# Understanding California Small Businesses Taxes

### What Taxes Do Small Businesses Have to Pay?

Owners of pass-through businesses must pay California's personal income and business taxes: the corporate tax, alternative minimum tax (AMT), and the franchise tax. Nearly all companies in California pay one of these taxes or all three.

A pass-through business is one in which profits are “passed through” to the owners or members. Also known as a flowthrough business, owners or members of these companies must pay income taxes. The businesses that generally fall into the pass-through category include sole proprietorships, partnerships, limited liability companies, and S-corporations. In contrast to traditional corporations, these businesses are exempt from corporate taxes.

If your business operates as a corporation, you must pay the corporate tax of 8.84% and the AMT of 6.65%, which prohibits writing off expenses against income. Other small businesses must pay a franchise tax depending on the type of corporation they choose to form in California.

### What Is a Franchise Tax?

Every business that wants to do business in California has to pay a franchise tax of $800. It is also known as a privilege tax, allowing a company to operate within a particular state. Franchise taxes are separate from federal and state income taxes. Despite the name, they are not a tax on franchise businesses, which are businesses licensed by a parent company and owned by individual business owners.

The $800 is due for each year a company is in business in California, regardless of whether the company generates any revenue or is profitable. The $800 is due on or before March 15 for that particular year (e.g., March 15, 2021 due date for the 2021 tax year).

### Who Collects Taxes in California?

The California Franchise Tax Board collects an annual franchise tax for all businesses. This tax applies to the following types of companies:

- LLCs (limited liability companies)
- LPs (limited partnerships)
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- S corps (subchapter S corporations)

Corporations in California without taxable income and LLCs that choose to operate as corporations are also subject to the California franchise tax. ‘Foreign entities’ such as corporations, S corps, LLCs, LPs, or LLPs organized under state law and founded in other states are also required to pay franchise taxes. California requires all foreign entities conducting business there to register with the California Secretary of State and pay the franchise taxes.

### Corporate Entities: Taxed on Net Earnings or $800

A corporation is a legal entity separate and apart from its owner. The corporation is taxed like an individual. The tax rate in California is 8.84% for non-pass-through entities. For example, if a company has net earnings of $500,000, the franchise tax would be $44,200 paid to the California Franchise Tax Board. However, if you form a business under an LLC, LP, or LLP in California before December 31, 2023, then you do not have to pay the $800 minimum annual franchise tax for the first taxable year. Before the new law, only corporations were exempt from the franchise tax in the first year after their registration with the state. This change removes an obstacle to the creation of small businesses. Regardless of whether your corporation is operating at a loss or fully active, it must still pay the franchise tax.

**Franchise Taxes and Pass-Through Entities**
In successful companies, after paying expenses and taxes, dividends are often paid to owners. This leads to double taxation, where the corporate shareholders are taxed at an individual level while the corporation's earnings were already taxed at the corporate level.

The California tax system applies pass-through taxation to limited partnerships, limited liability partnerships, and limited liability companies are taxed as partnerships.

**Limited liability companies (LLCs)**
Limited liability companies also pay the franchise tax. However, they are taxed at flat dollar amounts based on the LLC's annual gross income tiers. The level of taxation depends on the tier. For instance, a business generating a gross income between $50,000 and $99,999 pays $2,500.

Small businesses still pay the minimum franchise tax of $800, even if their gross income is less than $250,000. Business owners must pay marginal taxes on their net income at rates ranging from 1% to 12.3% for an LLC.

**Partnerships**
Limited liability partnerships (LLPs) and limited partnerships (LP) have to pay franchise taxes of $800. Business owners must file individual tax returns for any income that passes through those partnerships.

**S Corporations**
An S corporation pays a lower tax rate of 1.5% on net corporate income instead of the corporate tax of 8.84% for traditional corporations, passing the profits to the business owners. California is unusual in that while it recognizes an S corporation as a business organization, it doesn't recognize an S-corporation as a pass-through business.

S corporations in California have to pay a 1.5% franchise tax on net income, with a minimum threshold of $800. For example, 1.5% of an S corporation's net income of $100,000, or $15,000, goes towards California state income tax. Further, any individual shareholder has to pay tax on their share of an S corporation's income for their personal tax returns, respectively.

**Understanding business entities and taxes for small businesses**
While most corporations must pay the franchise tax, S corporations are not taxed the same way. You should explore the taxation system or hire an expert to determine which entity works best for your business. You can work with an accountant and a tax attorney to better understand how to operate your business best so that you're not paying unnecessary taxes.