Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Ma	Analyst:	Gail Hall	Bill Number:	AB 1591
Related Bills:	See Legislative History	Telephone:	845-7814	Amended Date:	June 14, 2007
		Attorney:	Tommy Leung	Sponsor:	

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

SUMMARY

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

SUMMARY OF AMENDMENTS

The June 14, 2007, amendments made the following changes to the bill:

- Revised the operative date to taxable years beginning on or after January 1, 2008, and before January 1, 2022.
- Revised the $250 million requirement from a cumulative requirement to a per tax year requirement.
- Provided a definition for the term "subgroup."
- Consolidated capital expenditures and maintenance expenses in the definition of qualified expenditure.
- Consolidated compensation and benefits paid to employees and payments to independent contractors and payroll companies in the definition of a qualified expenditure.
- Revised the definition of a qualified expenditure relating to compensation and benefits paid to employees.
- Added that only one subgroup of an apportioning trade or business may make an election under Alternatives No. 1 or 2.

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP		
_______ SA	_______ O	_______ NAR	Selvi Stanislaus	6/25/07
_______ N	_______ OUA	___X___ PENDING		

- Added amendments to create a disincentive for the elections made under Alternatives No. 1[1] and 2[2] if the amount of qualified expenditures or new investment decreased as compared to the prior taxable year.
- Added an amendment to exclude asset acquisitions of an entire ongoing business operation from meeting the requirements set forth in Alternative No. 1.
- Added rules for new elections after terminations of previous elections and determining the continuation of existing elections when new members are added to the combined unitary group.

The June 14, 2007, amendments resolved several, but not all, of the technical, implementation, and policy considerations as discussed in the department's analysis of the bill as amended June 7, 2007. Namely, the amendments resolved technical consideration Nos. 1 and 3 and implementation consideration No. 2 and made policy concern No. 3 moot. (See Appendix A).

As a result of the June 14, 2007, amendments, the department has identified additional technical and policy considerations. All new and existing concerns are provided below. The department's analysis of the bill as amended June 7, 2007, no longer applies.

PURPOSE OF THE BILL

It appears the purpose of the bill is to encourage corporations to retain existing business, attract new business, and create new jobs by adding an incentive for investing in California.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment and specifically operative for taxable years beginning on January 1, 2008, and before January 1, 2022.

POSITION

Pending.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

The federal method of taxing corporations doing business within and without a state is different from the California method; therefore, an analysis of federal law is not relevant.

---

[1] Election that provides an additional weighting of the sales factor if the $250 million requirement is met.
[2] Election to exclude property and payroll from the numerator of the property and payroll factor.

California has adopted the Uniform Division of Income for Tax Purposes Act, (UDITPA), with certain modifications, to determine how much of an apportioning 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. UDITPA uses an apportionment formula to determine the amount of "business" income attributable to California.[3]

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.

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

X Total Business Income
= California Business Income

For taxable years beginning on or after January 1, 1993, the apportionment formula for most taxpayers has been a three-factor apportionment formula consisting of property, payroll, and double-weighted sales (three-factor, double-weighted sales). An exception to this rule exists for taxpayers that derive more than 50% of their gross business receipts from conducting a "qualified business activity." These taxpayers are required to use a three-factor, single-weighted sales, apportionment formula. For this purpose, a qualified business activity is defined as an agricultural, extractive, savings and loan, and banking or financial business activity. In addition, current law requires that once a determination has been made that the apportioning trade or business is involved in a qualified business activity, the entire apportioning trade or business uses the same weighting, regardless of whether the particular entity was involved in a qualified business activity.

[3] "Business income attributable to California" is a taxpayer's "business income" multiplied by its California apportionment formula. Revenue and Taxation Code (R&TC) section 25120(a) defines "business income" as income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." R&TC section 25120(d) defines "nonbusiness income" as all income other than business income. In general, "business income" is income arising in the normal course of the taxpayer's business or from assets used in the normal course of the taxpayer's business.

State law permits a departure from the standard apportionment provisions only in limited and specific cases,[4] and recognizes that the standard apportionment provisions are not appropriate when applied to certain industries and types of transactions, in which case special apportionment provisions exist for those situations.[5]

THIS BILL

This bill would create two alternative apportionment methods a corporation or a subgroup of corporations in a unitary combined group may elect to instead of the standard apportionment formulas described under the Current State Law section above. Subgroup is defined as "a distinct group of affiliated corporations whose total business assets equal or exceed $1 billion," identified pursuant to Alternative No. 2.

Alternative No. 1: Qualified Expenditures

For every $250 million of qualified expenditures made by a member of an apportioning trade or business during a taxable year beginning on or after January 1, 2008, and before January 1, 2022, an additional sales factor would be added to the numerator of the apportionment formula and the denominator of the apportionment factor would be increased by one. For example, a corporation under current law is required to double-weight the sales factor. If in taxable year 2008 this corporation elects Alternative No. 1 and also has $250 million of qualified expenditures, this corporation would now use a triple-weighted sales factor in its apportionment formula.

Qualified expenditures shall expressly **include** any combination of the following:

1) Capital expenditures, including maintenance expenses, for real and tangible personal property located in California.
2) Research and development expenses incurred in California.
3) Expenses incurred to develop, enhance, or maintain real property and tangible personal property located in California.
4) Capitalized rent paid in California in excess of the prior year.
5) Compensation and benefits paid to employees, independent contractors, and payroll companies for work in California in excess of the amount paid in the prior year
6) Payments to independent contractors and payroll companies for work performed in California in excess of the prior year.
7) Training costs incurred in California.
8) Costs incurred in providing a basic level of health care to employees in California, as defined in the Knox-Keene Health Care Service Plan Act[6], in excess of the prior year.
9) Expenditures incurred in connection with funding research at a four-year public or private college or university located in California.

[4] R&TC section 25137.
[5] California Code of Regulations (CCR), title 18, Section 25137.
[6] Chapter 2.2 of the California Health and Safety Code

Qualified expenditures shall expressly **exclude** the following expenditures and transactions:

1) Sales or other transactions between members of an apportioning trade or business.
2) Amounts paid to acquire stock or other equity interests in a corporation or other business entity, or an asset acquisition of an entire ongoing business operation.

A subgroup is prohibited from increasing its sales factor weighting, even if it meets the $250 million requirement, if the apportioning trade or business incurs a reduction in the amount of qualified expenditures as compared to the subgroup's prior year qualified expenditures.

The apportioning trade or business, or a subgroup thereof, must submit and certify with each tax return filed a summary of the qualified expenditures.

Alternative No. 2: Property and Payroll Factor

A corporation may elect to adjust its property and payroll factors under Alternative No. 2 as follows:

- The value of property owned or rented in this state that is in excess of the value of the taxpayer's real and tangible personal property owned or rented and used in California in the base year shall be excluded from the numerator of the property factor .
- If real and intangible property is disposed of in the following taxable year and within one year or less of the date the property is first placed in service, then the amount of the excluded California property is required to be recaptured or added back to the numerator of the property factor in the period the property was placed in service.
- The amount of compensation paid in California by a taxpayer that is in excess of the amount of total compensation paid in the state in the base year would be excluded from the numerator of the payroll factor. Compensation in the base year excludes extraordinary events such as deferred compensation payouts or stock option exercised, but these extraordinary events are included in the amount of compensation paid in the state.
- "Base year" is defined as the year immediately preceding the year of election.
- The member of the apportioning trade or business, or a subgroup thereof, must submit and certify with each tax return filed a summary of the new investment made in California.

A subgroup is prohibited from excluding property and payroll from its property and payroll numerators if the apportioning trade or business's property or payroll, or both, in this state is less than the immediately preceding taxable year's property and payroll in this state.

Other Provisions For Alternatives No. 1 and 2

- The election for either Alternative No. 1 or 2 must be made by attaching a statement to the timely filed original return and by specifying the method of adjusting the apportionment factor. The election may be terminated either by the taxpayer with the permission of FTB, or by FTB if the taxpayer fails to submit and certify the required information. If the election is terminated within the 84-month period, the corporation or subgroup is prohibited from making another election under Alternative No. 1 or 2 for 84 months. The election may be terminated without the consent of FTB after the 84-month period. In addition, the following rules apply to elections made for Alternative No. 1 or 2:
    - After the termination of the election to use either Alternative No. 1 or 2, the sales factor weighting and excluded property and payroll from the prior election are carried forward until January 1, 2022. Only after the sunset of the provisions of the bill would the sales factor weighting and excluded property and payroll be adjusted as if the election was never made.
    - In the event of an acquisition either by or of a new affiliated member, if the electing member's total business assets exceed the new affiliated member's total business assets, the election will apply to the new affiliate; otherwise, the election would be terminated and any new election would not be subject to the 84-month waiting period.
- Electing Alternatives No. 1 or 2 would not be construed to terminate a water's-edge election or construed to allow a change or adjustment to the water's-edge election.
- Sales or other transactions between members of an apportioning trade or business shall not be considered a qualified expenditure under Alternative No. 1 or a new investment under Alternative No. 2.
- FTB may prescribe legislative rules and regulations to implement the provisions of this bill.
- The provisions of this bill are severable, so that if any provision or its application is held invalid, that invalidity shall not affect other provisions that can still be given effect without the invalidated provision.
- It is the intent of the Legislature that the sales factor used in any special apportionment rules under section 25137 of the Revenue and Taxation Code would still apply and would not be modified by the bill's provisions.
- Only one subgroup of an apportioning trade or business may make an election under Alternative No. 1 or 2.

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.

Concerns as provided in the June 7, 2007, analysis:

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 authority[7] 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.

New concerns:

2. On page 4, line 19, the provision provides a disincentive for qualified expenditures in a taxable year that are less than the previous taxable year's qualified expenditures, but the test compares qualified expenditures of the apportioning trade or business to qualified expenditures of a subgroup. Because the entities in an apportioning trade or business could be different from a subgroup, the comparison appears flawed. The author should consider applying the disincentive either to apportioning trades or to businesses or subgroups, but not between them.
3. The amendment adding rules for elections when a new affiliate is acquired and the definition of a subgroup refer to "total business assets," which is undefined. The absence of a definition to clarify this term could lead to disputes with taxpayers and would complicate the administration of this bill.

TECHNICAL CONSIDERATIONS

Concerns as provided in the June 7, 2007, analysis:

1. It appears the author intends to exclude corporate acquisitions generally from the definition of a qualified expenditure; however, the current language would allow corporate "acquisitions" to qualify as new investments under Alternative No. 2. The following amendment is recommended:

   "For purposes of this section, qualified expenditures and new investments do not include purchases or otherwise acquired stock or other equity interest in a corporation or other business entity. In addition, in any case where a member purchases or otherwise acquires all or any portion of the assets of an existing trade or business (irrespective of the form of entity) that is doing business in this state (within the meaning of Section 23101), the purchased assets shall not be treated as a qualified expenditure or new investment for purposes of subdivision (c)."

[7] Revenue and Taxation Code section 25106.5.

New concerns:

2. On page 8, line 29, the language provides that the section shall remain in effect until December 1, 2002, which appears to be an error.

LEGISLATIVE HISTORY

SB 359 (Runner, 2007/2008) would revise the current rules for apportioning business income to allow certain taxpayers an election to use a three-factor, quadruple-weighted sales apportionment formula, remove “extractive business activities” from the definition of a qualified business activity, and add other miscellaneous provisions. SB 359 is currently in the Senate Revenue and Taxation committee.

AB 1037 (Frommer, 2005/2006), as amended on August 7, 2006, would have created a three-factor, quadruple-weighted sales, apportionment formula for certain industries. AB 1037 was held in the Senate Revenue and Taxation Committee.

AB 2590 (Campbell, 2003/2004) and AB 2560 (Vargas, 2001/2002) would have replaced the three-factor, double-weighted sales apportionment formula used by most corporations with a single-factor apportionment formula based solely on sales. Exceptions to using the single-factor formula would have included: (1) taxpayers that had an average of property and payroll in California in excess of sales that did not meet certain employment requirements would use the three-factor, double-weighted sales formula, and (2) taxpayers that derive more than 50% of their gross business receipts from extractive activities could have used either the single-factor sales formula or the three-factor, single-weighted sales formula. AB 2590 and 2560 were held in Assembly Appropriations.

AB 1642 (Harmon, 2001/2002) and SB 1014 (Johnson, 2001/2002) would have changed the apportionment formula used to determine the amount of business income taxable by California to a single-factor apportionment formula based on sales and allowed extractive businesses to choose either the current three-factor formula based on property, payroll, and sales, or use the new single-factor formula. AB 1642 died pursuant to Article IV, Section 10(c) of the Constitution; SB 1014 was returned to the Secretary of Senate pursuant to Joint Rule 56.

OTHER STATES’ INFORMATION

The states surveyed 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 other states “weight” the sales factor in their apportionment formula.

Florida and *Massachusetts* generally use a double-weighted sales factor with some exceptions for specialized industries.

Illinois began using the single sales factor for tax years ending on or after December 31, 2000. The single sales factor formula is used by corporations deriving business income from the state, rather than being determined by a corporation's principal business activity code.

Michigan's apportionment formula consists of 5% payroll, 5% property, and 90% sales.

Minnesota's apportionment formula consists of 12.5% property, 12.5% payroll, and 75% sales for tax years beginning before 2007. In 2005, *Minnesota* enacted legislation to phase in a sales-only formula over an eight-year period beginning in 2007.

New York utilizes a business allocation formula to assign income from business capital to *New York*. For tax year 2006, *New York* will begin the process of phasing in a new, single-factor allocation formula based on in-state receipts. The single-factor allocation formula will be phased-in as follows: (1) for tax year 2006, the business allocation formula will be equal to 20% property, 60% sales, and 20% payroll; (2) for tax year 2007, the business allocation formula will be equal to 10% property, 80% sales, and 10% payroll; and (3) for tax years beginning on or after January 1, 2008, the business allocation formula will consist of 100% sales.

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. Once the implementation concerns discussed above have been resolved the additional costs will be identified.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

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 1/1/2008 Enacted after 6/1/2007			
2007-08	2008-09	2009-10	2010-11
-$100 Million	-$450 Million	-$1.1 Billion	-$1.6 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 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 bill was estimated at $450 million.

Finally, the tax year estimates were converted to fiscal year estimates shown in the table. For example, the 2008-09 cash flow estimate of a revenue loss of $450 million includes a $175 million loss from the 2008 tax year, plus $275 million loss from the 2009 tax year due to higher credit usage and reduced estimated tax payments.

LEGAL IMPACT

This bill would preface whether a taxpayer may use Alternative No.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 definition of qualified expenditures that are defined as only California property or expenses incurred in the state along with property and payroll in the state.

POLICY CONCERNS

Concerns as provided in the June 7, 2007, amendments:

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.

New concerns:

3. This bill would allow subgroups to elect Alternative No. 1, which means one member of the sub group could meet the $250 million requirement and the other members of the subgroup would benefit from the election without meeting the requirement. This appears to be in conflict with the intent of the bill.
4. The election under Alternative No. 2 would benefit new corporations over existing corporations that have built up property and payroll in the state before the election was available. This may result in new corporations having a financial advantage over existing corporations even if the election is available to both corporations.
5. The bill, under Alternative No. 2, specifies that extraordinary events such as compensation payouts and stock option exercises would be excluded from the calculation of compensation paid in the state for the base year; however, these extraordinary events would be included in the calculation of the compensation paid in the state. Providing different rules for how to calculate an amount of compensation for use in a test to determine whether a tax benefit is allowed is confusing and inconsistent.

LEGISLATIVE STAFF CONTACT

Gaill Hall	Brian Putler
Franchise Tax Board	Franchise Tax Board
(916) 845-6111	(916) 845-6333
gaill.hall@ftb.ca.gov	brian.putler@ftb.ca.gov

APPENDIX A
RESOLVED TECHNICAL AND IMPLEMENTATION CONSIDERATIONS AND POLICY CONCERNS

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.

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

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 rules[8] with respect to how changes in a group would be treated in order to resolve this implementation consideration.

POLICY CONCERNS

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.

[8] Revenue and Taxation Code section 25113.