

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Harman Analyst: Marion Mann DeJong Bill Number: AB 809

Related Bills: See Legislative History Telephone: 845-6979 Introduced Date: 02/20/2003

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Apportionment of Business Income

SUMMARY

This bill would make changes to the way California net income is calculated for corporations that earn income from multiple states or other countries by:

- changing the standard apportionment formula used to determine the amount of business income taxable by California to a single-factor apportionment formula based on sales,
- requiring certain corporations to use the current three-factor formula based on property, payroll, and double-weighted sales, and
- allowing extractive businesses to choose either the current three-factor formula based on property, payroll, and single-weighted sales, or use the new single-factor formula.

PURPOSE OF THE BILL

The purpose of the bill appears to be to attract investment to the state by lowering state income taxes for companies with substantial investment in property and payroll in California relative to sales.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment. However, the bill specifies that it would be operative for taxable years beginning on or after January 1, 2005.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are needed to resolve the implementation and technical concerns discussed in this analysis. See "Implementation Considerations" and "Technical Considerations" below.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director
Gerald H. Goldberg

Date
04/09/03

ANALYSIS

FEDERAL/STATE LAW

Under existing federal law, corporations organized in the U.S. are taxed on their worldwide income, regardless of source, and are allowed a credit for any taxes paid to a foreign country on their foreign source income. Foreign corporations engaged in a U.S. trade or business are taxed at regular U.S. graduated corporate income tax rates on income effectively connected with the conduct of that business in the U.S.

Under current California law, California source income for corporations that operate both within and without the state is determined on a worldwide basis using the unitary method of taxation. Under the unitary method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of that income is then apportioned to California on the basis of relative levels of business activity in the state, as measured by property, payroll, and sales.

As an alternative to the worldwide basis, California law allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources.

The general apportionment formula, applicable to most corporations, takes into account property, payroll, and double-weighted sales factors. Each factor is the ratio of in-state activity to that same activity worldwide. The taxpayer's apportionment percentage is determined by dividing the sum of the factors by four.

For corporations that derive more than 50% of their gross business receipts from agricultural, extractive, savings and loan, and banking and financial business activities, the apportionment formula is the average of three factors — property, payroll, and single-weighted sales.

Business income is multiplied by the apportionment percentage to determine the amount of income apportioned to this state for tax purposes.

THIS BILL

This bill would replace the three-factor, double-weighted sales apportionment formula used by most corporations with a single-factor apportionment formula based solely on sales. Exceptions to this formula would be provided for three groups:

1. Those that file a combined report, have a sales factor for the taxable year that is less than the average of their property and payroll factors, and **fail to meet both** of the following requirements:

- their average number of employees in California during the taxable year is at least 90% of the average number of employees employed in California during the preceding five taxable years; and
- their percentage decline in the number of employees in California between the current and immediately preceding taxable year is less than or equal to any corresponding, cumulative percentage decline in all other states in which the taxpayer is engaged in business.

In other words, taxpayers that file a combined report and have an average of property and payroll in California in excess of sales would use the single-factor sales formula only if certain employment requirements are maintained. If all of the employment requirements are not maintained, the taxpayer must use the three-factor, double-weighted sales formula.

However, if the employment requirements were not maintained because of natural disaster or other act of God, an act of terrorism, or an action of federal, state, or local government, the taxpayer would use the single-factor sales formula.

2. Taxpayers that derive more than 50% of their gross business receipts from extractive activities would be allowed to elect either the single-factor sales formula or the three-factor, single-weighted sales formula. The election must be made on a timely filed original return. This election would not apply to taxable years beginning prior to January 1, 2005.

The one-time election of the apportionment formula would be made by contract with the Franchise Tax Board. The election may be terminated if the taxpayer is acquired by a larger nonelecting entity or with the permission of the Franchise Tax Board.

3. Taxpayers that derive more than 50% of their gross business receipts from either a savings and loan activity or a banking or financial business activity, would be required to use the three-factor, single-weighted sales formula. (This is the formula that such businesses are required to use under current law.)

The bill would provide that if any part of the apportionment formula provisions is found unconstitutional or is otherwise unenforceable, the remaining provisions would remain in force and effect.

IMPLEMENTATION CONSIDERATIONS

This bill would raise the following implementation concerns:

- The employment tests for determining which apportionment formula would be used by taxpayers that file a combined report could be very complex when applied to complex taxpayer situations, such as water's-edge taxpayers. Such taxpayers would be required to identify the number of their employees whose compensation is used in determining the payroll factor. It is unclear how the tests would be applied in situations like Subpart F compensation that is normally included only in a ratio.

In addition, the tests do not provide complete rules for the sale or acquisition of members of a combined group. Although the bill specifies that the acquisition and disposition of entities is not considered for calculating the employment history of prior tax years, it is unclear whether they are considered for the current or future years. The tests will require an entity-by-entity tracking, because if their groups have significant changes, subtraction of the historical members, member-by-member, will have to be carefully done.

Further, it is unclear whether adjustments to the base year for purposes of the employment comparison are required if the taxpayer makes a water's-edge election, or returns to worldwide status.

Department staff is concerned that the employment tests could be onerous on taxpayers since they would be required to maintain and compare payroll records for at least five years. In addition, developing forms and instructions for the employment tests and auditing them would be difficult for the department. It is unclear whether the policy goals of rewarding taxpayers that maintain employment in California with continued use of the single-factor sales formula outweigh these implementation concerns.

- The bill defines “taxpayer” as a combined reporting group. This implies that a combined reporting group is a single taxpayer, when members of a combined group are separate taxpayers. Generally, members of a unitary group combine all unitary business income using a combined report when determining California-source income. Each taxpayer included in a combined report must generally file its own tax return. However, some unitary groups may elect to file a group return and report the sum of the separate tax liabilities of the unitary members. Unlike taxpayers that file a federal consolidated return, a taxpayer within the combined report is not jointly and severally liable for the tax liability of every other member within the combined group.

In addition, a combined report includes the business income and apportionment factors of all members of the combined group regardless of whether they are subject to the franchise or income tax. However, only the members subject to the franchise or income tax actually file a tax return, and only those members would physically attach a combined report to those returns. The definition of “taxpayer” as used in the bill makes it unclear whether the author intends to include the income and apportionment factors of all members of the combined group regardless of whether they are subject to the franchise or income tax.

Further, defining “taxpayer” as a combined reporting group leaves ambiguity as to what formula taxpayers who apportion income but that are not members of a combined reporting group (e.g., single entity taxpayers, partnerships) are to use. It appears that apportioning taxpayers that are members of a combined reporting group would use the single factor formula based on sales regardless of whether the employment requirements are maintained.

These issues may be resolved by using the term “apportioning trade or business” rather than “combined reporting group.”

- The election for taxpayers with extracting activities is accomplished by a one-time contract, similar to the water’s-edge contract. Currently the Franchise Tax Board is supporting legislation to eliminate the water’s-edge contract and replace the current contract with an election due to implementation issues caused by conflicts between contract law and tax law. The election in this bill would have the same implementation concerns, and should be changed to a simple election.

TECHNICAL CONSIDERATIONS

The reference to subdivisions that provide exceptions to the single-factor sales formula is incorrect and incomplete. Page 4, line 7, includes references to subdivision (b) and (d) as exceptions. Subdivisions (b), (f), and (g) provide the exceptions. Subdivision (d) would allow the single-factor sales formula if certain additional conditions are met. Thus, the reference to subdivision (d) should be deleted and references to subdivisions (f) and (g) should be added.

On page 4 line 33 of the bill, “on action” should be changed to “an action.”

The bill specifies that for taxable years beginning on or after January 1, 2005, taxpayers deriving 50% of their gross business receipts from either a savings and loan activity or a banking or financial business activity would use the three-factor, single-weighted sales formula. However, the bill does not define "savings and loan activity" or "banking or financial business activity." The bill should be amended to reinsert the current law definitions of these activities (see page 3, lines 11 through 16 of the bill) into subdivision (h) (page 5 of the bill beginning at line 28).

The bill specifies that if any part of the apportionment formula statute were found unconstitutional or unenforceable, the remaining provisions would remain in force and effect. However, the bill does not specify the actual remedy.

LEGISLATIVE HISTORY

AB 2560 (Vargas, 2001/2002) was basically the same as this bill. AB 2560 was held in the Assembly Appropriations Committee.

AB 1642 (Harman, 2001/2002) and SB 1014 (Johnson, 2001/2002) would have replaced the apportionment formula used by most corporations with a single-factor formula based on sales. Certain extractive corporations would have been allowed to use a different formula. Both bills failed to pass to the second house before the constitutional deadline.

PROGRAM BACKGROUND

Prior to 1993, California law strictly conformed to the Uniform Division of Income for Tax Purposes Act, which provides for the use of an apportionment formula when assigning business income to a state for tax purposes. This formula is the simple average of three factors: property, payroll, and sales. Each factor is the ratio of in-state activity to that same activity everywhere.

In 1993, California law was amended to double-weight the sales factor. However, certain taxpayers engaged in extractive and agricultural businesses were adversely impacted and objected. To resolve this issue, those taxpayers that derive more than 50% of their gross business receipts from an extractive or agricultural business are provided an exception to the use of the double-weighted sales factor and are instead required to use a single-weighted sales factor in the apportionment formula.

In 1994, the exception to the use of the double-weighted sales factor was expanded to include taxpayers that derive more than 50% of their gross business receipts from savings and loan, banking, or financial business activities.

The requirement for double-weighting the sales factor reflects a determination that sales represent a more significant contribution to a taxpayer's net income than the other two factors. Incidentally, double-weighting the sales factor shifts some tax burdens to companies with large sales in California relative to their investment in property and payroll, and reduces the tax burdens of corporations that have made substantial investment in property and payroll in California relative to sales.

OTHER STATES' INFORMATION

Florida, Massachusetts, Michigan, Minnesota, and New York all use an apportionment formula based on property, payroll, and sales. The sales factor is more heavily weighted than the other two factors for all of these states as indicated in the table below. *Illinois* uses an apportionment formula based entirely on sales. Some of these states provide special apportionment formulas for specific industries. *Massachusetts* uses an apportionment formula entirely based on sales for defense contractors, manufacturers, and mutual fund service corporations. The laws of these states were reviewed because of similarities to California's income tax laws.

	Property Factor	Payroll Factor	Sales Factor
California	25%	25%	50%
Florida	25%	25%	50%
Illinois	--	--	100%
Massachusetts	25%	25%	50%
Michigan	5%	5%	90%
Minnesota	12.5%	12.5%	75%
New York	25%	25%	50%

FISCAL IMPACT

If the bill were amended to resolve the implementation considerations discussed in this analysis, the department's costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate

The revenue impact of this bill is estimated to be as shown in the following table:

Estimated Revenue Impact of AB 809 Proposed February 20, 2003 Effective for tax years BOA 1/1/2005 \$ Millions			
2003-04	2004-05	2005-06	2006-07
-\$0	-\$30	-140	-\$215

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The revenue impact of this bill would depend on the change in tax liabilities from the proposed apportionment formula as compared with current formula.

Samples of corporate tax returns for the tax years 1998, 1999, and 2000 were used for this analysis. For each corporation, tax liabilities under current and the proposed apportionment formula were computed. The revenue impact was estimated as the difference between the computed tax liabilities. The impact for each individual corporation was then statistically weighted and aggregated to derive an estimate of the total revenue impact for each of the sampled tax years. It is assumed that 95% of corporations filing combined returns and having sales factors less than the averages of the other two factors would be required to use the single-factor sales formula. This assumption is based on an analysis of the relationship between California wages from the 1997, 1998, and 1999 corporate samples. The revenue impact of the bill was computed as the average of the three estimates. The estimated impact was extrapolated into future years using the Department of Finance December-2002 projection of corporate taxable revenues.

LEGAL IMPACT

There have been some concerns expressed in tax literature that a single-factor formula might be unconstitutional if done with the intent to benefit local commerce. In general, a single-factor sales formula would benefit companies that are physically located in one state to the detriment of those located outside that state. An equally weighted three-factor formula has been the bench mark reflecting a reasonable sense of how income is generated in a state, while a single-factor formula is more readily subject to distortions in the market and therefore more likely to be subject to litigation.

In addition, requiring certain taxpayers that file a combined report to use the current three-factor, double-weighted sales formula, instead of the single-factor sales formula, could be subject to challenge since the requirement would not apply to apportioning taxpayers that are not members of a combined group. This issue could be resolved by requiring all apportioning taxpayers to use the three-factor, double-weighted sales formula rather than only members of a combined group.

Further, the employment tests could be subject to constitutional challenge since they effectively punish taxpayers that shift some of their business to another state. Constitutionally, this is similar to a tax that rewards local commerce to the detriment of interstate commerce, with the objective of encouraging local commerce to stay.

ARGUMENTS/POLICY CONCERNS

This bill would allow taxpayers conducting extractive business activities to elect which apportionment formula to use. This bill could be considered inequitable to all other taxpayers since they are not allowed to choose the formula used.

Current law provides an exception to the use of the three-factor, double-weighted sales formula for corporations that derive more than 50% of their gross business receipts from agricultural, extractive, savings and loan, and banking and financial business activities. These corporations are instead required to use a three-factor, single-weighted sales formula because of the adverse impact on those industries by a formula that weighs sales more heavily than other factors. This bill would not provide an exemption from the more heavily weighted sales formula for agricultural activities.

“Guide to State Corporate Income Tax Apportionment – Part I,” by James K. Smith (*Journal of Taxation*, Vol. 19, No. 1, Summer 2000) discusses the trend by states to increase the weight of the sales factor in apportionment formulas. According to the article, proponents of increasing the weight of the sales factor claim that a more heavily weighted sales factor will increase economic development within a state, is necessary to prevent property and payroll from leaving the state, and is more constitutionally sound than other tax incentives. Opponents of a more heavily weighted sales factor claim the altered apportionment formulas only result in short-term advantages to the state, unfairly create corporate winners and losers, and do a poor job of measuring the state’s contribution to a corporation’s income.

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