

# ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: Perez Analyst: David Scott Bill Number: AB 1500  
Related Bills: See Legislative History Telephone: 845-5806 Amended Date: February 9, 2012  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Business Income Apportionment/Mandatory Single Sales Factor/Middle Class Scholarship Fund

### SUMMARY

This bill would do the following:

Establish the Middle Class Scholarship Fund (Education Code section 70200 and 70201)

- Require the Franchise Tax Board (FTB) to report to the Department of Finance the estimated and actual increase or decrease in revenue resulting from changes in the Revenue and Taxation Code in this bill.

Mandatory Single Sales Factor (Revenue and Taxation Code Sections 23101, 25128, 25128.5, 25128.7, 25136, 25136.1) for taxable years beginning on or after January 1, 2012:

- Repeal the annual election to choose single sales factor;
- Require taxpayers not in a qualified business activity or that do not make an election to use the four-factor formula to use a mandatory single sales factor;
- Require all taxpayers to use the “market rule” for assigning sales to the sales factor; and
- Allow qualified taxpayers to assign 50 percent of the mandatory sales factor to California.

This analysis will not address the changes to the Education Code, with the exception of the reporting requirement for the FTB listed above.

### RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

#### Summary of Amendments

The February 9, 2012, amendments removed legislative intent language and replaced it with provisions that would modify the method used by apportioning trades or businesses to apportion their business income to California and added provisions to the Education Code relating to the Middle Class Scholarship fund. This is the department’s first analysis of the bill.

#### Summary of Suggested Amendments

Amendments 1 and 2 are provided to resolve two technical considerations discussed below.

Board Position:	Executive Officer	Date
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## **PURPOSE OF THE BILL**

According to the author's office, the purpose of this bill is to provide the funding source for the Middle Class Scholarship Program (to be established with AB 1501), which will reduce UC and CSU student fees by 2/3 for middle income families earning less than \$150,000, making college more affordable for middle class families who have seen the continued rise in tuition and fees push a college education beyond their reach.

## **EFFECTIVE/OPERATIVE DATE**

As an urgency measure, this bill would be effective and operative immediately upon enactment. However, this bill would only be operative if AB 1501, which establishes the Middle Class Scholarship Program, is enacted. Generally, the changes to various provisions of the Revenue and Taxation code are specifically operative for taxable years beginning on or after January 1, 2012.

## **ANALYSIS**

### FEDERAL/STATE LAW

#### **Federal Law**

Federal law is not applicable to provisions of this bill because the federal method of multistate corporate taxation is different from the California method.

#### **California Law**

Current state law provides the following general rules to determine the amount of income reportable to California for entities that conduct business both within and outside of California.

#### Doing Business in California

For taxable years beginning on or after January 1, 2011, California established a bright-line test to determine if a taxpayer is doing business in California. This bright-line test is not a "safe-harbor." The test is met if any of the following conditions is satisfied.<sup>1</sup>

- The taxpayer is organized or commercially domiciled in California.
- The taxpayer's sales in California exceed the lesser of \$500,000 or 25 percent of the taxpayer's total sales, including sales by an agent or independent contractor.
- The real and tangible personal property owned or rented by the taxpayer in California exceeds the lesser of \$50,000 or 25 percent of the total owned or rented real and tangible personal property.
- The amount of compensation paid to an employee by the taxpayer in California exceeds the lesser of \$50,000 or 25 percent of the total compensation paid by the taxpayer.

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<sup>1</sup> Federal law, commonly referred to by tax practitioners as PL 86-272, still applies to sellers of tangible personal property. As a result, if a taxpayer's activities in California stay within the protections of PL 86-272, a taxpayer also remains protected from the imposition of those taxes that are computed based on net income, namely, the California franchise and income tax. Nevertheless, if a taxpayer is considered doing business in California under Revenue and Taxation Code (R&TC) Section 23101(a) or (b), it still has a filing requirement and will be subject to the minimum tax because that tax is not computed based on net income and therefore is not subject to the protections of PL 86-272.

If the taxpayer meets the bright-line test, then it is subject to tax in California. If the taxpayer has income from within and outside of California, it must apportion its income to California using the applicable apportionment formula.

Apportionment Formula

State law uses an apportionment formula to determine the amount of “business” income attributable to California.<sup>2</sup> The apportionment formula consists of property, payroll, and sales factors. Each of these factors is a fraction: the numerator is the value of the item in California and the denominator is the value of the item everywhere. The property factor generally 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.

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

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,<sup>3</sup> illustrated above). An exception to this rule exists for taxpayers of an apportioning trade or business that derive more than 50 percent of its gross business receipts from conducting a “qualified business activity.”<sup>4</sup> These “qualified business activity” taxpayers are required to use a three-factor, single-weighted sales,<sup>5</sup> apportionment formula (illustrated below).

$$\frac{\left( \frac{\text{Property Factor}}{\text{Average California Property}} \div \text{Average Total Property} \right) + \left( \frac{\text{Payroll Factor}}{\text{California Payroll}} \div \text{Total Payroll} \right) + \left( \frac{\text{Sales Factor}}{\text{California Sales}} \div \text{Total Sales} \right)}{3} = \text{California Apportionment Factor}$$

<sup>2</sup> “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.

<sup>3</sup> This formula is sometimes referred to as the “four-factor” formula because of double weighting of the sales and the denominator used is “4.”

<sup>4</sup> Extractive, agriculture, savings and loan, and banks and financials.

<sup>5</sup> This formula is sometimes referred to as the “three-factor” formula because the sales are single weighted and the denominator used is “3.”

For taxable years beginning on or after January 1, 2011, an apportioning trade or business (other than an apportioning trade or business that derives more than 50 percent of its gross business receipts from conducting a qualified business activity), is allowed to make an annual, irrevocable election to utilize a single factor, 100 percent sales (single sales factor), apportionment formula instead of the three-factor, double-weighted sales apportionment formula.

California Sales equals California apportionment factor  
Total Sales

The election must be on a timely-filed original return in the manner and form prescribed by the FTB.

### Assignment of Sales Rules

California has two basic rules for assigning sales.

An apportioning trade or business that has not made an election to utilize the single sales factor apportionment formula must use the pre-2011 income producing activity/cost of performance rules (see below) to assign all sales other than sales of tangible personal property, regardless of taxable year.

If the single sales factor election is made inoperative, all apportioning trades or businesses would be required to use the pre-2011 rules (see below) for assigning all sales other than sales of tangible personal property, commonly called "cost of performance."

An apportioning trade or business that has made a single sales factor election must utilize the post-2010 rules (see below) operative for years beginning on or after January 1, 2011, commonly referred to as the "market rule," to assign all sales other than sales of tangible personal property, namely sales of intangibles and services.

### **Pre-2011 Rules For Assigning Sales of Other Than Tangible Personal Property (Intangibles and Services)**

- Sales from intangibles and all other services are assigned to California if the income producing activity that gave rise to the receipts is performed wholly within California. If the income producing activity is performed within and outside the state, the sales from intangibles and all other services are assigned to California if the greater cost of performance of the income producing activity is performed in this state. For example, a taxpayer provides non-personal services to a client in California. The taxpayer incurs direct costs (salaries, equipment costs, etc.) to provide the service in Oregon and California. The total costs are \$10,000. The Oregon costs are \$4,800 (48%). The California costs are \$5,200 (52%). Based on the greater cost of performance, 100 percent of the receipts for the service provided to the California client would be assigned to California.

- Sales from the performance of personal services are assigned to California if the services are performed in California. If personal services are performed in more than one state, the receipts from the services are assigned to California based on the ratio of time spent performing such services in the state to total time spent in performing such services everywhere. For example, a taxpayer provides personal services for a single client in Oregon, Nevada, and California. The total time spent is 1,000 hours for all of the services. The hours are divided between the states as follows: 600 hours in Oregon, 100 hours in Nevada, and 300 hours in California. The total receipts for the services for the client are \$20,000. Based on the ratio of time spent, the amount assigned to California is \$6,000, which is 30 percent of the total time.
- Sales from the sale, rental, lease, or licensing of real property and the receipts derived from the rental, lease, or licensing of tangible personal property are assigned to California if the property is located in California.

#### **Post-2010 Rules For Assigning Sales, of Other than Tangible Personal Property (Intangibles and Services)**

- Sales from services are assigned to California to the extent the purchaser of the service receives the benefit of the service in California. (Market Rule)
- Sales from intangible property are assigned to California to the extent the property is used in California. In the case of marketable securities, sales are assigned to California if the customer is in California. (Market Rule)
- Sales from the sale, lease, rental, or licensing of real property are assigned to California if the real property is located in California.
- Sales from the rental, lease, or licensing of tangible personal property are assigned to California if the property is located in California.

#### **THIS BILL**

This bill would do the following:

- Require the FTB to annually report to the Department of Finance the amount of the estimated and actual increase or decrease in revenue from the changes in the apportionment rules made by this bill.
- Make the single sales factor apportionment formula mandatory for all apportioning trades or businesses, except those in a qualified business activity (extractive, agricultural, savings and loans, and banks and financials) or those apportioning trades or businesses that make an election to use the four-factor formula. The election is only available if the tax, before credits, using the four-factor formula is not less than the tax, before credits, using the single sales factor apportionment method. This election is available for taxable years beginning on or after January 1, 2012.
- Repeal the elective single sales factor provisions for years beginning on or after January 1, 2012.

- Remove references to the provisions of the repealed elective single sales factor.
- Revise the provision that determines how to assign sales of other than tangible personal property as follows:
  - The bill requires the use of “cost of performance” for assigning sales for taxable years beginning before January 1, 2011.
  - For taxable years beginning on or after January 1, 2011 and before January 1, 2012, taxpayers that have made an election to apportion business income using the single sales factor must use the “market rule”. Those taxpayers that did not elect to use the single sales factor use cost of performance to assign sales.
  - For taxable years beginning on or after January 1, 2012, all taxpayers, including those businesses in a qualified activity, are required to use the “market rule.”
- Add a provision to allow qualified taxpayers to exclude 50 percent of the total California sales of the apportioning trade or business determined under the market rule from the numerator of their single sales factor. A qualified taxpayer means:
  - A member of a combined reporting group that is also a qualified group; and
  - A qualified group that satisfies both of the following conditions:
    - has a minimum investment of \$250,000,000 in California for the taxable year; and
    - for the taxable year beginning in calendar year 2006, derived more than 50 percent of its U.S. network gross business receipts from operations of one or more cable systems.

### IMPLEMENTATION CONSIDERATIONS

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

The bill requires the FTB to make annual reports to the Department of Finance on the actual and estimated change in revenue resulting from changes to the apportionment of income rules made by this bill. This estimated change in revenue will be difficult to measure even if taxpayers are required to continue to report the numerators and denominators of the property, payroll, and sales factors as if they were filing under the four-factor method. The FTB would have to identify those taxpayers (out of the more than 66,000 apportioning taxpayers) that had not previously elected single sales factor or would not make the optional election for the tax year being measured; are not in a qualified business activity; and previously reported their apportioned income using the four-factor method of apportioning income to California. Once these taxpayers are identified, the FTB could estimate the increased or decreased income by using the reported apportionment information (property, payroll, and sales) to calculate the income that the taxpayer would have reported if they continued to use the four-factor method of apportioning income and compare it to the income the taxpayer reported under the new mandatory single sales factor method. The change in income would then be multiplied by the tax rate, then adjusted for credits the taxpayer was entitled to use. This would have to be done for all taxpayers identified as previously non-

electing. At best this would still be a rough estimate. Additionally, if taxpayers do not report the property and payroll factor information, the estimate could not be done. If a taxpayer uses the single sales factor method, they do not need to use the property or payroll information in order to compute their apportioned California income. There would be little incentive to report this information.

As an alternative, the FTB could track the changes to a limited sample of specific taxpayers and extrapolate the change to the universe of affected taxpayers to estimate the change in revenue. This method only works for a limited time, since the estimate will become less accurate as the data becomes outdated. An acceptable method of making this estimate would have to be worked out.

The FTB will not be able to isolate the tax data to just the effects of the changes to the apportionment rules from this bill, and therefore would not be able to provide actual changes in revenue because of the interaction of all of the sections of the Revenue & Taxation Code that affect the actual tax liability for a taxpayer.

#### TECHNICAL CONSIDERATIONS

- On page 3, line 38, the word “enduring” should be “ending.” Amendment 1 would resolve this concern.
- On page 7, line 10, (Section 25128 (c)(8)(B)) the bill deletes Section 25128.5 as an applicable method of apportioning income. While Section 25128.5 would not be valid for taxable years beginning on or after January 1, 2012, it would still be a valid method of apportioning for taxable years beginning in calendar year 2011. Amendment 2 would resolve this concern.

#### **LEGISLATIVE HISTORY**

ABX1 40 (Fuentes & Fletcher, 2011/12) would have mandated the use of the single sales factor formula for all companies except for certain qualified business activities (extractive, agricultural, banks and financials, and savings and loan), as well as certain qualified cable industry companies. The qualified business activity companies would continue to use the three-factor formula under current law. The qualified cable industry companies would use the single sales factor, but would assign 50 percent of their mandatory sales to California. This bill failed to pass out of the Assembly by the constitutional deadline.

SB 116 (DeLeon, 2011/12) a similar bill, would have mandated the use of the single sales factor formula for all companies except for certain qualified business activities (extractive, agricultural, banks and financials, and savings and loan), as well as certain qualified cable industry companies. The qualified business activity companies would continue to use the three-factor formula under current law. The qualified cable industry companies would use the single sales factor, but would assign 50 percent of their mandatory sales to California. This bill failed to pass out of the Senate by the constitutional deadline.

AB 1935 (DeLeon, 2009/10) would have mandated the use of the single sales formula for all companies except for financial institutions and oil companies, which, as under current law, would continue to use the three-factor formula. This bill was held in the Assembly Appropriations Committee.

SB 858 (Committee on Budget and Fiscal Review, Chapter 721, Statutes of 2010) among other things, reinstated the “cost of performance” rules for assigning the sales of intangibles and services for non-electors of the single sales factor formula.

SBX3 15 (Calderon, Chapter 17, Statutes of 2009) allowed specific entities to elect to utilize a sales only formula to apportion its income subject to franchise or income tax and modified the rules for assigning certain receipts for inclusion in the sales factor.

SBX6 18 (Steinberg and Alquist, 2009/10) would have required the use of the single sales factor formula for apportioning income for taxpayers not in a qualified activity. No hearing was held for the bill.

### **OTHER STATES’ INFORMATION**

In addition to California, 24 states have implemented or are in the process of phasing-in the single sales factor apportionment method. Of these, 18 states currently require use of the single sales factor: *Colorado, Georgia, Illinois, Indiana, Iowa, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Mississippi, Nebraska, New York, Oregon, South Carolina, Texas, Washington, and Wisconsin*. Moreover, only one state (*Missouri*) is like California’s current law, which allows corporations to annually elect which formula they prefer.

### **FISCAL IMPACT**

This bill would not significantly impact the department’s costs.

### **ECONOMIC IMPACT**

#### Revenue Estimate

Estimated Revenue Impact of AB 1500 For Taxable Years Beginning On or After January 1, 2012 Enactment Assumed After June 30, 2012 (\$ Millions)		
2012-13	2013-14	2014-15
\$1,200	\$950	\$950

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

## **Other Economic Impact**

This bill requires the initial deposit to be made on September 1, 2012. Calendar year taxpayers are not required to make an estimated tax payment for the third quarter. The previous estimated tax payment should be made in June 2012. There would be some estimated tax payments from some fiscal year taxpayers. However on September 1, 2012, there will not be sufficient cash deposited by taxpayers to fully fund the required deposit for the scholarship fund, which would be estimated at \$1 billion. The author may wish to consider postponing the initial deposit date to allow for sufficient collection of cash to fund the scholarship fund.

## **SUPPORT/OPPOSITION**

Support: None provided.

Opposition: None provided.

## **ARGUMENTS**

Pro: This bill would bring much needed relief to middle class families that have been hit the hardest by back-to-back fee increases at our public colleges and universities. This bill would be a huge step towards realizing the California Master Plan for Education and would greatly increase the accessibility and affordability of higher education for all Californians.”

Con: Opponents might argue that not all business models fit easily into a single sales calculation and that mandatory single sales factor negates the importance of out of state business contributions to the states overall economic health.

## **LEGISLATIVE STAFF CONTACT**

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO

AB 1500 Business Income Apportionment/Mandatory Single Sales Factor/  
Middle Class Scholarship Fund

AMENDMENT 1

On page 3, line 38, strikeout "enduring", and insert:

ending

AMENDMENT 2

On page 7, line 10, after "Section", insert:

25128.5 or