Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Burton	Analyst:	Norman Catelli	Bill Number:	SB 640
Related Bills:	See Legislative History	Telephone:	845-5117	Introduced Date:	February 21, 2003
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: State Agency Contracts/Expatriate Corporations/California Taxpayer and Shareholder Act of 2003

SUMMARY

This bill would prohibit the state, absent a compelling public interest, from entering into contracts or agreements with certain publicly traded foreign (non-U.S.) corporations.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to restore faith in corporate practices and in the nation's financial system.

EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative on January 1, 2004.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

The Homeland Security Act of 2002 (P.L. 107-296), as amended, prohibits the U.S. Department of Homeland Security from entering into a contract with a corporate expatriate, as defined. This prohibition may be waived if the Secretary of Homeland Security determines the contract is required in the interest of homeland security.

The U.S. tax treatment of a multinational corporate group depends significantly on whether the parent corporation of the group is domestic or foreign. A "domestic" corporation is one incorporated under the law of the U. S. or of any state, whereas a "foreign" corporation is incorporated elsewhere. A domestic corporation is taxed on its "worldwide income" with a tax credit available for any foreign income "double-taxed" in the foreign jurisdiction. A foreign corporation is only taxed on its U.S. source income. Some previously domestic corporations have reincorporated in a foreign jurisdiction (generally with low tax rates) so their foreign source income is not subject to U.S. taxation. Domestic corporations changing their place of incorporation to a foreign jurisdiction to avoid U.S. taxation, but not changing their actual management or business operations are generally called "expatriate" corporations.

Board Position:			Department Director	Date
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Currently, the Franchise Tax Board (FTB) contracts for various services, (e.g., information technology consulting, security services, etc.) in accordance with the requirements outlined in the Public Contract Code, State Administrative Manual, and rules of the Department of General Services (DGS).

Existing law requires DGS to approve an agency's mode of acquisition and the procedures followed for procurement. DGS must maintain appropriate criteria and procedures to ensure compliance with the law.

Article I, Section 10, of the U.S. Constitution provides that "No State shall…pass any…Law impairing the Obligation of Contracts…" The section is applicable to existing contracts and is not generally considered to impact future contracts.

THIS BILL

This bill would create the California Taxpayer and Shareholder Protection Act of 2003.

The provisions of this bill would:

- Prohibit the state from entering into contracts with expatriate corporations or their subsidiaries, as defined,
- Allow the executive officer of a state department or agency to waive the prohibition if the contract is necessary to meet a "compelling public interest," as defined, and,
- Require each vendor submitting a bid or contract proposal to certify under penalty of perjury that it is an eligible vendor.

An expatriate corporation is defined as a corporation incorporated outside the U.S. that also meets all the following requirements:

- The U.S. is the principal market for the entity's publicly traded stock,
- The entity has no "substantial" business activities in the place of incorporation as compared to the business activities of its subsidiaries,
- The entity was established in a transaction (or series of transactions) that resulted in:
  - The acquisition of substantially all of the properties held by a domestic corporation or partnership, and,
  - Former shareholders or partners hold more than 50% of the publicly traded stock (by vote or value) of the foreign entity. For this purpose, stock sold in a public offering is disregarded.

IMPLEMENTATION CONSIDERATIONS

The concept of "substantial business activities" in the place of incorporation plays a significant role in this bill, but the statutory language does not define the concept. The bill does not establish qualitative or quantitative standards by which the substantiality of business activity is to be evaluated for this purpose. Since this bill is evaluating foreign corporations, it may be advisable to consider how United Kingdom and other European tax systems incorporate the concept of "substantial business activities." The Organization for Economic Cooperation and Development (OECD) dropped "substantial activities" as an identifying criteria of a "tax haven" due to the complexities encountered in the OECD *Harmful Tax Practices* project.

The term “substantially all” referring to the acquisition of a domestic corporation's properties requires a definition. The phrase is not specifically defined in the Internal Revenue Code reorganization provisions, although federal case law and administrative pronouncements have defined it in certain contexts. For example, a corporation’s interest expense deduction on debt incurred to acquire another corporation is limited. For this purpose, “substantially all” is defined as 90% of the fair market value of the net assets or 70% of the fair market value of the gross assets. Similarly, for purposes of certain corporate reorganizations or inclusion in a federal consolidated income tax return, “substantially all” is defined as 80% of stock value and voting power. Additionally, in certain corporate reorganizations there is a “continuity of interest” requirement to prevent transactions that resemble sales from benefiting from favorable treatment. For this purpose, 50% of the value of the new stock is to be received by the former owners to receive the favorable treatment.

The provision relating to the stock of the new parent held by former shareholders or partners requires clarification. In an effort to avoid being classified as an “expatriate corporation” the former owners may receive securities other than common stock, thus keeping the 50% ownership threshold from being met. Some securities that may be used to avoid the expatriation threshold are convertible debt, tracking stock, and exchangeable stock.

Paragraph 1 of subdivision (a) contains the phrase “the principal market for the public trading of the foreign incorporated … .” This phrase probably should be modified to refer to “publicly traded stock” as in Paragraph 3.

<u>TECHNICAL CONSIDERATIONS</u>

This bill would add article 11 to Chapter 1 of Part 2 of Division 2 of the Public Contract Code. This new article would prevent certain foreign corporations from being awarded state contracts for public works, goods, or services. The existing provisions of Chapter 1 relate to contracts for public works. However, the provisions of Chapter 2 relate to contracts for goods and services. Consequently, this bill would add language regarding contracts for goods and services (Chapter 2) into the chapter relating to contracts for public works (Chapter 1).

LEGISLATIVE HISTORY

AB 1121 (Cardoza, 2001-2002) and AB 2375 (Cardoza, 2001-2002) were identical and would have prevented certain foreign corporations from being awarded state contracts for public works, goods, or services. Both bills were held in the Senate Judiciary Committee.

OTHER STATES’ INFORMATION

North Carolina is the only state identified that has enacted a statute prohibiting a state from entering into a contract with a vendor (or an affiliate of the vendor) that is incorporated in a tax haven country (defined as: Barbados, Bermuda, British Virgin Island, Cayman Island, Bahamas, Cyprus, Gibraltar, Isle of Man, Liechtenstein, Monaco, and Seychelles).

The states of *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* were surveyed due to their similarities to California’s economy, business entity types, and tax laws. Research did not indicate that any of these states has enacted or proposed legislation similar to this bill.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

This bill would not impact the state's income tax revenue.

LEGAL IMPACT

Article I, Section 8, of the U.S. Constitution provides that "Congress shall have Power …To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes;" If enacted, this bill could be viewed as unconstitutionally discriminating against certain foreign corporations. However, Article 3, Section 3.5 of the California Constitution, requires every administrative agency to enforce a duly enacted statute until an appellate court has determined the law is unconstitutional.

Since this bill would impact existing contracts, it is possible that an argument may be made that the bill unconstitutionally impairs contracts.

ARGUMENTS/POLICY CONCERNS

The definition of an "expatriate corporation" in this bill is different from the definition contained in the federal Homeland Security Act of 2002 (P.L. 107-296). In the event the US Congress passes legislation enabling the states to enact "expatriate" legislation, thus avoiding the potential Commerce Clause problems previously mentioned, there would likely be a definition of "expatriate corporation" contained in federal law. Additionally, since some state contracts may be related to federally mandated and funded programs, it may be problematic to deny contracts to an "expatriate corporation" that does not meet the federal definition.

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