

SUMMARY ANALYSIS OF AMENDED BILL

Author: Ma Analyst: Gail Hall Bill Number: AB 1591
 Related Bills: See Prior Analysis Telephone: 845-6111 Amended Date: July 18, 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 introduced/amended _____.
- 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 June 14, 2007, STILL APPLIES.
- OTHER – See comments below.

SUMMARY

This bill would allow corporations to elect a modified method for assigning income to California.

SUMMARY OF AMENDMENTS

The July 18, 2007, amendments made the following changes to the bill:

- Removed the provision that would have allowed subgroups of the combined group to make different elections under the proposed two new apportionment methods.
- Removed the provision that would have required a taxpayer to certify a summary of the qualified expenditures.
- Resolved the implementation considerations discussed in the analysis of the bill as amended June 14, 2007, except for the issue related to defining total business assets.
- Resolved the technical considerations discussed in the analysis of the bill as amended June 14, 2007.
- Removed the provision that clarified that a water's-edge election would be unaffected by an election for one of the proposed alternative apportionment methods.

Board Position:	Legislative Director	Date
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<input checked="" type="checkbox"/> PENDING		

- Added a provision that an apportioning trade or business is limited to two additional sales factor weightings each taxable year. Unused sales factor weightings would be carried over to subsequent years.
- Narrowed the definition of “qualified expenditures” under Alternative No. 1.
- Added that in order to elect Alternative No. 2, an apportioning trade or business must first invest at least \$50 million in a qualified facility. In addition, a definition was provided for a “qualified” facility.
- Added that the apportionment percentage under Alternative No. 2 is prohibited from being less than the California sales factor percentage. Clarified that the base year for Alternative No. 2 would be the same base line year for subsequent taxable years.
- Removed the provision under Alternative No. 2 that extraordinary events such as deferred compensation payouts or stock option exercised would be excluded from the calculation of compensation in the base year.
- Clarified that adjustments made to the sales factor under Alternative No. 1 and the property and payroll factors under Alternative No. 2 would remain in effect in subsequent years; and could be interpreted to extend the alternative apportionment rules past the repeal date.

Except for the “EFFECTIVE/OPERATIVE DATE,” “THIS BILL,” “FISCAL IMPACT,” AND “ECONOMIC IMPACT” discussions, the remainder of the department’s analysis of the bill as amended June 14, 2007, still applies. In addition, new implementation considerations, technical considerations, and policy concerns were added and the legal impact issue is provided for convenience.

POSITION

Pending.

EFFECTIVE/OPERATIVE DATE

This bill would be operative for taxable years beginning on or after January 1, 2008, and before January 1, 2022, and repealed on December 1, 2021. Current law would be operative for taxable years beginning on or after January 1, 2022.

ANALYSIS

THIS BILL

This bill would add two alternatives for apportioning income to California. This bill would allow a member, on behalf of the apportioning trade or business, to elect one of the new alternative methods instead of the standard three-factor apportionment formulas that double weight or single weight the sales factor.

Alternative No. 1: Qualified Expenditures

For every \$250 million of qualified expenditures incurred by the 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 apportionment formula. For example, an apportioning trade or business under current law is required to double weight the sales factor. If in taxable year 2008 this business elects Alternative No. 1 and also has \$250 million of qualified expenditures, this business would now use a triple-weighted sales factor in its apportionment formula.

The apportioning trade or business is limited to two additional sales factors each taxable year. Unused additional sales factors would be carried over to the subsequent taxable year.

Qualified expenditures incurred on or after January 1, 2008, shall expressly **include** any combination of the following:

- 1) Capital expenditures for real and tangible personal property located in California.
- 2) Research and development expenses incurred in California.
- 3) Expenses incurred to acquire, develop, or license intellectual property located in California.
- 4) Capitalized rent paid in California in excess of the prior year.
- 5) Compensation and benefits paid to employees, which under current law would be included in the California payroll factor, in excess of the amount paid in the prior year.

An expense that would qualify as a qualified expenditure under two or more categories would be taken into account only once when determining the total amount of qualified expenditures for the taxable year.

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

- 1) Sales, transfers 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.

Alternative No. 2: Property and Payroll Factor

An apportioning trade or business may elect to adjust its property and payroll factors under Alternative No. 2 once it invests over \$50 million in a qualified facility during a taxable year. A "qualified facility" is defined as a new facility, acquired or constructed in this state, or an existing facility, expanded or rehabilitated in this state. The \$50 million investment must be for capital expenditures, leasehold improvements, tangible personal property incurred for the qualified facility, and compensation paid to new employees for services performed at the qualified facility for the taxable year.

Once an apportioning trade or business meets the \$50 million investment requirement, it may adjust its property and payroll factors under Alternative No. 2 as follows:

- The value of real and tangible personal 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. "Base year" is defined as the year immediately preceding the year of election. "Value of real and tangible personal property" means the value of owned and rented property in California.
- Real and tangible personal property acquired from other members of the apportioning trade or business would be prohibited from being excluded from the property and payroll factors.

- If real and tangible property acquired or rented in this state is disposed of in the following taxable year and within one year or less of the date the property is first acquired or rented 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 acquired or rented.
- 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. "Amount of compensation" is defined as compensation that would be included in the numerator of the California payroll factor.

In subsequent years if the amount invested in qualified facilities fails to exceed the value of the qualified facilities in the taxable year the election becomes applicable, Alternative No. 2 would be disallowed and the apportioning trade or business would revert back to using the applicable standard apportionment formula.

The apportioning trade or business is prohibited from modifying its property or payroll factors, or both, under this election unless its property or payroll in this state exceeds its property and payroll in this state in the immediately preceding taxable year.

The California apportionment percentage under Alternative No. 2 may not be less than the apportioning trade or business's California sales factor percentage.

Sales, transfers, or other transactions between members of the apportioning trade or business are excluded from the calculation of the \$50 million investment threshold or when determining if property in California exceeds the base year property in California.

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 apportioning trade or business would be required to submit the aggregate information to substantiate the qualifications for apportionment factor adjustments under Alternatives No. 1 or 2. The apportioning trade or business may only switch between elections for Alternative No. 1 and No. 2 after the election has been in place for 84 months, unless permission is granted by FTB. If permission is granted by FTB for the election to be terminated within the first 84-months, the apportioning trade or business would be prohibited from making another election under Alternative No. 1 or 2 for 84 months, but any adjustment under Alternative No. 1 will remain in effect. The election may be switched between Alternative No. 1 and No. 2 without the consent of FTB after the 84-month period.
- If a new affiliate member is formed or acquired by an apportioning trade or business, or if an apportioning trade or business is acquired, then the election made by the apportioning trade or business would remain in effect unless the value of the new affiliate member's total business assets exceed the total business assets of the electing member.
- 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.
- The adjustments made under Alternative No. 1 or Alternative No. 2 would remain in effect in subsequent years.

IMPLEMENTATION CONSIDERATIONS

1. The amendment adding rules for elections when a new affiliate is acquired refers 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.
2. It is unclear how the \$250 million requirement would be calculated for intellectual property payments, or any other payments, made to affiliated entities outside the water's-edge group.
3. It is unclear how to determine what portion of an amount paid to acquire, develop, or license intellectual property usable everywhere would be "in this state." If it is intended to apply only to intellectual property located in this state there will be administrative difficulties in determining the location of intellectual property which by its very nature does not have a tangible presence and whose "location" can be easily shifted.
4. Costs associated with the purchase of stock and/or assets for corporate acquisitions are excluded from being a qualified expenditure, but it appears that the new payroll costs associated with the corporate acquisition and pre-existing rental payments would be included as a qualified expenditure, which is inconsistent with excluding costs from corporate acquisitions from being qualified expenditures and appears to be inconsistent with the purpose of the bill.
5. It is unclear what is meant by the rule that an apportioning trade or business may only switch between Alternative No. 1 and Alternative No. 2 after the election has been in place for 84 months, unless the FTB grants permission. The bill as amended June 14, 2007, provided that an election may not be terminated before the 84 months unless granted permission from the FTB.
6. It is unclear what is meant by "capitalized rent" in the definition of a qualified expenditure.
7. It is unclear if the adjustments made under Alternative No. 1 or Alternative No. 2 would remain after the repeal date.

TECHNICAL CONSIDERATIONS

The department has identified the following technical considerations. Department staff is available to work with the author's office to resolve these and other concerns that may be identified. Amendments 1 through 7 are attached that would resolve the technical considerations.

1. The language for calculating the amount of excluded property under Alternative No. 1 is inconsistent. (See Amendment 1).
2. The language that discusses the requirement that property and payroll in the current taxable year must exceed the preceding taxable year's property and payroll incorrectly references "paragraph" instead of "subparagraph." (See Amendment 2).

3. Amendment 3 would remove language that is technically incorrect and could cause confusion.
4. The language that discusses the effect on the election under Alternative No. 1 and Alternative No. 2 when a new or acquired affiliate becomes part of the apportioning trade or business compares appears flawed. The total business assets of the new or acquired affiliate are compared to the qualified taxpayer's total business assets instead of the apportioning trade or businesses total business assets. (See Amendment 4).
5. The language that discusses the termination of the election when a new or acquired affiliate joins the apportioning trade or business incorrectly references subparagraph (E) instead of subparagraph (F). (See Amendment 5).
6. The operative date for the bill ends for taxable years beginning before January 1, 2022, but the bill specifically repeals the statute on December 1, 2021. It is recommended that the repeal date is changed to December 1, 2022. (See Amendment 6).
7. The operative date for section 2 references "This action" instead of "This section." (See Amendment 7).

FISCAL IMPACT

Departmental costs to implement this bill are estimated to be approximately \$210,000 in the first year and approximately \$590,000 in each year thereafter.

Implementing this bill in the first year would require modifications to the department's information systems, tax forms and instructions, and additional customer service contacts from taxpayers seeking clarification on the election for the two new apportionment methods and filing requirements. Estimated annual costs include additional audit staff needed to examine the two new alternative apportionment methods and process elections, terminations, and unused additional sales factor carryovers. In addition, annual costs include auditor training, customer service contacts, and information systems support.

It is recommended that the bill be amended to include appropriation language that would provide funding to implement this bill. Lack of an appropriation will require the department to secure the funding through the normal budgetary process, which could delay implementation of this bill if funding is not approved by the Department of Finance.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue losses:

Estimated Revenue Impact of AB 1591 Effective for tax years BOA 1/1/2008 Enacted after 6/1/2007 (In \$ Millions)			
2007-08	2008-09	2009-10	2010-11
-\$50	-\$250	-\$550	-\$750

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 two alternative methods of apportioning business income were simulated using samples of corporation 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. These tax amounts were compared with the tax amount calculated under current law. It was assumed that a taxpayer would choose the apportionment method 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 future years. This extrapolation took into account the growth of the taxpayers' income, and the fact that both Alternative No. 1 (additional sales factors) and Alternative No. 2 (incremental property and payroll) would yield larger tax savings in subsequent years. There would be larger tax savings under Alternative No. 1 as new businesses meet the qualified expenditure threshold and while businesses that met the threshold in the first year continue to benefit. In addition, as businesses earn additional sales factors, and as businesses that were limited by the two additional sales factors are allowed to add additional sales factors to the apportionment formula, larger tax savings would occur. There would be larger tax savings under Alternative No. 2 as incremental property and payroll are accumulated each year. It is assumed that taxpayer's income would grow at the same growth rate as corporate profits as forecasted by the Department of Finance. For the 2008 taxable year, the revenue loss from this proposal was estimated at \$255.

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 \$250 million includes a \$100 million loss from the 2008 tax year, plus \$150 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.

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 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.
3. This bill would allow amounts paid to increase the salaries of current employees to be counted as a qualified expenditure despite the fact that it does not increase California employment.
4. Costs associated with the purchase of stock and/or assets for corporate acquisitions are excluded from being a qualified expenditure, but it appears that the new payroll costs associated with the corporate acquisition and pre-existing rental payments would be included as a qualified expenditure, which is inconsistent with excluding costs from corporate acquisitions from being qualified expenditures and appears to be inconsistent with purpose of the bill.
5. This bill would allow taxpayers in certain circumstances to claim multiple tax benefits for the same item of expense.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 1591
As Amended July 18, 2007

AMENDMENT 1

On page 6, lines 7 and 8, ~~strikeout "in this state"~~ and insert after
"owned and rented":

"and used in this state"

AMENDMENT 2

On page 7, line 7, ~~strikeout "paragraph"~~ and insert:

"subparagraph"

AMENDMENT 3

On page 7, line 21 and 22, ~~strikeout:~~

"of the apportioning trade or business"

AMENDMENT 4

On page 8, line 14, ~~strikeout "electing member's"~~ and insert:

"apportioning trade or business's"

AMENDMENT 5

On page 8, line 17, ~~strikeout "(E)"~~ and insert:

"(F)"

AMENDMENT 6

On page 11, line 36, ~~strikeout "2021"~~ and insert:

"2022"

AMENDMENT 7

On page 13, line 30, ~~strikeout "action"~~ and insert:

"section"