

The 2022-23 Budget:

# Secretary of State Request to Waive Business Filing Fees

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**Summary.** In this post we analyze the Governor’s proposal to waive the filing fee paid when a new limited partnership (LP), limited liability company (LLC), or corporation is registered with the Secretary of State (SOS) for the fiscal year of 2022-23. Under the proposal, the General Fund would provide SOS \$39.8 million to backfill the loss of fee revenue. The stated purpose of the proposed fee waiver is to encourage business growth in California. Because we do not view the business filing fees to be a barrier for new businesses, we recommend that the Legislature reject the proposal—freeing up the funding for other legislative priorities. If the Legislature chooses to approve the proposal, we recommend amendments to budget bill language to clarify legislative intent. In addition, we identify that the SOS Business Fees Fund requires attention as it seems that its fee levels may be too high and recommend that the administration evaluate the fund’s fees and reserve levels in light of desired service levels.

## BACKGROUND

### Business Entities

***Businesses Are Organized in Different Ways.***

Businesses take a variety of forms depending on the complexity of their ownership and management structure. The primary considerations for determining which form to take include the number of owners, whether the owners are all actively involved in managing the business, and whether the owners need or want protection from financial liabilities. We discuss five major types of business organizations below.

- **Sole Proprietorships.** A sole proprietorship is owned and managed by an individual. It is the most basic and most prevalent form of business entity. The owner is personally liable

for the business’ debts and other liabilities. Nearly 70 percent of California’s 5 million businesses are sole proprietorships.

- **General Partnerships.** When two or more individuals decide to jointly own and operate a business, they form a partnership. A general partnership is similar to a sole proprietorship in that the owners are equally responsible for any debts or other liabilities of the business.
- **Limited Partnerships.** Unlike general partnerships, LPs provide business owners with limited liability protection. This means that the owners are not personally liable for the business’s debts. An individual or another company may be a partner in an LP.
- **Limited Liability Companies.** An LLC also provides owners (members) with limited liability protection but is legally distinct from its owners. An LLC may be owned by individuals or companies. An LLC may have just a single member.
- **Corporation.** A corporation also provides liability protections and is a business that is legally distinct from its owners (shareholders). Individuals or companies may own a corporation. A corporation may have just a shareholder.

### SOS Business Filings

***Corporations, LLCs, and LPs File Information***

***With and Pay Fees to SOS.*** In order to establish a corporation, an LLC, or an LP in California, applicants first must register the new business entity with SOS and pay a filing fee. This initial filing fee is \$100 for corporations and \$70 for LLCs and LPs. This fee level has been in place for at least the past 20 years. In addition, there are a number of other types of filings and fees that businesses submit to SOS.

***Business Filing Fees Are Revenue Source of Special Fund.*** The fees paid to SOS by business entities are the primary revenue source for the SOS’s Business Fees Fund. The Business Fees Fund is established under Section 12176 of the Government Code, which specifies that (1) the Business Fees Fund be used to support the programs from which fees are collected, (2) the fees collected shall be sufficient to cover the costs of these programs, and (3) up to \$1 million may remain in the fund with any additional excess funds being transferred to the General Fund at the end of each fiscal year. The fee levels charged to business entities are specified in the Government Code, beginning with Section 12180. The Business Filing Fee is a significant fund source for SOS and typically pays for more than one-third of the department’s expenditures.

## **PROPOSAL**

### ***Waive New Business Filing Fees for 2022-23.***

For the fiscal year of 2022-23, the administration proposes waiving the filing fee paid when a new business entity is registered with SOS. The stated purpose of this proposal is “to encourage business growth in California.” Based on the fund condition statement, the administration estimates that this proposal would reduce revenues to the Business Filing Fund by about 45 percent—or \$39.8 million. To support SOS operations that are funded by the Business Filing Fund, the administration proposes that the General Fund be used to backfill the special fund with a one-time General Fund appropriation of \$39.8 million.

## **LAO COMMENTS**

***Waiving Fee Likely Would Do Little to Stimulate Business Growth*** Businesses likely consider the filing fees an unwelcome cost. However, the proposed one-time fee waiver would provide limited financial assistance to new businesses relative to the overall cost of starting a new business. These costs—such as equipment, construction costs, employee salaries, and rent—often sum to tens of thousands of dollars, or considerably more. Paying a \$100 or \$70 fee likely is not a barrier to the formation of new business

entities in California. Further, the request indicates that the number of filings has grown considerably over the past few years—from 289,879 in 2018 to 343,877 in 2020 and—through November 30—396,290 in 2021. This growth in new business entity formations has been occurring under the existing fee structure. Although new businesses may appreciate the one-time filing fee relief, we doubt that the administration’s proposal would do much, if anything, to stimulate meaningful business growth.

***Business Filing Fee and Reserve Structure Needs Attention.*** The Business Fees Fund consistently has a fund balance in excess of \$1 million at the end of the fiscal year. This has resulted in significant sums of money being transferred from the Business Fees Fund to the General Fund. For example, between 2011-12 and 2020-21, the General Fund received \$179 million from the special fund. The amount transferred to the General Fund has varied significantly year to year, ranging from \$5 million in 2011-12 to \$36 million in 2017-18. As a percentage of revenues, the transfer to the General Fund has varied from 9 percent of fee revenues in 2019-20 to 41 percent of fee revenues in 2017-18. The consistent and large transfers to the General Fund suggest that business entities have been paying higher fees than are necessary to support the program. The fee structure should be designed so that businesses pay fees that are at a level that is reasonable for the support of the program. That being said, lowering fees creates risk that the special fund might not have sufficient resources in a particular year. This is demonstrated by the volatility in revenues to the fund. For example, between 2011-12 and 2020-21, year-over-year growth in revenues ranged from a 40 percent *increase* in revenues between 2013-14 and 2014-15 (from \$50.7 million to \$71.1 million) and a 5 percent *decrease* between 2017-18 and 2018-19 (from \$87.8 million to \$83.3 million). The current reserve limit of \$1 million makes it difficult for SOS to charge businesses a lower fee while still fulfilling the requirements of Section 12176 that the fund be self-sufficient. A higher reserve limit for the fund would allow a lower fee for all businesses while still providing that the fund is self-sufficient.

**California Business Connect (CBC) Should Change SOS Operations.** The CBC project is automating the business filing processes at SOS. While many processes already have been automated under the project, filings related to business entities is the last module to be rolled out. This module is scheduled to be completed by April 2022. The project is scheduled to be through maintenance and operations by April 2023. Once fully operational, CBC will fundamentally change SOS operations. This could lead to changes in revenues and resource needs for the program.

**Budget Bill Language Could Be Clearer.** The administration proposes budget bill language to implement its plan to waive filing fees for new business entities. Specifically, provision one of the language states that the \$39.8 million General Fund appropriation “shall be limited to backfilling revenues related to waiving first-time Secretary of State filing fees for businesses (corporations, limited liability companies and limited partnerships).” If the Legislature is interested in adopting this fee waiver, this language could be clearer as to which fees are waived for 2022-23.

## LAO RECOMMENDATIONS

**Reject Proposal.** Because we do not view the business filing fees to be a barrier for new businesses, we recommend that the Legislature reject the proposal. Instead, we recommend that the Legislature use the proposed \$39.8 million in a more targeted manner that achieves legislative priorities—whether that be encouraging business growth in California or supporting other legislative priorities supported by the General Fund.

**If Adopting Proposal, Modify Budget Bill Language.** If the Legislature chooses to waive fees paid by new LPs, LLCs, and corporations, we recommend that the Legislature modify the proposed budget bill language to clarify legislative intent. Specifically, we would recommend that provision one under Item 0890-011-0001 be replaced with the following language:

1. It is the Legislature’s intent to encourage business growth in California by waiving fees established in state law for the creation of business entities for the fiscal year of 2022-23. Specifically, (1) filing fees pursuant to Section 12186, subsections (c), (d), (e), or (f), of the Government Code shall not be required to be paid to the Secretary of State, (2) filing fees pursuant to Section 12188, subsections (b) or (c), of the Government Code shall not be required to be paid to the Secretary of State, and (3) filing fees pursuant to Section 12190, subsections (b) or (c) of the Government Code shall not be required to be paid to the Secretary of State.

**Direct Administration to Evaluate Fund Structure.** Regardless of whether or not the Legislature approves the proposal, we think that the Business Fees Fund requires attention. The appropriate structure of the fund will not be known until the operational needs become clearer in a year or two after CBC is fully operational. We recommend that the Legislature direct the administration to include, with any future proposals related to the business filing division, a justification for existing fee levels and how those levels align with services provided by the SOS. After the full implementation of CBC, the Legislature could consider requiring SOS to report on options that align the fees for the Business Fees Fund with desired service levels. The report should include an analysis of (1) the fee levels, (2) service costs, (3) reserve levels, and (4) mechanisms for annual fee adjustments based on reserves.

## **LAO PUBLICATIONS**

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