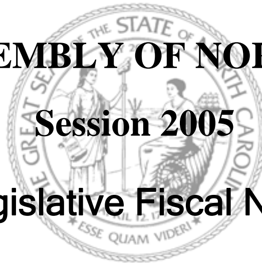

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

Legislative Fiscal Note

BILL NUMBER: House Bill 1962 (First Edition)

SHORT TITLE: Franchise Tax Loophole Closing.

SPONSOR(S): Representative Luebke

FISCAL IMPACT

	Yes (X)	No ( )	No Estimate Available (X)		
	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11
REVENUES:			**See Assumptions and Methodology**		
EXPENDITURES:					
POSITIONS: (cumulative):					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: The franchise tax is administered by the Department of Revenue. The enactment of the bill is not expected to affect the Department's budget requirements.

EFFECTIVE DATE: Tax years beginning on or after January 1, 2007.

ISSUE BACKGROUND*:* Under North Carolina law, limited liability companies (LLCs) are not subject to the franchise tax. In 1997 single-member LLCs were authorized in North Carolina. This allowed a corporation the opportunity to set up an LLC and transfer assets to the LLC in a tax-free transfer. The assets then held by the LLC would not be subject to the franchise tax.

The 2001 General Assembly attempted to correct this situation by requiring a corporation to pay tax on assets owned by the LLC if the corporation, including its affiliated corporations, indirectly owned at least 70% of the LLC's assets. However, tax planners found that the tax could still be avoided by using an additional paper transaction. For example, if the corporation interposed a partnership between itself and the LLC holding its assets, the assets would continue to escape the franchise tax.

In 2002, the General Assembly addressed this issue by including "related members" (other entities and individuals) who may partner with one or more corporate entities to own the LLC to which the corporate assets are transferred. If a corporation and its related members together indirectly own at least 70% of an LLC's assets, each corporation would pay the franchise tax on its relative share of the LLC's assets.

After the enactment of the 2002 session change, it was discovered that there are other paper transactions that can be interposed between the corporation and the LLC to avoid the franchise tax. One example is a business trust. The tax does not apply in this situation because the trust is not considered a “related member”. In addition, the 2002 legislation also had the effect of extending the tax to situations that did not involve corporate control of LLC assets.

The 2004 General Assembly attempted to address these issues by providing that for purposes of determining the ownership of an LLC’s assets, any membership interest of a business trust would be attributed to the owners of the beneficial interest in the business trust, according to their interests in the trust, and the trust itself would be disregarded as a separate entity. In addition, the 2002 bill limits the tax to only those assets that a corporation controls and exempts small LLC’s.

BILL SUMMARY: (1) Applies the corporate franchise tax to limited liability companies (LLCs) that elect to be taxed as a C corporation for federal income tax purposes; (2) provides these corporations are eligible for a nonrefundable credit equal to the difference between the annual report fee for corporations ($20) and the same fee for LLC’s ($200); (3) makes conforming changes regarding attribution of certain LLC assets to controlling corporations for franchise tax purposes.

ASSUMPTIONS AND METHODOLOGY: Discussions with tax administrators in the Department of Revenue indicate that the practical effect of the legislation is to address another potential method of avoiding franchise tax liability by corporate structuring arrangements. The concern arose as a result of a request from a major accounting firm for a private letter ruling. The tax planning scenario would involve a corporation headquartered in North Carolina, but whose parent company is domiciled outside the State. In addition, the parent's only contact with North Carolina is its ownership of the corporation. This corporation, which already files as a C-corporation for federal tax purposes, could convert to an LLC but make an election to continue being taxed as a C-corporation and avoid franchise tax because the parent has no nexus (tax situs) with this State. Thus, the "constructive ownership" attribution rules do not apply.

The Department has no data on whether any companies have already established such arrangements. An attempt by the tax research operation of the Department to quantify the number of 2003 taxpayers who might be affected by the proposal was not conclusive because many of the tax planning changes that would be affected by this legislation will have later than 2003 and the fact that many potential taxpayer impacts in 2003 many not materialize because the affected entity has since become a part of other corporate entities.

The request for a private letter ruling suggests that one or more accounting firms were contemplating the use of such a tax sheltering vehicle. With the passage of time since the legislation was originally proposed, it is possible that the activity level of this tax planning tool has accelerated.

SOURCES OF DATA: Discussions with Department of Revenue

TECHNICAL CONSIDERATIONS: None

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