Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Haynes	Analyst:	Marion Mann DeJong	Bill Number:	AB 2061
Related Bills:	See Legislative History	Telephone:	845-6979	Introduced Date:	02/17/2004
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Business Activity Tax Simplification Act

SUMMARY

This bill would expand both the number and quality of contacts that a business or individual can have in California before becoming obligated to pay tax.

Although the bill would apply to many California taxes, this analysis is limited to the taxes administered by the Franchise Tax Board.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to provide clear and easily navigable rules regarding when an out-of-state business is obligated to pay tax to California.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment. The bill specifies that it would apply to taxable years beginning on or after the first calendar year that begins after the date of enactment. Thus, this bill would apply to taxable years beginning on or after January 1, 2005.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENTS

Amendments are needed to resolve the implementation concerns discussed in "Implementation Considerations" below. Department staff is available to assist the author with the necessary amendments. In addition, department staff has suggested one minor technical change. See "Technical Considerations" below.

Board Position:			Department Director	Date
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_______ N	_______ OUA	___X___ PENDING		

ANALYSIS

BACKGROUND

Nexus and Public Law 86-272

Nexus is a constitutional prerequisite that must be satisfied before any state can exercise its power to tax. Nexus is generally defined as a level of presence or activity within the state that creates a legally sufficient connection between the state and the business or individual so that it is constitutionally permissible for the state to impose a tax.

Nexus is most clearly established if an out-of-state business maintains a physical presence within the state, like a sales, service, or administrative office.

Nexus requires some degree of presence within the state. The degree of presence necessary to create nexus is a matter often litigated before the courts. Solicitation of orders from outside the state by mail order, telephone, or other electronic media with delivery made by common carrier generally has been ruled to be insufficient to establish nexus to require collection of sales tax. Under virtually identical facts, but with in-state delivery of the product made by the business in its own capacity, nexus for income tax purposes may be established.

In the past, the concept of nexus has focused on a business' physical contacts or presence in the taxing state. As technological developments change the manner in which business is conducted, the physical presence focus is becoming outmoded and may be shifting to include a less explicit economic standard based on a regular and systematic exploitation of the taxing state's market by a business.

The U.S. Constitution under the Commerce and Due Process Clauses limits the jurisdiction of states to tax. The Commerce Clause of the U.S. Constitution prohibits the states from inhibiting or placing an undue burden on the free flow of interstate commerce. Income from business activities constituting purely interstate commerce may be taxed by a state provided the tax is not discriminatory and is properly apportioned to a specific local activity.

The Due Process Clause of the Fourteenth Amendment prevents a state from imposing a tax on a person over whom it has no jurisdiction and requires that the person, object, or activity subject to the tax have some relationship to the particular taxing jurisdiction. There must be some definite link or minimum connection between an activity within the state and the tax. The underlying question is whether the state has provided some service, protection, or facility for which a return in the form of a tax would be equitable and whether the tax imposed is a reasonable means of defraying the costs of state government. The U.S. Supreme Court has set a standard of fairness that implies that if a sufficient contact between the taxing state and the nonresident taxpayer exists, and the tax imposed is fairly related to the taxpayer's in-state business activities, the tax will pass constitutional review. A frequently cited description of the due process standard is found in an U.S. Supreme Court case dealing with the power of a state to impose a tax on a foreign corporation on dividend income derived from property located and business transacted in the state:

> "That test is whether property was taken without due process of law.... whether the taxing power exerted by the state bears fiscal relation to protection, opportunities, and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask for a return."[1]

There is no "bright line" test regarding the circumstances that cause a contact to be sufficient to subject a business to taxation by a state.

Congress further restricted the states' powers to tax even when constitutional nexus was established by enacting Public Law (P.L.) 86-272. P.L. 86-272 prohibits states from imposing an income tax upon the income of a person derived within the state if the person's only business activity in the state is "solicitation" of orders for sales of tangible personal property. P.L. 86-272 applies where the orders are sent outside the state for approval and, if approved, are filled and delivered from a stock of goods located outside the state.

California's interpretation of P.L. 86-272 is summarized in the publication, "Application and Interpretation of Public Law 86-272 (FTB Pub. 1050)." The key points of this interpretation are:

1. Under P.L. 86-272, only income derived within the state from the sale of tangible personal property is immune from taxation. This law does not prohibit California from taxing income from selling or providing services and selling, leasing, renting, licensing or other disposition of real estate, other personal property, intangibles, or other types of property in this state.

2. The activity must be limited to solicitation (except as noted under #3).

3. P.L. 86-272 extends to activities performed on behalf of the person by independent contractors that do not represent a single person. Independent contractors may solicit sales, make sales, and maintain a sales office without defeating a person's immunity from income taxation. However, the independent contractor may not maintain a stock of goods on behalf of the person in California.

STATE LAW

Existing state law imposes tax on the income earned by individuals, estates, trusts, and certain business entities. Tax is imposed on the entire taxable income of residents of California and upon the taxable income of nonresidents derived from sources within California[2]. The tax for individuals is computed on a graduated scale at rates ranging from 1% to 9.3%.

California law defines a resident as every individual who is:

1. in California for other than a temporary or transitory purpose (regardless of whether the individual's domicile, or permanent home, is in California or elsewhere).
2. domiciled in California but who is outside the state for temporary or transitory purposes.

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[1] *Wisconsin* v. *J.C. Penney Co.* (1940) 311 U.S. 435.

[2] "Income from sources within this state" is defined by regulations as income from tangible or intangible property located or having a situs in this state and income from any activity carried on in this state, regardless of whether carried on in intrastate, interstate, or foreign commerce.

Every corporation and every limited liability company (LLC) taxable as a corporation that is either organized, qualified to do business, or doing business in this state is subject to the corporate franchise tax, which is imposed for the privilege of doing business in California. The corporate franchise tax is not imposed on a corporation's income, but instead it is measured by a corporation's California source net income. The franchise tax rate is generally 8.84% for corporations, with a minimum franchise tax of $800. The tax rate for S corporations is 1.5%.

Corporations that are not organized in or qualified to do business in California and not doing business in California, but are deriving income from California sources, are subject to the corporate income tax, generally 8.84%. Certain non-corporate business entities, such as business trusts, are also subject to the corporate income tax. The tax rate for S corporations is 1.5%.

Limited partnerships, limited liability partnerships, and certain other business entities pay a tax for the privilege of doing business in California. In many cases this tax is equal in amount to the minimum franchise tax of $800.

THIS BILL

This bill would expand the P.L. 86-272 exemption from limited solicitation of sales of tangible personal property to apply to **all** sales, including services and intangibles.

This bill also would require a "physical presence" in California before the income or franchise tax can be imposed. A person would have physical presence only if that person's business activities in California include any of the following during the taxable year:

1. Being an individual physically within California, or assigning one or more employees to be in California, on more than 21 days. The following activities would be disregarded in determining whether the 21-day limit is exceeded:
   - Purchasing goods and services.
   - Gathering news for media distribution.
   - Meeting government officials for other than selling goods or services.
   - Participating in training seminars.
   - Participating in charitable activities.

2. Using the services of another person, except an employee, in California, on more than 21 days to establish or maintain the market in California, unless that other person performs similar functions for at least one other business during the taxable year.

3. Leasing or owning tangible personal property or real property in California on more than 21 days. The following activities would be disregarded in determining whether the 21-day limit is exceeded:
   - Tangible personal property located in California to be assembled, manufactured, processed, or tested by a contract manufacturer or processor.
   - Tangible personal property used by another business to furnish a service to the owner or lessee.
   - Marketing or promotional materials distributed in California using mail or common carrier or as inserts in publications.
   - Property used in conjunction with activities excluded from the 21-day time limits for employees or acts by a person on behalf of an out-of-state business (items 1 and 2 above).

Physical presence would occur on the first day rather than after 21 days in the following circumstances:

1. A live performance or sporting event where the event has more than 100 audience members or spectators.
2. Sales of tangible property if delivery of the property originates and is completed in California.
3. The performance of services to real property within California.

The physical presence test would not apply to a business that is incorporated, formed, or commercially domiciled in California, or an individual domiciled in California. Thus, the franchise or income tax could be imposed on such business or individuals regardless of whether there is a "physical presence" in California (as allowed under current law).

This bill would provide that if California is allowed to tax a partnership, S corporation, LLC, trust, estate, or similar business under this bill, then California is allowed to tax the owners or beneficiaries of those businesses.

IMPLEMENTATION CONSIDERATIONS

This bill will significantly impact the programs administered by the department. The current limitation to tax under P.L. 86-272 is narrower and provides a brighter line to identify activities in excess of solicitation. Under this bill, the activities allowed before nexus is reached are much broader. It is anticipated that identifying taxpayers that are not filing returns but have activities in California that exceed the limitations proposed by this bill, creating nexus, will be difficult. For example, the exemption for activities (personal or property) in California of 21 days or less will be difficult to enforce without requiring taxpayers to maintain logs or other documents for their employee's activity and the property location in the state. Significant investigative resources and taxpayer intrusive audit examinations might be required to have an effective audit program. New regulations and reporting requirements for taxpayers claiming an exemption from California taxation under this bill may be needed.

In addition, the department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

- This bill uses undefined terms such as "gathering news and covering events," "through the media," "participation in educational or training conference," "promotional materials" and "services to real property." Without clear, defined terms the department would have difficulty determining whether sufficient activity has occurred to subject the person to California tax. In addition, undefined terms can cause disputes between taxpayers and the department.

- The bill disregards various activities when determining whether an individual is physically present in California. When counting days for the physical presence test, it is unclear how to account for days where an individual performs more than one type of activity, some that are disregarded and some that are counted.

- It is unclear whether the rules for live performances or sporting events only apply to the performer or athlete or whether they would also apply to other people related to the performance or sporting event (e.g., stagehand, trainer, etc.). Further, it is unclear how this provision interacts with the term "covering events," which is disregarded for purposes of the physical presence test.

<u>TECHNICAL CONSIDERATIONS</u>

On page 3, line 7 of the bill, "person" should be added after "another" for clarity.

LEGISLATIVE HISTORY

This bill is almost identical to federal legislation, H.R. 3220, which was introduced in the U.S. House of Representatives on October 1, 2003, by Representatives Goodlatte and Boucher. H.R. 3220 would limit the states' ability to impose net income or franchise taxes on income derived from interstate commerce by imposing a physical presence test on an entity-by-entity basis. H.R. 3220 also would significantly expand both the number and quality of contacts that an individual or business could have in a state and remain exempt from that state's tax.

OTHER STATES' INFORMATION

The laws of *Florida*, *Illinois, Massachusetts, Michigan, Minnesota*, and *New York* were reviewed because their tax laws are similar to California's income tax laws. Based on a limited review, none of these states require physical presence in their state prior to imposing an income tax. These states impose a tax only if business activities in the state exceed "solicitation" of orders for sales of tangible personal property, the activities protected from taxation by P.L. 86-272. The review included the individual states' websites, tax forms, and tax handbooks.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined at this time but could be significant. Department staff will work on cost estimates as the bill moves through the Legislature.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Based on data and assumptions discussed below, this bill would result in the revenue losses approximated as follows in the initial five fiscal years.

Estimated Revenue Impact of AB 2061 As Introduced 2/17/04 with Enactment Assumed After 6/30/04 [$ In Millions]				
2004-05	2005-06	2006-07	2007-08	2008-09
-$10	-$50	-$150	-$325	-$525

Revenue Discussion

The revenue impact of this bill would be determined by the degree to which taxpayers restructure operations to reduce or eliminate business nexus in California. In addition, new administrative challenges would be faced regarding the nature of future audit capabilities where taxpayers do not fully comply. Generally, business entities commercially domiciled in California and individuals whose residency and domicile are in the state would not be affected.

Since this bill provides specific activities that can occur without creating nexus, it is anticipated that some taxpayers, particularly members of a unitary group, would structure their activities to ensure that income cannot be taxed by California or any state by creating "nowhere property, payroll, and sales" factors. To approximate potential revenue losses under this bill, sales, property, and payroll numerator values were reduced by various proportions to replicate the tax effects of opportunities for taxpayers to reduce or eliminate business nexus in California. Using the reduced numerators as new parameters, a simulation was performed using corporate sample data (2001 base) to derive a maximum potential revenue loss. The projected maximum loss at the 2001 level is grown to out years by the growth rate of corporate profits as forecasted by the Department of Finance (December 2003).

It is assumed that taxpayers would maximize planning opportunities that this bill would permit to reduce or eliminate business nexus in California. Reaching the maximum potential would occur over several years. For this estimate, a six-year period is assumed. To reflect more and more taxpayers taking advantage of the proposed exemptions, revenue losses are phased in as reflected in the table. By the end of the sixth taxable year, the revenue loss would exceed $725 million.

LEGAL IMPACT

Because a business that is conducted wholly in California does not apportion income, and thus cannot create "nowhere income" by establishing subsidiary entities and agency relationships that would prevent California taxation under this bill, it could be argued that this bill discriminates against wholly in-state business in favor of multistate and multinational businesses in violation of the Commerce Clause.

ARGUMENTS/POLICY CONCERNS

- While this bill would provide clear rules regarding when an out-of-state business is obligated to pay tax to California, this bill would reduce California's ability to impose net income or franchise taxes on income derived from interstate commerce by imposing a physical presence test on an entity-by-entity basis and by significantly expanding both the number and quality of contacts that a business or individual can have in California and still be exempt from California taxation.

- This bill would decrease California's current power to tax by requiring contacts (nexus) more substantial than required by the U.S. Constitution. In addition, this bill provides a broader exemption than that provided by P.L. 86-272, since the "physical presence" standard required by this bill applies to both domestic and foreign commerce while P.L. 86-272, applies only to interstate commerce.

- This bill would allow taxpayers to use exemption rules in concert, providing double exemptions. For example, an out-of-state business could use a 21-day exemption for employees soliciting sales in the state, and another 21-day exemption for non-employee agent soliciting additional sales, for a total 42-day exemption. In addition, the bill would allow an unlimited number of employees in the state for 21 days.

- This bill would allow taxpayers to have a large quantity of tangible personal property in California without incurring an income or franchise tax, despite enjoying substantial benefits and protections of the state with respect to that property.

- This bill could limit the taxation of residents in some cases. For example, if an individual living in California for the entire year performed services in this state as a freelance reporter, that individual would be able to rely upon the news gathering exemption, so long as the individual did not establish a legal domicile in California. Under current law, such an individual would be a resident because he or she would be in California for other than a temporary or transitory purpose.

- This bill could provide an incentive for a corporation to terminate employees and hire them back as independent contractors to do the same work because the bill allows an independent contractor to be disregarded for the 21-day test if he or she performs services for more than one business.

- This bill would require "physical presence" before any business activity tax could be imposed. The definition of business activity tax includes any tax imposed on a business for the right to do business in California. Because the minimum franchise tax and other entity taxes are based on the privilege of "doing business" in California, this bill could prevent the imposition of the corporate minimum tax, the tax on limited partnerships or LLC taxes and fees, even if the entity was "doing business" or qualified to do business in California, or registered with the Secretary of State. In many cases, the minimum tax could not be imposed even if the entity owned substantial real and personal property in California. The exemption from the minimum tax would not apply if the entity were incorporated, formed, or commercially domiciled in California.

- This bill would provide an opportunity for a group of unitary taxpayers to have a major presence in California, but substantially reduce its California tax liability by simply separating its business activities into separate corporations. It would thus weaken a foundational principle of the unitary method, that it should not make a difference for purposes of apportioning income between the states whether a trade or business activity is conducted by one entity or by several affiliated members of a unitary group.

- This bill appears to be changing tax policy from benefiting in state activity to benefiting out-of-state activity. The policy behind changing the apportionment formula from a single-weighted sales factor to a double-weighted sales factor was to provide a benefit to corporations with significant property and payroll in California. This bill instead provides a benefit to corporations headquartered outside of California, and could provide an incentive to move jobs outside the state.

LEGISLATIVE STAFF CONTACT

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