Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Runner	Analyst:	Gail Hall	Bill Number:	SB 359
Related Bills:	See Legislative History	Telephone:	845-6111	Introduced Date:	February 20, 2007
		Attorney:	Daniel Biedler	Sponsor:	

SUBJECT: Increase Research And Development Credit Percentage To 16%/Extend The Repeal Date For The Joint Strike Fighter Credit/Net Receipts In Sales Factor For Treasury Function/Quadruple-Weighted Sales Factor For Qualified Business Activity

SUMMARY

Under the Personal Income Tax and Corporation Tax laws, this provision would do the following:

- Modify the credit for research expenses to 16% of the excess of the qualified research expenses.
- Modify the alternative incremental research credit (AIRC).
- Add manufactured property for Crew Exploration Vehicles to the Joint Strike Fighter property and wage credits.
- Extend the repeal dates to an undefined date for the Joint Strike Fighter property and wage credits.

Under the Corporation Tax Law, this provision would do the following:

- Provide a definition for gross receipts addressing treasury function receipts.
- Change the method used by companies in specified industries to calculate their California net income by modifying the apportionment formula.

PURPOSE OF THE BILL

According to the author's staff, the purpose of the bill is to accomplish the following:

1. Increase economic productivity in California.
2. Encourage certain industries to invest in California.
3. Provide a clear definition of gross receipts to prevent potential manipulation of the franchise tax apportionment formula.

POSITION

Pending.

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP		
_______ SA	_______ O	_______ NAR	Selvi Stanislaus	4/20/07
_______ N	_______ OUA	___X___ PENDING	by Lynette Iwafuchi	

SUMMARY OF ECONOMIC IMPACT

Estimated Revenue Impact of SB 359 Effective for tax years BOA 1/1/2007 Enacted by 6/1/2007 ($ in Millions)				
	2007-08	2008-09	2009-10	2010-11
Research Expense Credit	-$40	-$50	-$55	-$55
Joint Strike Fighter Credit	*	*	*	*
Treasury Function	$70	$70	$55	$50
Sales Factor	-$125	-$160	-$165	-$165
Total	-$95	-$140	-$165	-$170

* See revenue discussion in the Joint Strike Fighter Credit section below.

1. <u>RESEARCH EXPENSE CREDIT</u>

EFFECTIVE/OPERATIVE DATE

This provision is a tax levy and would be effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2007.

ANALYSIS

<u>FEDERAL/STATE TAX LAW</u>

Existing federal law allows taxpayers a research credit that is combined with several other credits to form the general business credit. The research credit is designed to encourage companies to increase their research and development activities.

To qualify for the credit, research expenses must qualify as an expense or be subject to amortization, be incurred in the U.S., and be paid by the taxpayer. The research must be experimental or laboratory research and pass a three-part test as follows:

1. Research must be undertaken to discover information that is technological in nature. The research must rely on the principles of physical, biological, engineering, or computer sciences.
2. Substantially all of the research activities must involve experimentation relating to quality or to a new or improved function or performance.
3. The application of the research must be intended for developing a new or improved business component. This is a product, process, technique, formula, or invention to be sold, leased, or licensed, or used by the taxpayer in a trade or business.

Ineligible expenses include seasonal design factors; efficiency surveys; management studies; market research; routine data control; routine quality control testing or inspection; expenses incurred after production; or development of any plant, process, machinery, or technique for the commercial production of a business component unless the process is technologically new or improved.

The federal credit does not apply to any expenses paid or incurred after December 31, 2007.

California conforms to the federal credit with the following modifications:

- The state credit is not combined with other business credits.
- Research must be conducted in California.
- The credit percentage for qualified research expense in California is 15% versus the 20% federal credit.
- The credit percentage for basic research payments in California, limited to corporations, is 24% versus the 20% federal credit.
- The percentages for the alternative incremental research portion of the credit are less than the federal credit.

The California research credit is allowed for taxable years beginning on or after January 1, 1987, and is permanent without regard to whether the federal credit is operative.

THIS PROVISION

This provision would increase the research and expense credit from 15% to 16% and conform to the AIRC.

LEGISLATIVE HISTORY

AB 751 (Lieu, 2007/2008) would increase the research credit for increasing qualified research expenses from 15% to 20% for taxable years beginning on or after January 1, 2007, and would also fully conform to the federal alternative incremental research expenses credit for taxable years beginning on or after January 1, 2007. This provision is currently in the first house.

AB 2032 (Lieu, 2005/2006) would have increased the amount of the qualified research expense credit from 15% to 18%. AB 2032 failed to pass out of the Assembly Revenue & Taxation Committee.

AB 2567 (Arambula, 2005/2006) would have conformed the amount of the qualified research expense credit to the amount allowed at the federal level. AB 2567 failed to pass out of the Assembly Revenue and Taxation Committee.

AB 483 (Harman, 2001/2002) and SB 1165 (Brulte, 2001/2002) would have increased the credit for qualified research expenses from 15% to 20%. AB 483 was held in the Senate Revenue and Taxation Committee. SB 1165 failed to pass out of the originating house by the constitutional deadline.

AB 511 (Stats. 2000, Ch. 107) increased the state credit for qualified research expense from 12% to 15%.

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.

Florida allows corporate taxpayers to claim a corporate income tax credit for tax years beginning on or after January 1, 2007, for certain "eligible costs" for renewable energy technologies investment. *Florida* does not have a comparable credit for personal income taxpayers because Florida has no state personal income tax.

Illinois corporate and individual taxpayers may claim an income tax credit for qualified expenditures that are used for increasing research activities in *Illinois*. The credit equals 6½% of the qualifying expenditures.

Massachusetts allows corporate taxpayers to claim an income tax credit for qualified expenditures that are used for increasing research activities in *Massachusetts*. The credit is 15% of the basic research payments and 10% of qualified research expenses conducted in *Massachusetts*.

Minnesota allows corporate taxpayers a credit equal to 5% for qualified research expenses up to $2 million. The amount of the credit is reduced to 2.5% for expenses exceeding the first $2 million.

Michigan allows corporate taxpayers a credit for pharmaceutical research and for a percentage of the compensation for services paid by the taxpayer that is engaged in research and development of a hybrid system for propelling motor vehicles. An eligible taxpayer may claim a credit against the Single Business Tax equal to 6.5% of the excess of qualified research expenses paid in the tax year that relate to pharmaceutical-based business activity in Michigan paid during the three immediately preceding tax years.

Beginning in 2005, *New York* allows a credit for qualified emerging technology companies. The credit is equal to 18% of the cost of research and development property, 9% of the qualified research expenses, or the costs of high-technology training expenditures paid by the taxpayer. The credit is limited to $250,000 per taxable year.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of SB 359 Effective for Tax Years BOA 1/1/2007 Enacted by 6/1/2007 ($ in Millions)				
	2007-08	2008-09	2009-10	2010-11
Research Expense Credit	-$40	-$50	-$55	-$55

Revenue Discussion

The revenue loss due to increased research expense credit rate was estimated using a corporate and personal income tax model based on the 2001-04 Franchise Tax Board (FTB) samples of corporate tax returns. For each corporation in the sample of corporate tax returns, the tax liabilities under the current and proposed laws were simulated taking into account the entity's taxable income, net operating losses, qualified research expenses, the research expense credit rates, and carryover credits. Not all additional research credit generated in a particular year could be used in that year. Taxpayers without sufficient tax liability would not be able to fully use the additional credit. Unused credit would be carried forward to subsequent years. The unused research expense credit is currently in excess of $8 billion. The corporate and personal income tax model results show that the proposed increased research expense credit rate would generate $115 million additional credit in 2004; however, it is estimated that only $35 million of this amount could be used in reducing tax liability for the same tax year.

AIRC currently accounts for about 2% of the research expense credit claimed. The percentage increases in the AIRC rates under this provision are higher than that of the research expense credit rate. Therefore, it was assumed that the revenue loss due to higher AIRC rates would be about 4% of the loss from higher regular research and development credit rate. The results from the tax model were expanded from the samples to corporate population.

The personal income tax revenue impact in future years as a fraction of the corporate revenue impact is assumed to be equal to the ratio of personal income tax research expense credits to corporate qualified research expense credits in 2004. The percentage in 2004 was 4%.

2. JOINT STRIKE FIGHTER CREDIT

EFFECTIVE/OPERATIVE DATE

This provision is a tax levy and would be effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2007.

ANALYSIS

FEDERAL/STATE TAX LAW

There are no comparable federal credits specifically for the Joint Strike Fighter (JSF) program.

Prior state law allowed qualified taxpayers a wage credit and a property credit under the JSF program. Qualified taxpayers were those under an initial contract or subcontract to manufacture property for ultimate use in a JSF.

The *wage credit* was equal to a specified percentage of employee wages, not to exceed $10,000 per year, per qualified employee, that were direct costs allocable to property manufactured in this state for ultimate use in a JSF, with certain limitations.

The *property credit* was equal to 10% of the cost of qualified property used by a taxpayer primarily in qualified activities to manufacture a product for ultimate use in a JSF, with certain exceptions.

The credits were available for taxable years beginning on or after January 1, 2001, and before January 1, 2006, and were repealed as of December 1, 2006. Any excess credit can be carried forward for up to eight years.

BACKGROUND

The JSF Program is the Department of Defense's focal point for defining affordable next generation strike aircraft weapon systems for the Navy, Air Force, Marines, United Kingdom Royal Navy, and other U.S. allies.

The current phase of the program is known as the System Development & Demonstration phase and is expected to take ten years. Lockheed Martin, using pieces manufactured by several other companies in various states, including California, will assemble a total of 22 test aircraft to be used in flight testing, non-airborne testing, and evaluation of the radar signature. The assembly will take place at Lockheed Martin's Aeronautics Company in Fort Worth, Texas.

The department annually releases a report on state tax expenditures. Appendix A contains information from the 2006 State Tax Expenditure Report regarding the usage of the JSF Property and Wage credit and the Research and Development Credit.

THIS PROVISION

This provision would make the following changes to existing state law, and also reenact the JSF credits, with modifications:

- Repeal the December 1, 2006, date and extend the repeal date to an unspecified date for the JSF credit.
- Expand the use of the JSF wage and property credits to include wages paid and property manufactured for use in a Crew Exploration Vehicle.
- Defines a "Crew Exploration Vehicle" as the next generation spacecraft being planned by the National Aeronautics and Space Administration.

<u>TECHNICAL CONSIDERATIONS</u>

The JSF credit section that this provision purports to amend ceased to be operative for taxable years beginning on or after January 1, 2006, and was repealed as of December 1, 2006. Because the prior law was repealed, it appears the provision would restore the previous credit for taxable years beginning on or after January 1, 2007 – one year after the prior law was no longer operative.

LEGISLATIVE HISTORY

AB 2033 (Lieu, 2005/2006) would have extended the JSF wage and property credits for five additional taxable years. This provision failed to pass out of the Assembly Revenue and Taxation Committee.

AB 485 (Runner, 2001/2002) would have extended the JSF credits for two years, from 2006 to 2008. This provision failed to pass out of the house of origin before the constitutional deadline.

AB 2797 (Machado, Stats. 1998, Ch. 322) enacted the JSF credits.

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.

A review of *Florida, Illinois*, *Massachusetts, Michigan, Minnesota*, and *New Yo*rk tax laws found no comparable tax credits for the JSF program. These states were reviewed because of the similarities between California income tax laws and their tax laws.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Estimated Revenue Impact of SB 359 Effective for Tax Years BOA 1/1/2007 Enacted by 6/1/2007 ($ in Millions)				
	2007-08	2008-09	2009-10	2010-11
JSF Credit	*	*	*	*

* This provision, as written, would not extend nor expand the JSF as intended due to technical reasons. (See Technical Consideration section above.) If this technical consideration is corrected, the revenue impact of the JSF provision would be a revenue loss of approximately $30 million per year.

3. TREASURY FUNCTION

EFFECTIVE/OPERATIVE DATE

This provision is a tax levy and would be effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2006.

ANALYSIS

FEDERAL/STATE TAX LAW

The federal method of income taxation 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 a taxpayer's total income, which is earned from activities both inside and outside of California, is attributed to California and subject to California franchise or income tax. UDIPTA uses an apportionment formula to determine the amount of "business" income attributable to California.[1]

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; 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.

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

X Total Business Income
= California Business Income

[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." 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 or from assets used in the normal course of the taxpayer's business.

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

BACKGROUND

On August 17, 2006, the California Supreme Court issued its decisions in *Microsoft Corp* v. *Franchise Tax Board* (2006) 39 Cal.4th 750, and *General Motors Corporation et al* v. *Franchise Tax Board* (2006) 39 Cal.4th 773.

Microsoft

The court held that the return of capital from marketable securities held to maturity constituted a gross receipt, and thus, a sale. Specifically, the court stated, "We agree with Microsoft that the meaning of 'gross receipts' in the UDITPA more naturally includes the entire redemption price (purchase price plus interest) of marketable securities." Thus, the court concluded that such receipts were properly included in Microsoft's sales factor at gross. The court went on to hold, however, that the FTB had met its burden to prove that including such receipts in the sales factor under the facts presented by the case resulted in an apportionment formula that did not fairly represent the extent of Microsoft's activities in California. Accordingly, FTB was entitled to depart from the standard apportionment formula and implement an alternative apportionment formula under Revenue and Taxation Code (R&TC) section 25137, which resulted in using "net" receipts instead of "gross."

General Motors (GM)

The court held that repurchase agreements are comparable to secured loans, as opposed to sales; therefore, the return of principal is simply the return of money used and not gross receipts. Only the interest income earned from the repurchase agreements is includable in the sales factor.

In addition, the court affirmed its decision in *Microsoft* that the entire redemption price (purchase price plus interest) of a marketable security is includable in the sales factor as a gross receipt. An analysis was still needed on whether including the gross receipts from GM's marketable securities in the sales factor fairly represented GM's activities in the state; therefore, the court remanded that portion of the case back to the lower court for further consideration.

The California Supreme Court denied the department's Petitions for Rehearing (Modification) in both *Microsoft* and *GM. Microsoft* is now final unless the taxpayer files and the US Supreme Court accepts a petition for certiorari.

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[2] R&TC Section 25134.
[3] R&TC Section 25120(e).

THIS PROVISION

This provision would make the following changes to existing state law:

- Include in the definition of business income all income arising from the treasury function of the taxpayer's trade or business.
- Provide that gross receipts arising from a treasury function shall be limited to the overall net gain, including interest and dividends.
- Define "income arising from the treasury function" to mean interest, dividends, and any overall net gain realized from transactions undertaken as part of the treasury function of the taxpayer's trade or business.
- Define "treasury function" to mean the pooling, management, and investment of liquid assets. The treasury function definition specifically excludes hedging activities relating to the business of the taxpayer. For example, if a taxpayer makes a product using wheat, and the taxpayer participates in hedging activities to reduce the risk of cost fluctuations of its wheat inventories (raw materials), these hedging activities would not be included in the definition of treasury function activities, and therefore, the receipts from these hedging activities would be included in the sale factor at "gross receipts" instead of "net gain."
- Define "liquid asset" to mean a readily marketable intangible. Examples are stocks, bonds, debentures, options, warrants, futures contracts, foreign currency, and mutual funds that hold those intangibles. A liquid asset excludes from its definition currency held in bank accounts regularly used by the business, unless that currency is an instrument that may be purchased or sold for a gain or loss. An intangible is considered marketable if it is traded in an established stock or securities exchange or market and is regularly quoted by brokers or dealers.
- Provide that a broker-dealer registered with the Securities and Exchange Commission or equivalent federal agency excludes its regular business activities in the definition of liquid assets.

IMPLEMENTATION CONSIDERATIONS

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

TECHNICAL CONSIDERATIONS

1. The reference to "Section 38006" should be expanded to provide that it is located in Part 18. See attached Amendment 1.
2. The definition of the "treasury function" should be revised to resolve the issue discussed in the LEGAL IMPACT portion of this analysis. See attached Amendment 2.
3. A comma should be added to the definition of a liquid asset between "options" and "warrants." See attached Amendment 3.

LEGISLATIVE HISTORY

AB 1037 (Frommer, 2005/2006), as amended on August 7, 2006, had nearly identical provisions relating to the treasury function. AB 1037 was held in the Senate Revenue and Taxation Committee.

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 states define "gross receipts." *Minnesota*, *Michigan*, *Massachusetts*, *New York*, and *Florida* exclude treasury transactions in the definition of "gross receipts," and *Illinois* includes the net gains from treasury transactions in "gross receipts."

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

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

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

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

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

New York – The sales factor includes total business receipts, which are defined as receipts from sales of tangible personal property, services, rentals from tangible property, patent, and copyright royalties, and receipts from closed circuit television and cable television. *New York* has not adopted UDITPA.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of SB 359 Effective for Tax Years BOA 1/1/2007 Enacted by 6/1/2007 ($ in Millions)				
	2007-08	2008-09	2009-10	2010-11
Treasury Function	$70	$70	$55	$50

Revenue Discussion

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

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

About 300 corporations met the above conditions. The preliminary revenue impact of the proposed law is estimated by re-computing the tax liability using the new apportioning factor in which the denominator of the sales factor is replaced with net receipts. Next, the top 50 of these corporations were evaluated using the department's tax audit cases to identify the revenue impact due to treasury function issues for each corporation. The result of this evaluation was adjusted upward to account for the remaining 250 corporations, including the corporations that did not include Schedule F or Schedule R with their tax returns. Finally, the revenue estimate was adjusted downward to account for the recent *Microsoft* Supreme Court decision because some corporations will report treasury function receipts at "net" instead of "gross" because "gross" would distort the corporation's apportionment formula. This estimate assumes that FTB will ultimately prevail in each case in which treasury receipts are reported at gross. However, this provision will cause an acceleration of revenue because it will force taxpayers to report their treasury receipts at net when they file their returns, rather than waiting until FTB audits the taxpayers and issues assessments. This acceleration of revenue is estimated to be $37 million for the 2007 tax year.

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

A third component of the treasury function activity relates to the amendment that removes hedging activities from the definition of a treasury function activity. This amendment is estimated to result in short-term revenue losses as some taxpayers may take aggressive positions on reporting gross receipts from hedging activities. These positions are estimated to result in less revenue collected in the short-term, but collected in later years after an audit has been completed and the administrative dispute resolution process is final. Based on discussions with the department's audit and legal staff regarding actual cases, it is estimated the short-term loss would be approximately -$2 million in tax year 2007. This estimated loss is grown to subsequent taxable years by the projected growth in corporate profits as forecasted by the Department of Finance (DOF) and offset against revenues collected in subsequent audits.

The three component's ($37, $22.5, and -$2 million) revenue estimates were grown to subsequent taxable years by the projected growth in corporate profits as forecasted by DOF and converted to fiscal numbers (see the table above).

LEGAL IMPACT

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

POLICY CONCERNS

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

4. SALES FACTOR

EFFECTIVE/OPERATIVE DATE

This provision is a tax levy and would be effective immediately upon enactment and provides the following operative dates:

- New R&TC section 25128 would be operative for taxable years beginning on or after January 1, 2007, and establishes an unspecified repeal date.
- Current R&TC section 25128 would be operative for taxable years beginning before January 1, 2007, and again for taxable years beginning on or after an unspecified date.

ANALYSIS

FEDERAL/STATE TAX LAW

The federal method of income taxation is different from the California method; therefore, federal law is inapplicable.

California has adopted the UDITPA, with certain modifications, to determine how much of a taxpayer's total income, which is earned from activities both inside and outside of California, is attributed to California and subject to California franchise or income tax. UDITPA uses an apportionment formula to determine the amount of "business" income attributable to California.[4]

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; 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.

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

X Total Business Income
= California Business Income

[4] "Business income attributable to California" is a taxpayer's "business income" multiplied by its California apportionment formula. 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 or from assets used in the normal course of the taxpayer's business.

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 is taxpayers that derive more than 50 % of their gross business receipts from conducting a "qualified business activity." Such taxpayers use a three-factor, single-weighted sales apportionment formula. A qualified business activity is defined as an agricultural, extractive, savings and loan, and banking or financial business activity.

Current law provides that if the corporations (members) included in a combined report (combined group tax filing) meet different requirements for weighting their sales factor, both of the following shall apply:

1. The application of the more than 50% gross business receipts test shall include the gross receipts from all members of the combined group tax filing, and
2. The total business income of the members of the combined group tax filing shall use the apportionment formula of the member with more than 50% of the group's gross business receipts. If no member has more than 50% of the group's gross business receipts, then the three-factor, double-weighted sales apportionment formula will be required.[5]

State law permits a departure from the standard apportionment provisions only in limited and specific cases[6] and recognizes that the standard apportionment provisions are not appropriate when applied to certain industries and types of transactions and provide special apportionment procedures for those situations.[7]

Sales of all items other than tangible personal property are categorized as California sales if the income producing activity related to the sale is performed in California, or if the income producing activity is performed in more than one state, the greater proportion of the activity, as determined by cost, is performed in California.[8] In the past, the department has taken the position that canned or prewritten software should be treated as tangible personal property for sales factor purposes.

THIS PROVISION

This provision would add a new R&TC section 25128 that would revise the current rules for apportioning business income to allow certain taxpayers to elect 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.

Three-Factor, Quadruple-Weighted Sales Apportionment Formula

This provision would allow certain taxpayers to elect to use a three-factor, quadruple-weighted sales apportionment formula under the following three elections.

[5] R&TC Section 25128 and California Code of Regulations (CCR), title 18, Section 25128(c).
[6] R&TC Section 25137.
[7] CCR, title 18, Section 25137.
[8] R&TC section 25136.

1. A “qualified taxpayer” may elect to use a three-factor, quadruple-weighted sales apportionment formula. The election would be in a form and manner prescribed by the FTB and may be made on a year-to-year basis. A “qualified taxpayer” is defined as an apportioning trade or business that derives more than 50% of its gross business receipts from conducting a business activity, or combination of activities, described in specified federal Principal Business Activity Codes (PBACs). (See Appendix A.) A qualified taxpayer that elects to apportion business income using a three-factor, quadruple-weighted sales apportionment formula shall treat prewritten software as tangible personal property for sales factor purposes, regardless of the method of delivery.
2. A taxpayer that fails to meet the 50 % “qualified taxpayer” requirement may elect to use a three-factor, quadruple-weighted sales apportionment formula if the taxpayer derives more than $1 billion of gross business receipts from conducting a business activity or a combination of activities described in specific PBACs. (See Appendix A.) The $1 billion requirement includes all members of the apportioning trade or business that are engaged in the specific PBACs. The election must be made on a timely original tax return by contract with the FTB and is a one-time binding election. The $1 billion requirement must only be met in the year the apportioning trade or business makes the election.

   This election provides an exception to the standard rule for determining how to weight the sales factor for a combined group tax filing when the members of the group weight their sales factors differently. (See State Law Treasury Function/Sales Factor section of the analysis for a discussion of current state law.)
3. A taxpayer that derives more than 50 % of gross business receipts from specified industries (see Appendix A), may elect to use a three-factor quadruple-weighted sales apportionment formula or a three-factor single-weighted sales formula. The election would be a one-time binding election made by contract on a timely original tax return in a form and manner prescribed by the FTB.

The one-time binding elections described above in paragraphs 2 and 3 may be terminated by the taxpayer if either of the following occurs:

- The taxpayer is acquired, directly or indirectly, by a nonelecting entity that alone, or together with the members of its combined group filing, is larger than the taxpayer as measured by “equity capital.” Equity capital is defined as stock of any class, paid-in capital and retained earnings, or earned surplus, as set forth in the balance sheet of the taxpayer or nonelecting entity, for the immediately preceding year-end accounting period.
- The taxpayer obtains permission from the FTB.

<u>Extractive Business Activity</u>

This provision would remove an extractive business activity from the definition of a qualified business activity. Under current law, a qualified business activity is required to use a three-factor, single-weighted sales apportionment formula. This provision would allow an extractive business to elect either a three-factor, quadruple-weighted sales apportionment formula, or a three-factor, single-weighted apportionment formula. If no election is made, the extractive business would use the three-factor, double-weighted sales apportionment formula.

Miscellaneous Provisions

This provision would make the following miscellaneous changes to the rules for apportioning business income:

- Provide that if any portion of this section is held invalid, the other provisions of the section that can be reasonably separated shall remain in effect.
- Provide that the PBACs referenced in the provision are as prescribed by the IRS on December 31, 2005.
- Provide that any change in the apportionment formula caused by this provision would not be considered for granting a change of water's-edge election.
- Exclude sales arising from a treasury function activity of a taxpayer's trade or business from the definition of "gross business receipts."

This provision would also allow a sales tax exemption for certain fuel and petroleum products and tangible personal property. This analysis will not address these amendments as they do not impact the department or state income tax revenue.

IMPLEMENTATION CONSIDERATIONS

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

1. This provision provides a new apportionment rule for determining the tax owed by each taxpayer of a combined group tax filing where that taxpayer elects to use the quadruple-weighted sales factor under the $1 billion requirement and the other members of the group are not qualified taxpayers. Current law already provides rules that could be modified to apply to members of a group tax return with different weighted sales factors that may provide simplicity. (See the State Law section of this analysis).
2. Further amendments are recommended to clarify the nexus rule that is intended to apply when a taxpayer sells prewritten software that is never reduced to a tangible form (e.g., download of software from the Internet). Likewise, amendments are recommended to eliminate destination issues such as the ultimate destination and whether the customer billing address should be used.
3. It may be necessary to add "notwithstanding Section 38006" language to the proposed amendments relating to prewritten software. Without this language, in-state companies could assign outbound sales of prewritten software to other states and out-of-state companies could make a Multistate Tax Compact[9] election and assign inbound sales of prewritten software also to other states resulting in zero sales assigned to California for purposes of the sales factor.

[9] The Multistate Tax Compact (R&TC Section 38006) is an agreement among participating states to facilitate the uniform administration of state taxes for multistate taxpayers. Taxpayers in participating states may use the current state laws or elect the provisions of the law in the multistate tax compact under Section 38006.

4. It is unclear if the election relating to a qualified taxpayer and prewritten software is a year-to-year, transaction-by-transaction, or a binding election. In addition, while the treatment of prewritten software as tangible personal property is consistent with current departmental practice, the department has not taken a formal position regarding whether the method of delivery impacts this determination.
5. Two of the binding elections found in this provision would require the election to be made by contract. This is inconsistent with the other election found in the provision and may result in substantial performance issues as found with the repealed water's-edge contract provisions that were replaced with binding election rules. It is recommended the reference "shall be made by contract with the Franchise Tax Board" be deleted. This change would make the election statutory instead of contractual. See attached Amendments 4 and 5.

LEGISLATIVE HISTORY

AB 1037 (Frommer, 2005/2006), as amended on August 7, 2006, had nearly identical provisions relating to the hyper-weighted sales factor. 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 PBAC(s).

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 business income 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 is being phased-in as follows: (1) for tax year 2006, the business allocation formula equals 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.

<u>Sales Of Other Than Tangible Property</u>

Florida – In general, sales from intangibles are assigned to the state where the income producing activity is located. If the income producing activity is unknown, the sales are excluded from the sale factor. Sales from canned software are assigned to *Florida* if the customer is located in *Florida*.

Illinois, *Massachusetts*, *New York*, and *Michigan* assign sales of intangibles to the state where the income producing activity is located. If the income producing activity is located in more than one state, the sales are assigned to the state with the greater cost of performance.

Massachusetts assigns sales from prewritten software in the same manner as tangible personal property.

Minnesota – Sales from intangible assets are assigned to the state where the intangible property is used.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of SB 359 Effective for tax years BOA 1/1/2007 Enacted by 6/1/2007 ($ in Millions)				
	2007-08	2008-09	2009-10	2010-11
Sales Factor	-$125	-$160	-$165	-$165

Revenue Discussion

For the proposed three-factor, quadruple-weighted sales apportionment formula, samples of corporate tax returns for the tax years 2002, 2003, and 2004 were used for this analysis. For each corporation, tax liabilities under current and the proposed apportionment formulas were computed. The revenue impact was estimated as the difference between the computed tax liabilities. The impact for each individual corporation was then statistically weighted and aggregated to derive an estimate of the total revenue impact for each of the above sampled tax years. The revenue impact was computed as the average of these three tax years; $87 million for tax year 2002, $138 million for 2003, and $163 million for 2004, for an average revenue impact of $129 million ($87 million + $138 million + $163 million/3). The $129 million revenue impact for 2004 was grown to the subsequent taxable years by the projected growth in corporate profits as forecasted by the Department of Finance and converted to fiscal numbers.

POLICY CONCERNS

This provision would allow a “qualified taxpayer” to elect the quadruple-weighted sales factor on a year-to-year basis on an original or amended tax return. Generally, an election must be made on a timely filed original tax return and permission must be granted by the taxing authority before the election may be revoked. The purpose of these rules is to prevent retroactive and prospective tax planning, and prevent an undue burden on the administration of tax laws.

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FRANCHISE TAX BOARD
SB 359 As Introduced February 20, 2007

AMENDMENT 1

On page 35, line 31, strikeout “Section 38006,” and insert:

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

AMENDMENT 2

On page 36, line 2, strikeout “investment of liquid assets.” and insert:

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

AMENDMENT 3

On page 36, revise lines 7 through 9 to read as follows:

(2)(A) “Liquid asset” means a readily marketable intangible, including, but not limited to, bonds, stocks, future contracts, debentures, options, warrants, foreign currency, and mutual funds

AMENDMENT 4

On page 39, delete line 24, and insert:

made on the original

AMENDMENT 5

On page 40, delete line 18, and insert:

made on the original

APPENDIX A – SALES FACTOR
(Principal Business Activity Codes Used In SB 359 As Introduced February 20, 2007)

1. QUALIFIED TAXPAYER

Code	Description
312130	Wineries
325410	Pharmaceutical & Medicine Mfg
333200	Industrial Machinery Mfg (Semiconductor only)
334110	Computer & Peripheral Equipment Mfg
334200	Communications Equipment Mfg
334410	Semiconductor & Other Electronic Component Mfg
339110	Medical Equipment & Supplies Mfg
511210	Software Publishers
512100	Motion Picture & Video Industries (except video rental)
515100	Radio & Television Broadcasting
515210	Cable & Other Subscription Programming
517000	Telecommunications
713100	Amusement Parks & Arcades

2. MORE THAN $1 BILLION OF GROSS BUSINESS RECEIPTS

Code	Description
312130	Wineries (Added)
325410	Pharmaceutical & Medicine Mfg (Added)
333200	Industrial Machinery Mfg (Semiconductor only) (Added)
334110	Computer & Peripheral Equipment Mfg (Added)
334200	Communications Equipment Mfg (Added)
334410	Semiconductor & Other Electronic Component Mfg (Added)
339110	Medical Equipment & Supplies Mfg (Added)
511210	Software Publishers (Added)
512100	Motion Picture & Video Industries (except video rental)
515100	Radio & Television Broadcasting
515210	Cable & Other Subscription Programming
517000	Telecommunications (Added)
713100	Amusement Parks & Arcades

3. MORE THAN 50% OF GROSS BUSINESS RECEIPTS

Code	Description
211110	Oil & Gas Extraction
221210	Natural Gas Distribution
324110	Petroleum Refineries (including integrated)
324190	Other Petroleum & Coal Products Mfg
424700	Petroleum & Petroleum Products
425120	Wholesale Trade Agents & Brokers
447100	Gasoline Stations (including convenience stores w/gas)
454312	Liquefied Petroleum Gas (Bottle Gas) Dealers
486000	Pipeline Transportation
523130	Commodity Contracts Dealing