State of Rhode Island
Budget Office
Department of Administration

State Fiscal Note for Bill Number: 2014-H-7034

Date of State Budget Office Approval:

Date Requested: **Monday, March 17, 2014**

Date Due: **Thursday, March 27, 2014**

Impact on Expenditures		*Impact on Revenues*	
FY 2014	n/a	FY 2014	n/a
FY 2015	n/a	FY 2015	$(13,919,250)
FY 2016	n/a	FY 2016	$(14,253,000)

Explanation by State Budget Office:

This bill would amend Rhode Island General Law Chapter 44-12, entitled "Franchise Tax" by eliminating the minimum franchise tax of $500 for the tax year in which a corporation is formed, and for the two tax years immediately following the corporation's formation. After three years, the minimum franchise tax would be $500 for the entity.

The act also provides for the minimum franchise tax to be reduced by $100 for each employee hired by any corporation subject to the franchise tax up to a maximum reduction of $400.

Under current law, the minimum franchise tax is $500 for all business entities subject to the tax regardless of the length of time the taxpayer has been in business or the number of employees employed by the taxpayer.

It should be noted that only business entities that issue shares of stock are subject to the franchise tax. These business entities are subchapter C and subchapter S corporations. Only Subchapter S corporations would be affected by these changes as subchapter C corporations are required to pay the greater of the tax imposed under Rhode Island General Law Chapter 44-11 entitled "Business Corporation Tax" or Rhode Island General Law Chapter 44-12. Limited liability companies (LLC), limited partnerships (LP), and limited liability partnerships (LLP) are subject only to the tax imposed under Rhode Island General Law Chapter 44-11. The minimum tax imposed under Rhode Island General Law Chapter 44-11 would remain at $500.

Comments on Sources of Funds:

All franchise taxes are considered to be general revenues.

Summary of Facts and Assumptions:

This act takes effect upon passage but it's assumed to apply to tax years beginning on or after January 1, 2014. The Office of Revenue Analysis (ORA) assumed that tax liabilities incurred in a given tax year are realized in the following fiscal year.

To calculate the fiscal impact of the proposed legislation ORA utilized the Rhode Island Secretary of State's New Entity Listings database, a database which tracks only new business formations, when determining the fiscal impact of the proposed legislation. The New Entity Listings database lists the number of new entities that filed papers with the Secretary of State's office on a weekly basis. ORA also relied on information provided by the Rhode Island Department of Revenue's Division of Taxation on the number of subchapter S corporations and C corporations who paid

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either the minimum corporate tax or franchise tax on or before January 27, 2014.

To calculate the fiscal impact of the proposed exemption in the franchise minimum tax for newly incorporated subchapter S corporations, According to the Rhode Island Secretary of State's New Entity Listings database, from August 11, 2013 through January 26, 2014 3,061 C-corporations, subchapter S-corporations, LLCs, LLPs and LPs filed new business formation paperwork. For the same period in the prior year, in this case August 12, 2012 through January 27, 2013, there were a total of 3,003 new C-corporations, subchapter S-corporations, LLCs, LLPs and LPs that filed new business formation paperwork. From this data, ORA calculated the year over year growth rate for newly registered C-corporations, subchapter S-corporations, LLCs, LLPs and LPs to be 1.93 percent (i.e. 3,061/3,003 – 1). ORA utilized the August 11, 2013 through January 26, 2014 time frame as a proxy to match the latest report on minimum filers from the Division of Taxation, which was January 27, 2014. As a result, ORA assumed a compounded annual rate of growth of 1.93 percent for all minimum tax filers for tax years 2013 through 2017.

According to the Division of Taxation, as of January 27, 2014 a total of 55,592 C corporations, subchapter S corporations, LLCs, LLPs and LPs paid either the minimum corporate or the minimum franchise tax of $500 for tax year 2012. ORA assumed that all minimum filers have paid the minimum tax by January 27, 2014 for tax year 2012. ORA applied the 1.93 percent growth rate noted above sequentially to estimate the total number of minimum tax filers for tax years 2013 through 2016. Thus, for tax year 2013 the total number of C-corporations, subchapter S-corporations, LLCs, LLPs and LPs minimum filers is estimated to be 56,666; for tax year 2014 the total number of C-corporations, subchapter S-corporations, LLCs, LLPs and LPs minimum filers is estimated to be 57,760; for tax year 2015 the total number of C-corporations, subchapter S-corporations, LLCs, LLPs and LPs minimum filers is estimated to be 58,876; and for tax year 2016 the total number of C-corporations, subchapter S-corporations, LLCs, LLPs and LPs minimum filers is estimated to be 60,013.

Of the total 55,592 minimum filers in tax year 2012, C corporations and S corporations represent 77.9 percent of the total minimum tax filers (i.e. 43,284/55,592). Applying the 77.9 percent of minimum tax filers that were C corporations or subchapter S corporations for tax year 2012 to the estimated number of all minimum filers for tax year 2013 through tax year 2016, results in an estimated number of C corporations and subchapter S corporations that paid the corporate minimum tax of 44,120 for tax year 2013 (i.e. 56,666 * 0.779); 44,972 for tax year 2014 (i.e. 57,760 * 0.779); 45,841 for tax year 2015 (i.e. 58,876 * 0.779) and 46,726 for tax year 2016 (i.e. 60,013 * 0.779).

According to the Division of Taxation by January 27, 2014, there were a total of 31,922 subchapter S corporations who paid the minimum franchise tax and 10,026 C corporations who paid either the minimum franchise tax or the minimum business corporation tax. ORA calculated that 76.1 percent of C corporations and subchapter S corporations that paid the minimum franchise or minimum business corporation tax were subchapter S corporations (i.e., 31,922 / (31,922 + 10,026)).

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In order to determine the number of subchapter S-corporations, ORA applied the 76.1 percent of C corporations and subchapter S corporations that paid the minimum franchise or business corporation minimum tax that were subchapter S corporations to the tax year 2013 through tax year 2016 estimated minimum tax filers for C corporations or subchapter S corporations. The estimated number of subchapter S corporations that were minimum tax filers are 33,575 for tax year 2013, 34,223 for tax year 2014, 34,884 for tax year 2015 and 35,558 for tax year 2016.

Under the proposed legislation, with an assumed implementation date of January 1, 2014, any newly incorporated subchapter S corporation would be exempt from paying the minimum franchise tax of $500. As a result, any subchapter S corporation incorporated after tax year 2013 would be exempt from the franchise tax under the proposed legislation. Therefore, in tax year 2014 a total of 648 subchapter S corporations would be exempt from paying the franchise tax (i.e., 34.223 – 33,575). In tax year 2015 a total of 1,309 subchapter S corporations would be exempt from paying the franchise tax, of which 648 are in the second year of the exemption and 661 are in the first year of the exemption (i.e., 34,884 – 34,223). In tax year 2016 a total of 1,983 subchapter S corporations would be exempt from paying the franchise tax, of which 648 are in the third and final year of the exemption, 661 are in the second year of the exemption, and 674 are in the first year of the exemption (i.e., 35,558 – 34,884). As a result, ORA estimated foregone revenue of $324,000 in tax year 2014 (i.e. 648 * 500); $654,000 in tax year 2015 (i.e. 1,309 * 500) and $991,500 in tax year 2016 (i.e. 1,983 * 500).

Since each newly incorporated subchapter S corporation would be exempt from paying the franchise minimum tax of $500 they would not be eligible for the proposed reduction in the franchise tax by $100 for each employee hired by the corporation up to a maximum reduction of $400. Only subchapter S corporations incorporated prior to tax year 2014 would be eligible for the credit, or 33,575 subchapter S corporations for the tax years 2014 through 2016. Thus, for tax year 2014 through tax year 2016 a total 33,575 subchapter S corporations would qualify for the franchise tax credit of $100 for each employee hired by the corporation up to a maximum reduction of $400. The total estimated maximum revenue loss of allowing the $100 per employee credit against the franchise tax would be $13,430,000 for tax years 2014 through 2016 (i.e., 33,575 * 4 * $100).

The total tax year fiscal impact was calculated by summing the two components of the bill. ORA estimated the tax year fiscal impact for tax year 2014 to be $13,754,000 (i.e., $324,000 + $13,430,000), $14,084,500 for tax year 2015 (i.e., $654,500 + $13,430,000) and $14,421,500 for tax year 2016 (i.e., $991,500 + $13,430,000).

It is assumed that business corporation minimum tax payments in a given tax year are collected in the following fiscal year. According to the accrual method of accounting, tax revenues should be recognized over the period in which the tax is imposed. Accordingly, business corporation minimum tax revenues for TY 2015 should be recognized partially in FY 2015, for the period January 2015 through June 2015, and partially in FY 2016, for the period July 2015 through December 2015. Based on this principle, one half of the projected business corporation minimum tax

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revenues for TY 2015 should be accrued to FY 2015, and one half of the projected business corporation minimum tax revenues for TY 2016 should be accrued to FY 2016. Based on the accrual method of accounting revenues are projected to decrease by $13,919,250 for FY 2015 (i.e., ($13,754,000 + $14,084,500)/2) and $14,253,000 for FY 2016 (i.e., $14,084,500 + $14,421,500)/2).

It should be noted that some limited liability companies (LLCs) choose to pay tax as a corporation rather than having the LLC's taxable income pass through to the returns of the individual shareholders. As a result, these LLCs may be subject to the tax imposed by Rhode Island General Law Chapter 44-12 and would face a reduced tax liability if the act were to pass. These LLCs are not included in the analysis of the fiscal impact of the passage of the act above. The Office of Revenue Analysis does not believe that the exclusion of these LLCs from the fiscal impact calculation materially affects the calculations contained herein.

The Governor's FY 2015 Recommended Budget projects an ending balance of $400,000 in FY 2015 and a deficit of $151.1 million in FY 2016. Passage of the act would put the Governor's FY 2015 Recommended Budget out of balance and increase the FY 2016 projected deficit.

Summary of Fiscal Impact:

FY 2014:Not applicable given the assumption that the act is to apply to tax years beginning on or after January 1, 2014.

FY 2015:A revenue loss of $13,919,250 is forecast.

FY 2016:A revenue loss of $14,253,000 is forecast.

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