

SUMMARY ANALYSIS OF AMENDED BILL

Author: Ma Analyst: Gail Hall Bill Number: AB 1591
 Related Bills: See Prior Analysis Telephone: 845-6111 Amended Date: June 7, 2007
 Attorney: Tommy Leung Sponsor: _____

SUBJECT: Business income Apportionment/Members Of Apportioning Trade Or Business May Elect To Utilize One Of The Alternative Formulas

- DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as amended April 10, 2007.
- 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/amended _____.
- FURTHER AMENDMENTS NECESSARY.
- DEPARTMENT POSITION CHANGED TO _____.
- REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED
- April 10, 2007, STILL APPLIES.
- OTHER – See comments below.

SUMMARY

This bill would provide new rules for corporations to assign income to California.

SUMMARY OF AMENDMENTS

The June 7, 2007, amendments made the following changes to the bill:

- Revised the \$250 million requirement from a per tax year requirement to a cumulative requirement. For example, if a corporation makes an election and has \$100 million in qualified expenditures in 2007 and \$150 million of qualified expenditures in 2008, the corporation would meet the \$250 million requirement in 2008.
- Resolved the technical considerations discussed in the analysis of the bill as amended April 10, 2007, (see Appendix A).
- Resolved five of the implementation considerations discussed in the analysis of the bill as amended April 10, 2007, (see Appendix A). The unresolved implementation consideration is provided below for convenience.

Board Position:	Legislative Director	Date
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- Resolved two of the policy concerns discussed in the analysis of the bill as amended April 10, 2007, (see Appendix A). The unresolved policy concerns are provided below for convenience.
- Provided that new investment in property would be excluded from the property factor until the election is terminated.
- Provided that the election to use one of the alternative apportionment methods may be terminated without the consent of the Franchise Tax Board (FTB) if the election has been in effect for at least 84 months.
- Provided that expenditures paid to acquire stock or other equity interests in a corporation or other business entity would be excluded from the definition of a qualified expenditure.
- Provided that sales or other transactions between members of an apportioning trade or business shall not be considered a qualified expenditure or new investment in property for purposes of meeting the requirements for one of the proposed alternative apportionment methods.
- Resulted in additional technical considerations and an additional implementation consideration and policy concern.

Except for the “Technical Considerations,” “Implementation Considerations,” “Fiscal Impact,” “Legal Impact,” “Arguments/Policy Concerns,” and “Economic Impact,” the remainder of the department’s analysis of the bill as amended April 10, 2007, still applies.

POSITION

Pending.

ANALYSIS

TECHNICAL CONSIDERATIONS

1. It is recommended that the author clarify that the definition of “value of real and tangible personal property” means property in this state. If the phrase “in this state” is added after “value of real and tangible personal property,” this consideration would be resolved.
2. It appears the author intended to exclude corporate acquisitions generally from the definition of a qualified expenditure, but the current language would allow corporate “asset” acquisitions to qualify as a qualified expenditure. Without further amendment, this language could result in a substantial increase in the weighting of the sales factor without any additional California activity, simply by allowing apportioning corporations to acquire an existing California company’s assets in a tax-free manner. In addition, the author should consider excluding property and payroll increased by corporate acquisitions from being included in the “excess” amount used to determine if property and payroll are excluded from the numerator of the property and payroll factors.

3. The June 7, 2007, amendments would provide a recapture rule requirement that property purchased and sold in the state within a year shall be included in the numerator of the property factor even if an election was in place to freeze the payroll and property factor numerator values. On page 3, lines 21 through 26, of the bill as amended June 7, 2007, the author should consider making the following changes:

“(D) For purposes of this section, if real and tangible personal property acquired or rented by a taxpayer in this state in a taxable year is disposed of in the subsequent taxable year by the taxpayer, and that disposition occurs within one year or less of the date the property was first placed in service in this state, then the value of that property shall be included in the numerator of the taxpayer’s property factor for that period.”

Property purchased and sold during the same taxable year is already excluded from the property factor under current law; therefore, the recapture rule should concentrate on property purchased in one taxable year and sold in another taxable year.

IMPLEMENTATION CONSIDERATIONS

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

1. It is unclear under the bill how the apportionment formula for a combined report (group tax filing) would be calculated when members and subgroups of the combined group make different elections under the proposed two new apportionment methods. Current law lacks provisions specifying how different members of the same apportioning trade or business would utilize different sales factor weighting. Additionally, current law lacks provisions specifying how subgroups formed within a combined group are to be treated. Because the department already possesses legislative rulemaking authority¹ to prescribe rules governing the mechanics of combined reporting, it is suggested that general intent guidance for the content of regulations be added to the bill. For example, the author may consider providing legislative findings and declarations within the bill that would expand on the intent of the bill, specifically with respect to the two issues identified in this paragraph. In addition, the author may wish to add a finding of emergency to the bill in order to allow the department to issue these regulations on an emergency basis so both taxpayers and the department will have governing rules as expeditiously as possible.
2. The election mechanism is unclear regarding new entities that may be added to a group. If an entity is purchased, and that entity had an election in place prior to the acquisition, through its old unitary group, would that election carry over to the new group? If so, would the length of the election be counted from the time it was originally made, or start as a new election with the new group? The author could refer to the existing water’s-edge election rules² with respect to how changes in a group would be treated in order to resolve this implementation consideration.

¹ Revenue and Taxation Code section 25106.5.

² Revenue and Taxation Code section 25113.

FISCAL IMPACT

This bill would allow subgroups of a combined group tax filing to elect an alternative apportionment method that could result in subgroups weighting their sales factor in a variety of ways (i.e. double, triple, quadruple-weighted sales). If the department is required to implement subgroups filing combined within a unitary combined group, forms and information systems may need changes and auditors may need additional training. The additional costs have not been determined at this time, but will be developed as the bill moves through the legislative process.

LEGAL IMPACT

This bill would preface whether a taxpayer may use Alternative 1 or 2 based on the level of activity in this state, which could be subject to constitutional challenge under the Commerce Clause of the United States Constitution. Possible constitutional issues found in the bill include the investment of qualified expenditures, property, and payroll in the state.

ARGUMENTS/POLICY CONCERNS

1. The intended effect of encouraging business to expand in California would only apply to apportioning trades or businesses if this bill were adopted. A business located in California that is wholly in-state would receive no benefit from this bill because wholly in-state businesses do not apportion their income.
2. The bill includes maintenance costs as qualified expenditures. This appears to be at odds with the purpose of the bill to expand California business activity. These costs would already be incurred and are not a new activity of the taxpayer, yet they are treated as such.
3. This bill provides an incentive to electing members and subgroups to increase their California property and payroll in this state over the base year, but provides no disincentive for electing members and subgroups that decrease their California property and payroll in this state compared to the base year. The bill appears to allow electing taxpayers to lower their numerators based on a loss of payroll or property, even though the election is in place. This appears to be in conflict with the intent of the bill to encourage additional new investment in California.

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 1591 Effective for tax years BOA 1/1/2007 Enacted after 6/1/2007			
2007-08	2008-09	2009-10	2010-11
-\$550 Million	-\$1.3 Billion	-\$1.950 Billion	-\$2.250 Billion

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

Revenue Discussion

First, the tax amounts resulting from the above two alternative formulas were simulated using samples of corporate tax returns for the tax years 2003, 2004, and 2005. The simulations accounted for the taxpayers' specific financial situation as reported on their tax returns, and the changes in the taxpayers' behaviors in later years as they develop tax minimization strategies regarding the provisions of this bill. These tax amounts were compared with the tax amount calculated under current law. It was assumed that a taxpayer would choose the apportionment formula that yields the lowest tax. The revenue impact of this bill for the 2005 tax year was estimated as the average amount of tax reduction of these tax years.

Next, the estimated 2005 revenue impact was extrapolated to the future years. This extrapolation took into account the growth of the taxpayers' income, and the fact that both apportionment alternative No. 1 (hyper weighting of sales) and apportionment alternative No. 2 (reductions of property and payroll factors) would yield larger tax savings in subsequent years as the qualified expenditures (alternative No. 1) and incremental property and payroll (alternative No. 2) are accumulated each year. It was assumed that the taxpayers' income would grow at the same growth rate as corporate profit as forecasted by the Department of Finance. For the 2008 tax year, the revenue loss from this proposal was estimated at \$910 million.

Finally, the tax year estimates were converted to fiscal year estimates shown in the table. For example, the 2007-08 cash flow estimate of a revenue loss of \$550 million includes a \$240 million loss from the 2007 tax year, plus \$310 million loss from the 2008 tax year due to higher credit usage and reduced estimated tax payments.

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APPENDIX A
Resolved Implementation And Technical Considerations and Policy Concerns
From Analysis of Bill As Amended April 10, 2007

RESOLVED IMPLEMENTATION CONSIDERATIONS

1. The bill provides that property shall be excluded from the numerator of the property factor if it is in excess of the value of the property used in the state in the base year. The department has interpreted this requirement to mean the numerator of the property factor would be zero if the excess requirement is met. If the author meant for only the incremental amount of property over the base year value would be excluded from the numerator of the property factor, amendments should be considered.
2. The bill lacks a definition for “value of the taxpayer’s real and tangible personal property owned or rented” (i.e., cost, fair-market value) and “the amount of compensation” relating to the payroll factor. The department would be unable to implement this bill without a definition.
3. The bill lacks detailed guidelines for FTB to determine when an election is terminated. The author should consider creating an election similar to the water’s-edge election that binds the taxpayer to the water’s-edge election for seven years, upon the expiration of which would allow the taxpayer to terminate it.
4. The bill appears to grant FTB mandatory legislative rulemaking authority. The author should consider making the grant discretionary and clarify this is legislative rulemaking authority to ensure effective implementation of the provisions of the bill relating to the new elections for calculating the apportionment formula.
5. On page 6, line 8, the bill provides that the entire business income of the group shall be apportioned using a three factor, single-weighted sales factor or a three factor, double-weighted sales factor apportionment formula. This appears to be in conflict with the allowance of subgroups for the proposed alternative apportionment formulas. The author should consider using the same rules for all the methods for determining the apportionment formula or clarify the difference.

RESOLVED TECHNICAL CONSIDERATIONS

1. On page 3, line 23, it appears “in this state” should be inserted after “compensation paid.” If the author meant for the current year’s compensation amount to be the amount paid in the state, an amendment is necessary.
2. On page 3, line 38, the author should consider adding “timely filed” before “original return” to avoid unintended tax planning opportunities.
3. On page 5, line 34, there is a reference to “paragraph (4) of subdivision (c), but there is no paragraph (4) of subdivision (c) in the bill. The author should consider deleting lines 34 through 39, on page 5, in order to avoid confusion.
4. On page 6, line 8, the bill provides that the entire business income of the group shall be apportioned using a three factor, single-weighted sales factor or a three factor, double-weighted sales factor apportionment formula. This appears to be in conflict with the allowance of subgroups for the proposed alternative apportionment formulas. The author should consider using the same rules for all the methods for determining the apportionment formula or clarify the difference.

RESOLVED ARGUMENTS/POLICY CONCERNS

1. The allowance of sub-grouping could lead to different filing positions on a yearly basis determined solely on whether the tax effect is greater for a member to utilize the base year computation for property or payroll versus the sales factor effect of multiple weighting.
2. The value of property test lacks a provision for recapture. A taxpayer could purchase property at the end of the year to meet the test's requirement, and then return the property after the test is met; alternatively, the members of a unitary group could continuously dispose of the same property to each member of their combined reporting group to qualify multiple members for the election utilizing the same property.