pay appropriate tax. This "pass-through" is meant to limit or eliminate double taxation of the same income, which can occur with C-corporations, which pay an entity-level tax and whose owners pay tax on dividend income or capital gains from the sale of stock.

Annual Tax. Similar to C-Corps and S-Corps, state law imposes an annual tax on pass-through entities such as LLCs, Limited Partnerships (LPs), Limited Liability Partnerships (LLPs), and qualified Subchapter S subsidiaries (QSubs). Similar to the MFT, these entities are subject to an annual entity-level tax that operates as a minimum charge for the privilege of doing business/maintaining registration in California, set at \$800. Individual sections of state law require each LLC, LP, and LLP to pay an annual tax, with the amount set by reference to the MFT amount for C-Corps. However, unlike corporations subject to the MFT, LLCs, LPs, LLPs, and QSubs are not currently granted a first-year exemption from the annual tax.

AB 85 (Committee on Budget, 2020) temporarily authorized a first-year exemption to the annual tax for partnerships and LLCs for tax years 2020 through 2023, estimated to result in a General Fund revenue loss of \$50 million in the 2020-21 fiscal year (FY). The exemption expired after the 2023 taxable year, and the Legislature did not renew it. Like corporations, LLCs, LPs, and LLPs are not currently subject to the annual tax if they did not do business in California during the taxable year and the taxable year was 15 days or less.

LLC fee. Additionally, every LLC subject to the annual tax must also pay an annual fee based on the total income from all sources derived from or attributable to the state. The current LLC fee schedule is \$900 if total income is more than \$250,000 but less than \$500,000; \$2,500 if total income is more than \$500,000 but less than \$1 million; \$6,000 if total income is more than \$1 million but less than \$5 million; and \$11,790 if the total income is more than \$5 million.

Seeking to make California's business environment more competitive, the author wants to reduce the annual tax on LLCs, LPs, and LLPs.

Proposed Law

Senate Bill 347 amends the three sections of law requiring LLCs, LPs, and LLPs to reduce the \$800 annual tax to \$200. The bill applies to taxable years beginning on or after January 1, 2026, and before January 1, 2031. The measure also makes legislative findings and declarations to comply with Section 41 of the Revenue & Taxation Code.

State Revenue Impact

According to the Franchise Tax Board, this bill will result in a General Fund revenue loss of \$1.2 million in FY 2026-27, \$ 1.1 million in FY 2027-28, and \$1.2 million in FY 2028-29.

Comments

1. **Purpose of the bill.** According to the author, "Small businesses are the backbone of California's economy. According to the California Office of the Small Business Advocate, our state is home to more than 4.3 million small businesses, which account for more than 7.6 million jobs. Millions of these businesses are registered as LLCs, LLPs, or LPs. Existing law imposes an annual tax of \$800 on every business in the state, regardless of whether they are a small business with a handful of employees or a large business with hundreds of employees. California continues to compete with other states to attract new businesses and retain its existing businesses. By reducing the annual tax for limited liability companies and partnerships from \$800 to \$200, Senate Bill 347 would help California become a more competitive and business-friendly environment, while providing relief for millions of small businesses."

2. Effective incentive? The 2020-21 Governor's budget included a proposal to expand the first-year MFT exemption that applies to C-Corps to LLCs, LPs, and LLPs, the same entities that would pay a reduced minimum tax under SB 347. The Legislature subsequently enacted the proposal in AB 85. At the time, the Legislative Analyst's Office (LAO) analysis of the Governor's proposed expanded exemption noted that reducing the annual tax amount provides limited financial assistance relative to businesses' overall costs, such as equipment, construction, salaries, and rent.¹ LAO's analysis further noted that according to U.S. Census data the growth rate of new business formations increased about 3% per year since 2007, and that despite the lack of an exemption, the number of LLCs had grown more quickly in recent years (about 7% per year since 2007, according to the Franchise Tax Board), suggesting that the lack of the first-year minimum franchise tax exemption did not significantly hinder the formation of new businesses. Using first-time registration data from the Secretary of State, the Franchise Tax Board's October 2023 report on the expanded exemption data indicated that taxpayers qualifying as first-year LLCs, LPs, and LLPs increased by 3.8% from 2021 to 2022, which is substantially similar to the 3% growth rate for all new business formations cited in the LAO report.²

3. The rationale. Like the MFT, the annual tax on LLCs, LPs, LLPs, and QSubs is a tax for the privilege of doing business in California. Regardless of whether a corporation, LLC, LP, LLP, or QSub generates income, the entity accrues benefits from the state. For example, one of the benefits corporations receive is the limitation of personal liability for all of the entity's officers. In other words, if the business fails, the entity can discharge its debts, and its officers can avoid personal bankruptcy. The state imposes the MFT or annual tax of \$800 in return for these benefits, among others. Regardless of the size of the business, the state incurs administrative burdens from the business's activities, such as processing the entity's tax returns. Whether the MFT or annual tax is \$800 or \$200, the state will still incur those administrative costs, even if the corporation is small.

4. Revenue loss. By reducing the annual tax to \$200, SB 347 will result in the State General Fund receiving less revenue. As a result, the state will have to reduce spending on vital public services such as education and public safety or increase taxes to fund the annual tax reduction. The Committee may wish to consider whether SB 347 is worth the spending cuts and/or tax increases.

5. MFT and annual tax on QSubs remain the same. Reducing the annual tax on LLCs, LPs, and LLPs from \$800 to \$200 while leaving the QSub annual tax at \$800 would create a \$600-per-entity disparity, making QSub structures and corporations subject to the MFT comparatively more expensive to maintain in California.

6. California competitiveness. The author states that the purpose of this bill is to make California's business environment more competitive for partnerships and limited liability companies. When a business is considering what jurisdiction to do business in, the state's market size, workforce, and tax environment are often key considerations. California has been

¹ Brian Weatherford. (2020, March 23). *The 2020-21 Budget: Expanding the Minimum Franchise Tax Exemption*. California Legislative Analyst's Office. <https://lao.ca.gov/reports/2020/4207/min-franchise-tax-exemption-032320.pdf>

² Franchise Tax Board. (2023, October). *Limited liability company, limited liability partnership, and limited partnership first year annual tax exemption*. California Franchise Tax Board. <https://www.ftb.ca.gov/about-ftb/data-reports-plans/Limited-Liability-Company-Limited-Liability-Partnership-and-Limited-Partnership-First-Year-AnnualTax-Exemption-October-2023.pdf>

successful in fostering new businesses and retaining existing businesses, in part due to its unmatched market size, strong workforce, and competitive tax incentives. States with smaller market sizes and workforces often use lower taxes to increase their attractiveness to businesses. For example, Delaware has a \$300 annual tax and Nevada has \$350 annual fee. Reducing California's annual tax to \$200 is intended to directly compete for business that may find a lower annual tax a compelling reason to do business outside of California. However, will a difference of a few hundred dollars in minimum tax truly make or break a business? The committee may wish to consider whether reducing the California annual tax will meaningfully increase California's business competitiveness.

7. Inflation. California's MFT and annual tax were set at \$800 in 1990 but have not increased since then. If the Legislature had indexed the MFT and annual tax to inflation, it would be set at \$1,957.45 in 2025. In other words, the actual cost of the MFT and annual tax, in real dollars, has significantly decreased and is essentially 60% less than what it was in 1990. The Committee may wish to consider whether a further reduction is necessary.

8. Section 41. Section 41 of the Revenue and Taxation Code requires any bill enacting a new tax expenditure to contain, among other things, specific goals, purposes, and objectives that the tax expenditure will achieve and detailed performance indicators, along with data collection and reporting requirements (SB 1335, Leno, 2014). To satisfy these requirements, SB 347 states that its purpose is to make California's business environment more competitive for partnerships and limited liability companies. The performance indicator for the Legislature to use in determining whether the act achieves its goal shall be the number of partnerships and limited liability companies that are affected by the act. The measure then directs the Franchise Tax Board to report to the Legislature regarding the performance indicator on or before April 1, 2028, and annually thereafter.

9. Committee amendments. To reduce the measure's fiscal impact, the Committee may wish to consider amending SB 347 to revise the annual tax reduction from \$800 to \$600, instead of the bill's current \$200.

Support and Opposition (1/8/26)

Support: None received.

Opposition: None received.

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