Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author: Frommer   Analyst: Gail Hall   Bill Number: AB 1037

Related Bills: See Prior Analysis   Telephone: 845-6111   Amended Date: August 29, 2006

Attorney: Patrick Kusiak   Sponsor: ______

SUBJECT: Net Receipts In Sales Factor For Treasury Function

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ____________.

_X_ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

_X_ AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as amended August 7, 2006.

_X_ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ____________.

____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED ____________ STILL APPLIES.

_X_ OTHER – See comments below.

SUMMARY

Under the Corporation Tax Law, this bill would define gross receipts.

SUMMARY OF AMENDMENTS

The August 29, 2006, amendments made the following changes to AB 1037:

- Removed the provisions of the bill relating to the quadruple-weighted sales factor.
- Removed the provisions of the bill relating to prewritten software.
- Reinstated extractive business activities in the definition of a qualified business activity.

PURPOSE OF THE BILL

The author's office has indicated the purpose of this bill is to define a previously undefined term to prevent potential manipulation of the franchise tax apportionment formula.

Board Position:			Legislative Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR	Brian Putler	11/28/06
____ N	____ OUA	_X_ PENDING		

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment and operative for taxable years beginning on or after January 1 of the year of enactment.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

The issues discussed in this bill are not applicable to federal law because the federal method of taxation is different from the California method.

California has adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), with certain modifications, to determine how much of a taxpayer's total income, which is earned from activities both inside and outside of California, is attributed to California and subject to California franchise or income tax. UDIPTA uses an apportionment formula to determine the amount of "business"[1] income attributable to California.

"Business" income attributable to California is a taxpayer's business income multiplied by its California apportionment formula. The apportionment formula consists of property, payroll, and sales factors. The property factor includes tangible property owned or rented during the taxable year; the payroll factor includes all forms of compensation paid to employees; and the sales factor is double weighted and generally includes all gross receipts from the sale of tangible and intangible property. The calculation of the apportionment formula and California business income is illustrated below:

$$\frac{\boxed{\frac{\text{Average CA Property}}{\text{Average Total Property Everywhere}}} + \boxed{\frac{\text{CA Payroll}}{\text{Total Payroll Everywhere}}} + \left(2 \times \boxed{\frac{\text{CA Sales}}{\text{Total Sales Everywhere}}}\right)}{4} = \text{California Apportionment Formula}$$

$$\underline{\times \text{ Total Business Income}}$$

$$= \text{California Business Income}$$

[1] Revenue & Taxation Code (R&TC) Section 25120(a) defines business income as income arising from an integral part of the activities of a trade or business. Nonbusiness income is all income other than business income.

The sales factor is defined as a taxpayer's total California sales divided by a taxpayer's total sales everywhere.[2] Sales are defined as all gross receipts of the taxpayer except for certain nonbusiness income.[3] California law does not provide a definition for gross receipts.

In *Microsoft v. Franchise Tax Board*, the court held that, in general terms, the gross receipt from the redemption of a marketable security held to maturity is the total amount received upon the redemption. This effectively was Microsoft's position in its claims for refund. The court rejected the FTB's position that the gross receipt upon redemption should be limited to the interest income (net gain) received by the taxpayer. Therefore, the court held that the sales factor should include the total amount received from the disposition of marketable securities, regardless of whether they are sold prior to maturity or are redeemed.

Current law permits a departure from the standard allocation and apportionment rules only in limited and specific cases where using the standard formula would produce an unreasonable result and not fairly represent the taxpayer's activities within the state. Either the taxpayer or the FTB may deviate from the standard formula if they can establish distortion. There are no bright-line tests for determining whether distortion is present, so determinations of distortion must be based on the unique facts and circumstances of each case. In *Microsoft v. Franchise Tax Board*, the Court went on to ask if the inclusion of all of these gross receipts in the sales factor leads to the apportionment formula no longer clearly representing the activities of the taxpayer in the state. The Court held that the inclusion *does* lead to a distortion and FTB prevailed in proving distortion and included "net gain" in the sales factor.

Sales from intangible assets are categorized as California sales if the greater portion of the activities that produced the sales is performed in California.[4] Generally, treasury function activities[5] are performed at the headquarters of the taxpayer.

<u>THIS BILL</u>

This bill would limit gross receipts from a treasury function activity to the overall net gain from such activity in the calculation of the California sales factor. This bill provides the following definitions:

1. "Treasury function" means the pooling, management, and investment of liquid assets and provides that income arising from the treasury function shall be classified as business income. The treasury function definition specifically excludes hedging activities relating to the business of the taxpayer. For example, if a taxpayer makes a product using wheat, and the taxpayer participates in hedging activities to reduce the risk of cost fluctuations of its wheat inventories (raw materials), these hedging activities would not be included in the definition of treasury function activities, and therefore, the receipts from these hedging activities would be included in the sales factor as "gross receipts" instead of "net gain."
2. "Liquid asset" means a readily marketable intangible. Examples are stocks, bonds, debentures, options, warrants, futures contracts, foreign currency, and mutual funds that

[2] R&TC Section 25134.
[3] R&TC Section 25120(e).
[4] R&TC Section 25136.
[5] A taxpayer's treasury function activities are investments in intangible assets such as stocks, bonds, and certificates of deposit, for the purpose of satisfying a taxpayer's cash flow needs.

hold those intangibles. An intangible is considered marketable if it is traded in an established stock or securities exchange or market and is regularly quoted by brokers or dealers.

In addition, this bill provides that a broker-dealer registered with the Securities and Exchange Commission or equivalent federal agency would not include its regular business activities in the definition of liquid assets.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concern. Department staff is available to work with the author's office to resolve this and other concerns that may be identified.

1. An equity interest in a business entity that is unitary with the taxpayer, such as stock in a corporation, could be interpreted to meet the definition of a liquid asset and be classified as a marketable intangible even though the equity interest is not part of the treasury function. This may cause confusion for taxpayers and the department.

TECHNICAL CONSIDERATIONS

1. The reference to "Section 38006" should be expanded to provide that it is located in Part 18. See attached Amendment 1.
2. The definition of the "treasury function" should be restored to the amendments in the bill as amended April 7 and 12, 2005. This would resolve issue number one found in the LEGAL IMPACT portion of this analysis below. See attached Amendment 2.

LEGISLATIVE HISTORY

R&TC Section 25120 (Stats. 1966, Ch. 2) was added as part of California's adoption of UDIPTA. It provides definitions for terms used in the apportionment and allocation of income derived from sources within and without California. The objective of UDIPTA was to provide for a uniform method for allocating income between states.

OTHER STATES' INFORMATION

The states surveyed relating to the treasury function and sales factor include *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

General research was performed to determine how these states define "gross receipts." *Minnesota*, *Michigan*, *Massachusetts*, *New York*, and *Florida* exclude treasury transactions in the definition of "gross receipts," and Illinois includes the net gains from treasury transactions in "gross receipts."

Florida – The term "sales" means all gross receipts received by the taxpayer from transactions and activities in the regular course of its trade or business, except interest, dividends, rents, royalties, and gross receipts from the sale, exchange, maturity, redemption, or other disposition of securities.

<u>*Illinois*</u> – Gross receipts from the sales of business intangibles, such as patents, copyrights, bonds, stocks, and other securities, are disregarded, and only the net gains or losses are included in the sales factor.

<u>*Massachusetts*</u> – The sales factor is a fraction, the numerator of which is the total sales of the corporation in that Commonwealth during the taxable year, and the denominator of which is the total sales of the corporation everywhere during the taxable year. As used in that law, “sales” means all gross receipts of the corporation except interest, dividends, and gross receipts from the maturity, redemption, sale, exchange, or other disposition of securities.

<u>*Michigan*</u> – “Sales” includes gross receipts from the sales of tangible property, from the rental of property and from providing services provided as part of the taxpayer's business activity (such as legal or accounting services).

<u>*Minnesota*</u> – The sales factor includes *all* sales, gross earnings, or receipts received in the ordinary course of the business, *except* interest, dividends, sales of capital assets, sales of property used in the trade or business, and sales of stock and debt instruments.

<u>*New York*</u> – A treasury function receipt from the sale of a capital asset is not a business receipt and is not includable in the receipts factor. *New York* has not adopted UDIPTA.

FISCAL IMPACT

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

ECONOMIC IMPACT

Estimated Revenue Impact of AB 1037 As Amended August 7, 2006 Assumed Enacted After June 30, 2006 Effective for Tax Years BOA Jan. 1, 2006 ($ in Millions)					
	2006-07	2007-08	2008-09	2009-10	2010-11
Treasury Function:					
Net Gain	$93	$100	$28	-$36	-$155
Business Income	24	30	32	32	35
Hedging	-2	-5	-5	-6	-5
Subtotal	$115	$125	$55	-$10	-$125

One component of the treasury function revenue estimate relates to limiting gross receipts from treasury function activities to net gains and reflects only a short-term cash flow gain. The reason for this is that the department assumes that it will prevail in establishing distortion and will include “net gain” from treasury function activities in the sales factor. Therefore, regardless of how taxpayers file, the use of “gross receipts” instead of “net gain” in the sales factor for the treasury function will ultimately be disallowed. The impact of this bill would be to provide certainty and to accelerate the cash flow. This revenue would, under this bill, come into the state during the fiscal year when the taxpayer makes estimated and final payments, as opposed to several years later after an audit has been completed and the administrative dispute resolution process is final.

The revenue impact of the treasury function issue relating to gross receipts in the sales factor is estimated in three steps. Because the treasury function issue is associated mostly with large, apportioning out-of-state corporations, all corporations that met the following conditions for the 2001 tax year were identified:

1. Taxable income greater than $5 million,
2. Headquarters outside of California,
3. Income apportioned to California, and
4. Gross receipts (as reported on line 1C of Schedule F, Computation of Net Income, Form 100) are less than 90% of gross sales (the denominator of the sales factor as reported on Schedule R, Apportionment and Allocation of Income, Form 100).

About 300 corporations met the above conditions. The preliminary revenue impact of the proposed law is estimated by re-computing the tax liability using the new apportioning factor in which the denominator of the sales factor is replaced with gross receipts. Next, the top 50 of these corporations were evaluated using the department's tax audit cases to identify the revenue impact due to treasury function issues for each corporation. Finally, the result of this evaluation was adjusted upward to account for the remaining 250 corporations, including the corporations that did not include Schedule F or Schedule R with their tax returns. The 2001 revenue estimate is extrapolated into future years based on the 2006 May revise Department of Finance's projection of corporate profits.

The California Supreme Court recently issued its opinions on August 17, 2006, on two cases pertaining to the treasury function issue, General Motors v. Franchise Tax Board and Microsoft v. Franchise Tax Board. The court ruled that corporations can include "gross receipts" from treasury function activities in the sales factor. However, the court also supported the FTB interpretation of the law to include only "net gain" from treasury function activities in the sales factor when the use of "gross receipts" would create distortion of the corporations' apportionment formula. For practical purpose, the court decision supported the FTB position for the cases that have any significant tax impact, and therefore, is consistent with the estimate presented above.

A **second component** of the treasury function revenue estimate is the revenue impact from the amendment that would reclassify all nonbusiness income from a treasury function activity to business income. For tax year 2002, total nonbusiness income from treasury function activities was estimated to equal $8.4 billion. Of this amount, $190 million was allocated to California and subject to state tax. This bill would classify the $8.4 billion of nonbusiness income from a treasury function activity to business income, and therefore, this amount would be subject to apportionment. Using an average apportionment percentage of 6.7 percent, the amount of nonbusiness income from treasury function activities that would be subject to California tax would be $565 million ($8.4 billion times 6.7%). If this bill becomes law, an additional $375 million in nonbusiness income from treasury function activities would be subject to California taxation ($565 million less $190 million). The amount of revenue gain would be $22.5 million ($375 million times 6% marginal tax rate) on a taxable year basis. The estimate at the 2002 level is grown to subsequent taxable years by the projected growth in corporate profits as forecasted by the Department of Finance and converted to fiscal numbers.

A **third component** of the treasury function activity relates to the amendment that removes hedging activities from the definition of a treasury function activity. This amendment is estimated to result in short-term revenue losses as some taxpayers may take aggressive positions on reporting gross receipts from hedging activities.

These positions are estimated to result in less revenue collected in the short-term, but collected in later years after an audit has been completed, and the administrative dispute resolution process is final. Based on discussions with the department's audit and legal staff regarding actual cases, it is estimated the short-term loss would be approximately $2 million in tax year 2006. This estimated loss is grown to subsequent taxable years by the projected growth in corporate profits as forecasted by the Department of Finance and offset against revenues collected in subsequent audits.

LEGAL IMPACT

This bill would treat all treasury function income as apportionable business income subject to California tax. If treasury function income has no relationship to activities that occur in the state, this rule may be determined to violate the Commerce Clause of the United States Constitution. Taxpayers may argue that the Commerce Clause is violated because inclusion of the treasury function in apportionable business income is not rationally related to activities that take place in the state.

POLICY CONCERNS

This bill would exclude a taxpayer's hedging activities, such as the purchase and sale of futures contracts relating to business activities, from the definition of the treasury function. This may allow taxpayers to decrease their California sales factor by including the gross receipts from these activities in the sales factor denominator. The issue of what constitutes a "gross receipt" from hedging activity as well as the distortive effect of the inclusion of these receipts at "gross" is already the subject of pending litigation.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD
PROPOSED AMENDMENTS TO AB 1037
As Amended August 29, 2006

AMENDMENT 1

On page 3, line 25, strikeout “Section 38006,” and insert:

Section 38006 of Part 18 (commencing with Section 38001),

AMENDMENT 2

On page 3, line 35, strikeout “investment of liquid assets.” and insert:

investment of liquid assets for the purpose of satisfying the cash flow needs of the trade or business, including, but not limited to, providing a reserve for business contingencies and business acquisitions.