

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Villines/Ma Analyst: Gail Hall Bill Number: AB 2114
Related Bills: See Legislative History Telephone: 845-6111 Introduced Date: February 20, 2008
Attorney: Patrick Kusiak 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.

PURPOSE OF THE BILL

According to author's staff, 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 or after January 1, 2008.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

The federal method of taxing corporations doing business within and without a state is different from the California method; therefore, federal law is inapplicable.

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.¹

¹ "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."

Board Position:	Department Director	Date
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The apportionment formula consists of property, payroll, and sales factors. Each of these factors is a fraction the numerator of which is the value of the item in California and the denominator of which is the value of the item everywhere. 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 generally includes all gross receipts from the sale of tangible and intangible property and is double-weighted.

The calculation of the apportionment formula and California business income is illustrated below.

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

$$\underline{\underline{\text{X Total Business Income}}} = \underline{\underline{\text{California Business Income}}}$$

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.

State law permits a departure from the standard apportionment provisions only in limited and specific cases,² 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.³

THIS BILL

This bill would create two alternative apportionment methods a taxpayer, on behalf of the apportioning trade or business or subgroup thereof, may elect to utilize that would deviate from the standard apportionment formulas described under the Current State Law section above.

² R&TC section 25137.

³ California Code of Regulations (CCR), title 18, Section 25137.

Alternative 1 – Sales Factor

For each \$250 million of qualified expenditures incurred after January 1, 2008, an apportioning trade or business or subgroup thereof, may add an additional sales factor to the numerator of the apportionment formula and increase by one the denominator of the apportionment factor.

- The apportioning trade or business, or a subgroup thereof, must submit and certify with each tax return filed a summary of the qualified expenditures.
- Qualified expenditures shall include all of the following:
 - 1) Capital expenditures for real and tangible personal property located in California.
 - 2) Expenses incurred to acquire, develop, or license intellectual property in California.
 - 3) Research and development expenses incurred in California.
 - 4) Expenses incurred to develop, enhance, or maintain real property and tangible personal property located in California.
 - 5) Capitalized rent paid in California in excess of the prior year.
 - 6) Compensation and benefits paid to employees in California in excess of the prior year.
 - 7) Payments to independent contractors and payroll companies for work performed in California in excess of the prior year.
 - 8) Training costs incurred in California.
 - 9) 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, in excess of the prior year.
 - 10) Expenditures incurred in connection with funding research at a four-year public or private college or university located in California.

Qualified expenditures exclude amounts paid to acquire stock or other equity interests in a corporation or other business entity.

Alternative 2 – Property and Payroll Factor

A corporation may elect to adjust its property and payroll factors as follows:

- Property shall be excluded from the numerator of the property factor if it 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.
- The amount of compensation paid 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 exercises.
- "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.

Other Provisions

- The election for either Alternative 1 or 2 must be made by attaching a statement to the 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. In addition, the election may be terminated by the taxpayer without the consent of FTB after it has been in effect for at least 84 months.
- Electing Alternatives 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.
- FTB shall prescribe 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.
- Sales or other transactions between members of an apportioning trade or business shall be excluded from being considered a qualified expenditure or new investment made in California.

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 prohibits different members or subgroups of the same apportioning trade or business from utilizing different sales factor weighting, and it may be difficult, if not impossible, to draft rules that would allow differently weighted apportionment formulas within the same apportioning trade or business. Because the department already possesses legislative rulemaking authority⁴ to prescribe rules governing the mechanics of combined reporting, it is suggested at the very least 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.
2. On page 2, lines 34 and 36, the bill provides that an apportioning trade or business, or a subgroup, "may" add an additional sales factor numerator to the sales factor and "may" add an additional sales factor denominator to the sales factor if it meets the \$250 million qualified expenditure requirement.

⁴ Revenue and Taxation Code section 25106.5.

As drafted, the language could be interpreted to allow an apportioning trade or business or subgroup to increase only the denominator of the sales factor and receive a greater benefit from choosing Alternative 1 than what the author may have intended.

3. The election mechanism makes no provision for the adding of entities, new or existing, 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 rules⁵ with respect to how changes in a group would be treated in order to resolve this implementation consideration.
4. 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.
5. It is unclear what is meant by "capitalized rent" in the definition of a qualified expenditure.
6. It is unclear what is meant by "new investment" on page 3, line 33, of the bill

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.

1. On page 2, line 38, the author should consider adding "by the apportioning trade or business, or a subgroup thereof," after the word "made" for clarity.
2. On page 3, line 1 through 3, and lines 35 through 38, "and certify" should be deleted and replaced with "a certification signed by an officer" to provide consistency.
3. On page 3, line 16, the bill provides 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. The author should consider making the following changes to page 3, lines 16 through 21:

"(ib) 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 available for use in this state, then the value of that property shall be included in the numerator of the taxpayer's property factor for such period."

Property purchased and sold during the same taxable year is usually included in the property factor determined by averaging the values at the beginning and ending of the taxable year; therefore, the recapture rule should concentrate on property purchased in one taxable year and sold in another taxable year.

⁵ Revenue and Taxation Code section 25113.

4. On page 3, lines 28 and 29, "in the base year" should be deleted to provide a consistent comparison of compensation paid in the base year versus compensation paid in the taxable year.
5. On page 3, lines 31 through 34 apply to both Alternatives 1 and 2, yet these provisions are located in the bill that discusses only Alternative 2. For clarity, these provisions should be moved to another paragraph that discusses both Alternatives 1 and 2.
6. On page 3, line 39, "for taxable years beginning" should be added before "on or after January 1, 2008, to be consistent with the operative date of the bill.
7. On page 4, line 4, the word "as" should be deleted.
8. On page 4, line 15, the word "a" should be replaced with the word "the".
9. On page 5, line 37, "section 24365 that modifies" should be inserted after "as defined in" to clarify that the state definition of research and development expenses is a modification of the federal laws.
10. On page 6, line 14, 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.

LEGISLATIVE HISTORY

AB 1591 (Ma, 2007/2008) contained almost identical apportionment provisions to this bill and would have created two alternative apportionment methods that a corporation may elect to use to deviate from the standard apportionment formulas. AB 1591 did not meet the constitutional deadline for passing out of the Assembly.

SB 98 (Budget & Fiscal Review, 2007/2008) contained similar apportionment provisions to this bill and would have created an alternative apportionment method that a taxpayer may elect to use to deviate from the standard apportionment formula. In addition, SB 98 contained a repeal date and specific reporting requirements. SB 98 was placed on inactive file.

SB 359 (Runner, 2007/2008) would have revised 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 was held 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. In addition, several western states were surveyed and discussed in Appendix A because of their locality to California.

General research was performed to determine how the surveyed 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.

Michigan's apportionment formula, for tax years before 2006, consisted of 5% payroll, 5% property, and 90% sales. In 2006 and 2007, the formula will place a 92.5% weight on sales and a 3.7% weight on both property and payroll. For tax years beginning after 2007, each tax base of a taxpayer must be apportioned by multiplying the base by the sales factor.

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* began phasing in a new, single-factor allocation formula based on in-state receipts. The single-factor allocation formula is phased-in as follows: (1) for tax year 2006, the business allocation formula was 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

The department's costs to administer the amendments cannot be determined until the department's implementation concerns have been resolved. If the department is required to implement subgroups filing combined within a unitary combined group, forms and information systems may need changes.

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 2114 Effective for tax years BOA 1/1/2008 Enacted after 6/1/2008			
2008/09	2009/10	2010/11	2011/12
-\$700 Million	-\$1.6 Billion	-\$2.6 Billion	-\$3.0 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 Alternatives 1 and 2 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 1 (hyper weighting of sales) and apportionment alternative (reductions of property and payroll factors) would yield larger tax savings in subsequent years as the qualified expenditures (Alternative 1) and incremental property and payroll (Alternative 2) are accumulated each year. It was assumed that the taxpayers' income would grow at the same growth rates as corporate profits as forecasted by the Department of Finance. For the 2008 tax year, the revenue loss from this bill was estimated at \$575 million.

Finally, the tax year estimates were converted to fiscal year estimated shown in the table. For example, the 2008/09 tax year revenue loss of \$700 million includes a \$385 million loss from the 2008 tax year, plus \$315 million revenue loss from the 2009 tax year.

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.
4. The election under Alternative 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. 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.
6. This bill would allow taxpayers in certain circumstances to claim multiple tax benefits for the same item of expense. For example, the same research and development (R & D) expenses may qualify a taxpayer for both the R & D credit and for a favorable apportionment percentage under Alternative 1.

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APPENDIX A
AB 2114
STATES LOCATED NEAR CALIFORNIA: SALES FACTOR WEIGHT

- *Arizona* uses a three factor, double-weighted sales factor apportionment formula similar to California. Effective from and after December 31, 2007, but applying retroactively to taxable years beginning from and after December 31, 2006, an alternative formula that enhances the sales factor and reduces the payroll and property factors of the apportionment formula may be available for use by certain corporations if certain conditional requirements are satisfied. If the conditions are met, then from December 31, 2006 through December 31, 2007, the numerator of the alternative formula will be two times the property factor plus two times the payroll factor plus six times the sales factor, divided by ten. From December 31, 2007 through December 31, 2008, the numerator of the alternative formula is one and one half times the property factor plus one and one half times the payroll factor plus seven times the sales factor, divided by ten. Finally, from December 31, 2008, the numerator of the alternative formula is the property factor plus the payroll factor plus eight times the sales factor, divided by ten.

The alternative formula will become effective only if two conditions occur. First, on or after June 15, 2005, one or more corporations must publicly announce one or more capital investment projects in Arizona that individually or collectively cost in excess of \$1 billion. Project announcements must be reported in writing to the joint legislative budget committee and the governor's office of strategic planning and budgeting and must provide detailed information about each project. Second, no later than December 15, 2007, one or more corporations must publicly notify the joint legislative budget committee and the governor's office of strategic planning and budgeting that one or more reported projects have commenced.

- *Colorado* allows a corporation to elect to use a three-factor, equally weighted property, payroll, and sales factor or a two-factor property and sales factor. If a corporation elects to use the two-factor apportionment formula, the corporation must initially divide its entire net income (both business income and nonbusiness income) in half. One half of the net income is then multiplied by a property factor and the other half is multiplied by a sales factor to determine the amount of net income attributed to sources within Colorado. All income is apportioned using these two factors and no income is directly allocated to its source state.
- *Idaho* uses a three factor formula and double-weights the sales factor similar to *California*, but allows electric and telephone companies to equally weight the property, payroll, and sales factor.

- *Montana, Utah, and New Mexico* equally weight the property, payroll, and sales factors. *New Mexico* allows some industries to double-weight sales and *Utah* allows a taxpayer to elect to double-weight the sales factor.
- *Oregon* requires that all business income be apportioned to Oregon by multiplying the income by the sales factor, but a taxpayer that is in the forest products industry may use a three-factor double-weighted sales factor if it meets certain requirements.
- *Washington, Wyoming, and Nevada* lack a corporation income tax.