ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	DeLeon, et al.	Analyst:	David Scott	Bill Number:	SB 116
Related Bills:	See Legislative History	Telephone:	845-5806	Introduced Date:	January 19, 2011
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Business Income Apportionment/Repeal Elective Single Sales Factor & Add Mandatory Single Sales Factor

SUMMARY

This bill would do the following to the corporate tax code:

- repeal the annual election to use single sales factor;
- require taxpayers not in a qualified business activity to use a mandatory single sales factor; and
- require all taxpayers to use the "market rule" for assigning sales to the sales factor.

PURPOSE OF THE BILL

It appears the purpose of this bill is to enact a mandatory single sales factor to more closely reflect changes in California's economy from a manufacturing based economy to service based economy.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2011.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENTS

Suggested amendments to make clarifications and to renumber provisions of the bill are recommended under the Technical Considerations heading, below, and actual suggested amendment language is attached.

ANALYSIS

STATE 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.

Board Position:			Department Director	Date
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Doing Business in California

In 2009, California established a bright-line test to determine if a taxpayer is doing business in California. The test is met if any of the following are satisfied.[1]

- 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.

If the taxpayer meets the bright-line test, then 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.[2] 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.

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[1] 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.

[2] "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.

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

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,[3] 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."[4] These "qualified business activity" taxpayers are required to use a three-factor, single-weighted sales,[5] apportionment formula (illustrated below).

$$\frac{\underset{\text{Property Factor}}{\dfrac{\text{Average California Property}}{\text{Average Total Property}}} + \underset{\text{Payroll Factor}}{\dfrac{\text{California Payroll}}{\text{Total Payroll}}} + \underset{\text{Sales Factor}}{\dfrac{\text{California Sales}}{\text{Total Sales}}}}{3} = \text{California Apportionment Factor}$$

For taxable years beginning on or after January 1, 2011, an apportioning trade or business (other than an apportioning trade of 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.

$$\frac{\text{California Sales}}{\text{Total Sales}} \quad \text{equals} \quad \text{California apportionment factor}$$

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

[3] This formula is sometimes referred to as the "four-factor" formula because of double weighting of the sales and the denominator used is "4."
[4] Extractive, agriculture, savings and loan, and banks and financials.
[5] This formula is sometimes referred to as the "three-factor" formula because the sales are single weighted and the denominator used is "3."

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 by future legislation, 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

Sales of Tangible Personal Property before 2011 (Joyce Rule)

- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser in this state, and the taxpayer (seller) is taxable in this state.
- Sales of tangible personal property are assigned to California if the product is delivered or shipped from California to a purchaser out of state, and the taxpayer (seller) is not taxable in the state of destination.
- Sales of tangible personal property to the U.S. Government are assigned to California if the goods are shipped from California.

This is commonly called the Joyce rule because the rule was declared in a decision of the Board of Equalization.

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

Sales of Tangible Personal Property (Finnigan Rule)

- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser in this state, and the taxpayer (seller) or any member of the taxpayer's combined reporting group[6] is taxable in this state.
- Sales of tangible personal property are assigned to California if the product is delivered or shipped to a purchaser out of state and neither the taxpayer (seller) nor any other member of the combined reporting group is taxable in the state of destination.
- Sales of tangible personal property to the U.S. Government are assigned to California if the goods are shipped from California.

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.

[6] A combined report is a report (a single tax form for the group) in which the business income and apportionment factors of a unitary group of corporations are combined for purposes of determining each taxpayer's share of the California unitary business income. A combined reporting group would be all of the taxpayers included in a single combined report.

THIS BILL

This bill would do the following:

- Make the single sales factor apportionment formula mandatory for all taxpayers, except those in a qualified business activity (extractive, agricultural, savings and loans, and banks and financials) for taxable years beginning on or after January 1, 2011.
- Repeal the elective single sales factor provisions.
- 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, to require the use of "cost of performance" for assigning sales for taxable years beginning before January 1, 2011, and require all taxpayers, including those businesses in a qualified activity, to use the "market rule" for assigning sales of other than tangible personal property to California for taxable years beginning on or after January 1, 2011.
- Make non-substantive changes to the order, but not the language, of the subdivision that defines a "qualified business activity."

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

TECHNICAL CONSIDERATIONS

Recommended technical corrections are provided as follows:

Amendments one and eleven would delete references to subdivisions that will be non-operative on or after January 1, 2011. These amendments would help eliminate confusion about which provisions are applicable.

Amendments two through ten, except amendments number four, six and nine, would make technical corrections or renumber some of the provisions after deleting a non-operative provision.

Amendment four would delete a non-operative provision. This deletion would reduce the possibility of taxpayers thinking the double weighted sales factor formula still applies.

Amendment six would clarify the definition of a qualified business activity.

Amendment nine would delete language that is unnecessary since California adopted regulations for apportioning the income of banks and financial corporations in 1996.

Amendment twelve would clarify the operative date for using the single sales factor formula.

LEGISLATIVE HISTORY

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 moved from the Assembly Appropriations Committee without further action.

SB 858 (Stats. 2010, Ch. 721, Committee on Budget and Fiscal Review), 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 (Stats. 2009/10 Third Extraordinary Session, Ch. 17, Calderon), 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 factor apportionment method. Of these, 18 states 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 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 SB 116 For Tax Years Beginning On or After January 1, 2011 Enactment Assumed After June 30, 2011 ($ in Millions)		
2011-12	2012-13	2013-14
$1,300	$1,100	$1,100

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 116

AMENDMENT 1

On page 2, before line 1, insert:

SEC. XX. Section 23101 of the Revenue and Taxation Code is amended to read:

23101. (a) "Doing business" means actively engaging in any transaction for the purpose of financial or pecuniary gain or profit.
(b) For taxable years beginning on or after January 1, 2011, a taxpayer is doing business in this state for a taxable year if any of the following conditions has been satisfied:
(1) The taxpayer is organized or commercially domiciled in this state.
(2) Sales, as defined in subdivision ~~(e) or~~ (f) of Section 25120 ~~as applicable for the taxable year~~, of the taxpayer in this state exceed the lesser of five hundred thousand dollars ($500,000) or 25 percent of the taxpayer's total sales. For purposes of this paragraph, sales of the taxpayer include sales by an agent or independent contractor of the taxpayer. For purposes of this paragraph, sales in this state shall be determined using the rules for assigning sales under Section 25135 and ~~subdivision (b) of~~ Section 25136 and the regulations thereunder, as modified by regulations under Section 25137.
(3) The real property and tangible personal property of the taxpayer in this state exceed the lesser of fifty thousand dollars ($50,000) or 25 percent of the taxpayer's total real property and tangible personal property. The value of real and tangible personal property and the determination of whether property is in this state shall be determined using the rules contained in Sections 25129 to 25131, inclusive, and the regulations thereunder, as modified by regulation under Section 25137.
(4) The amount paid in this state by the taxpayer for compensation, as defined in subdivision (c) of Section 25120, exceeds the lesser of fifty thousand dollars ($50,000) or 25 percent of the total compensation paid by the taxpayer. Compensation in this state shall be determined using the rules for assigning payroll contained in Section 25133 and the regulations thereunder, as modified by regulations under Section 25137.
(c) (1) The Franchise Tax Board shall annually revise the amounts in paragraphs (2), (3), and (4) of subdivision (b) in accordance with subdivision (h) of Section 17041.

(2) For purposes of the adjustment required by paragraph (1), subdivision (h) of Section 17041 shall be applied by substituting “2012” in lieu of “1988.”
(d) The sales, property, and payroll of the taxpayer include the taxpayer’s pro rata or distributive share of pass-through entities. For purposes of this subdivision, “pass-through entities” means a partnership or an “S” corporation.

AMENDMENT 2

On page 3, line 29, strikeout “business”, insert:

business,

AMENDMENT 3

On page 3, line 30, strikeout “(c) of Section 25128”, insert:

(b) of Section 25128,

AMENDMENT 4

On page 8, strikeout lines 9 through 14, inclusive.

AMENDMENT 5

On page 8, line 15, strikeout “(b)”, and insert:

25128. (a)

AMENDMENT 6

On page 8, line 17, after “activities,”, insert:

as defined in subdivision (b),

AMENDMENT 7

On page 8, line 22, strikeout “(c)”, and insert:

(b)

AMENDMENT 8

On page 9, line 8, strikeout “(e) or”.

AMENDMENT 9

On page 10, strikeout lines 22 through 27, inclusive.

AMENDMENT 10

On page 10, line 29, strikeout “(e)”, and insert:

(c)

AMENDMENT 11

On page 10, line 39-40, strikeout “subdivision (a) or (b), or subdivision (b) of” and insert:

this section or

AMENDMENT 12

On page 10, after line 40, insert:

(d) This section, as amended by the act amending this subdivision to include the date of January 1, 2011, shall apply to taxable years beginning on or after January 1, 2011.