Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Klehs	Analyst:	Gail Hall	Bill Number:	AB 675
Related Bills:	See Legislative History	Telephone:	845-6111	Amended Date:	May 1, 2006
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Require Taxpayers With Assets Equal To or Greater Than $10 Million To Report Tax And Book Differences/Penalty For Failure

SUMMARY

This bill would require corporations with assets equal to or greater than $10 million to provide detailed information on the differences between book income and taxable income.

SUMMARY OF AMENDMENTS

The May 1, 2006, amendments removed the language of the bill as amended April 19, 2005, that would require the Franchise Tax Board (FTB) to conduct a study on a different method for taxing certain corporations.

The May 1, 2006, amendments added a requirement that corporations provide an information return that consists of a reconciliation of financial statement net income or loss to the net income or loss reported on the tax return. If the corporation fails to provide the information return, the corporation would be subject to a penalty.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to improve the level of corporate reporting on the differences between book income and taxable income to ensure that corporations pay the correct amount of tax.

EFFECTIVE/OPERATIVE DATE

The May 1, 2006, amendments would be effective and operative on January 1, 2007, and would specifically apply to any return or combined report filed on or after January 1, 2007.

POSITION

Pending.

Board Position:			Department Director	Date
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ANALYSIS

Federal Law

The Internal Revenue Service (IRS), effective for any tax year ending on or after December 31, 2004, requires a corporation or consolidated tax group with assets of $10 million or greater to file Schedule M-3 with Form 1120, the corporation tax return. The Schedule M-3 asks certain questions about the corporation's or consolidated tax groups' financial statement. It also reconciles financial statement net income or loss for the corporation or consolidated financial statement group to income or loss with the income statement for the U.S. corporation or consolidated tax group.

The Schedule M-3 is made up of three parts:

- Part I requires financial statement information and reconciles book income or loss from the consolidated financial statements to the income or loss of the corporations included in the consolidated tax return.

- Part II reconciles the net income or loss from the books to the taxable income or loss for the corporations included in the federal consolidated tax return. This part is filled out by the parent corporation and each corporation included in the federal consolidated tax return.

- Part III reconciles expenses from the book income statement to the expenses from the tax return. This part is filled out by the parent corporation and each corporation included in the federal consolidated tax return.

If the corporation is not required to file the Schedule M-3, then the Schedule M-1 must be filed with the corporate tax return. If the corporation has total receipts and total assets less than $250,000, the Schedule M-1 is not required. The Schedule M-3 specifically reconciles over 50 items of book income and deductions to tax, whereas, the Schedule M-1 provides a substantially less detailed reconciliation of book income or loss to taxable income or loss.

Federal law requires a taxpayer that participates in a reportable transaction to disclose the transaction to the Internal Revenue Service on federal Form 8886. One category of a reportable transaction is a transaction with a significant book-tax difference. A transaction with a significant book-tax difference is defined as one that differs by more than $10 million on a gross basis. A taxpayer that participates in a significant book-tax difference that meets the requirement of a reportable transaction will satisfy the disclosure requirement if that transaction is reported on the federal Schedule M-3.

There is no penalty under federal law for failing to prepare and file a Schedule M-1 or a Schedule M-3.

State Law

The Franchise Tax Board requires a corporation to do either of the following:

1. Attach a copy of the federal Schedule M-3 to the California tax return.
2. Attach a complete copy of the federal return.

FTB will accept the federal Schedule M-3 in a spreadsheet format if more convenient for the taxpayer.

FTB requires a corporation to file Schedule M-1 with Form 100, the California corporate income tax return, if the corporation has total receipts and total assets of $250,000 or greater. There is no penalty for failure to prepare and file a Schedule M-1.

THIS BILL

The May 1, 2006, amendments would provide the following:

1. Require any corporation, including S corporations, subject to state franchise or income tax or any corporation included in a combined report to file with its tax return an information return if the total assets of the corporation or the combined group equal or exceed ten million .

2. Require that an information return shall consist of a reconciliation of financial statement net income or loss to the net income or loss reported on the tax return.

3. Require that the reconciliation include the distributive share of items from a unitary partnership.

4. Impose a $50,000 penalty for each failure to furnish the information.

5. Require that a corporation would be excused from the penalty under either of the following two circumstances:

   a. The corporation furnishes the information return before being notified by FTB that the information return has not been provided.
   b. The corporation has not previously failed to provide the information return.

6. Apply to any tax return or combined report filed on or after January 1, 2007.

7. Authorize FTB to prescribe regulations as may be necessary or appropriate to carry out the purposes of this law.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill could be accomplished during the normal annual update.

PROGRAM BACKGROUND

Most states use federal taxable income as the starting point for calculating taxable income for state purposes. This is done mainly for administrative ease because the taxpayer has already calculated its federal taxable income; however, using federal taxable income as the starting point makes a state vulnerable to the same tax avoidance and tax sheltering schemes used by corporations to lower their federal taxable income. According to a Harvard University paper,[1] the gap between book income and tax income has widened over the last ten years and has generated concern over the rapid increase of tax sheltering activity by corporations. In 1998, more than half of the difference between federal tax and book income, approximately $154.4 billion, could not be accounted for by traditional tax and book differences.

Under federal law, a group of affiliated corporations that meet certain ownership requirements may elect to file a single tax return called a consolidated tax return. If a corporation owns at least 80% of the stock possessing the voting power and at least 80% of the total value of all the classes of stock of another corporation or of multiple corporations, then those corporations are considered an affiliated group and can file a consolidated tax return.

Under state law, a group of affiliated corporations (which is determined under state law using a 50%, rather than 80%, ownership test) is referred to as a "commonly controlled group." Corporations in a "commonly controlled group" that meet certain requirements file on a combined basis if they are a unitary business. Over the years the courts have developed a number of different tests for determining whether a unitary business exists.

Even though state and federal laws appear similar, there are significant differences. First, federal law does not have a unitary concept, so after a corporation meets the federal ownership requirement, it may simply elect to file a consolidated tax return with an affiliate (unless the corporations are not treated as affiliates because one corporation is an insurance company, S corporation, or foreign corporation). In contrast, for state purposes, after a corporation meets the unity of ownership test, it must also meet other tests before it may file a state combined report with another entity as part of a combined unitary group. As a result, the information contained in the federal Schedule M-3 that is attached to the California corporate tax return does not reconcile book income or loss to California taxable income or loss, as the composition of the federal consolidated return may differ from the composition of the California combined report. Second, state law may differ from federal law relating to certain income or expense transactions, therefore, book-tax difference for state purposes would differ from the book-tax difference for federal purposes.

[1] Desai, Mihir A. Harvard University. "The Divergence Between Book and Tax Income." October 2002.

FISCAL IMPACT

The May 1, 2006, amendments would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Discussion

The book-to-tax-income reconciliation would be a significant audit tool. This tool could assist auditors in identifying tax shelter activity and could dissuade some taxpayers from entering in tax avoidance schemes. The revenue gain is dependent on the number and size of tax shelters identified, the amount of additional income self-reported by taxpayers, and the number of taxpayers that fail to provide the reconciliation. Because future corporate tax shelter activities are unknown, it is not possible to calculate the revenue gain from future audit assessments and penalties.

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