NORTH CAROLINA GENERAL ASSEMBLY

LEGISLATIVE FISCAL NOTE

BILL NUMBER: SB 51 (Second Edition)

SHORT TITLE: Close Franchise Tax Loophole

SPONSOR(S): Senator Clodfelter

FISCAL IMPACT

Yes ( ) **No ( )** **No Estimate Available (x)**

PRINCIPAL DEPARTMENTS AFFECTED: The franchise tax is collected by the Department of Revenue. The enactment of the bill should not affect the budget requirements of the Department.

EFFECTIVE DATE: Applies to taxes due on or after January 1, 2004.

BILL SUMMARY: 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 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.

Since that time it has been 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”.

The bill provides 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.

The bill also makes a number of technical changes to correct the law and to limit its application in situations where there is the strong possibility that it will affect LLCs that were not created for tax avoidance purposes.

ASSUMPTIONS AND METHODOLOGY: A discussion with the Department of Revenue indicated that there is no data available on this issue.

SOURCES OF DATA:

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