

# SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Haynes Analyst: John Pavalasky Bill Number: AB 2061

Related Bills: See Prior Analysis Telephone: 845-4335 Amended Date: 04/21/2004

Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Business Activity Tax Simplification Act

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended \_\_\_\_\_.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced February, 17, 2004.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO \_\_\_\_\_.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED February 17, 2004, STILL APPLIES.

OTHER - See comments below.

## 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.

## SUMMARY OF AMENDMENTS

The April 21, 2004, amendments added an additional activity, storing materials, goods, or products in a public warehouse, that would be disregarded when determining whether the 21-day limit is exceeded for determining if nexus is established.

The "This Bill" discussion from the prior analysis is updated below to reflect the April 21, 2004, amendments. The remainder of the department's analysis of the bill as introduced February 17, 2004, still applies. The "Implementation Considerations," "Technical Consideration," "Fiscal Impact," "Economic Impact," "Legal Impact," and "Policy Considerations" from the prior analysis are provided below for convenience. The Franchise Tax Board's position remains pending.

Board Position:

\_\_\_\_\_ S      \_\_\_\_\_ NA      \_\_\_\_\_ NP  
\_\_\_\_\_ SA      \_\_\_\_\_ O      \_\_\_\_\_ NAR  
\_\_\_\_\_ N      \_\_\_\_\_ OUA       PENDING

Legislative Director

Date

Brian Putler

4/30/04

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).
  - Storing materials, goods, or products in a public warehouse pursuant to a public warehouse contract.

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, Limited Liability Company (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.

### TECHNICAL CONSIDERATION

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

### **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**

### Revenue Estimate

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.

## **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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