Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	DeLeon, et al.	Analyst:	David Scott	Bill Number:	SB 116
Related Bills:	See Legislative History	Telephone:	845-5806	Amended Date:	September 9, 2011
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Alternative Minimum Tax/Standard Deduction/Small Business Income Exclusion/Corporation Tax Rate/Corporation Minimum Tax/Single Sales Factor

SUMMARY

This bill would do the following for taxable years beginning on or after January 1, 2012:

Provision No. 1: Increase Standard Deduction by 27 Percent (Section 17073.5)

Provision No. 2: Business Income Exclusion (Section 17137)

- Exclude ten percent of business income, up to $5,000, from gross income; and
- Make the business income exclusion an Alternative Minimum Tax preference item.

Provision No. 3: Corporation Tax Rate & Minimum Franchise Tax (Sections 23151 & 23153)

This provision would reduce the corporation tax rate from 8.84 percent to 8.34 percent for the first $50,000 of net income of certain taxpayers and would reduce the Minimum Franchise Tax from $800 to $750.

Provision No. 4: Mandatory Single Sales Factor (Sections 23101, 25128, 25128.5, 25128.7, 25136, 25136.1)

- Repeal the annual election to choose single sales factor;
- Require taxpayers not in a qualified business activity or that 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.

The analysis will not address the sales and use tax exemption in the sales and use tax provision, except that the provision requires the Franchise Tax Board (FTB) to prepare a report to the Director of Finance to show the estimated increase or decrease in revenues as a result of the four provisions described above. The report will be used to adjust the sales and use tax exemption rate.

Board Position:			Executive Officer	Date
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_____ SA	_____ O	_____ NAR	Anne Maitland	10/11/11
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SUMMARY OF AMENDMENTS

The September 9, 2011, amendments changed authors, removed the provision for modifying the New Jobs Tax Credit, and added provisions to:

- require the FTB to report the change in revenues as a result of the non-sales and use tax provisions of this bill;
- increase the standard deduction;
- exclude ten percent of the first $50,000 of business income for small businesses under the Personal Income Tax Law;
- reduce the corporation tax rate for the first $50,000 of net income; and
- reduce the minimum franchise tax.

RECOMMENDATION AND SUPPORTING ARGUMENTS

No recommendation.

PURPOSE OF THE BILL

According to the text of the bill, the purpose is to address the fiscal emergency declared by the Governor by proclamation on January 20, 2011.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2012.

ECONOMIC IMPACT – SUMMARY REVENUE TABLE ($ in Millions)

Estimated Revenue Impact of SB 116 as Amended on September 9, 2011 For Taxable Years Beginning On or After January 1, 2012 Enactment Assumed After June 30, 2011 ($ in millions)				
Provision #		**2011-12**	**2012-13**	**2013-14**
1	Increase std deduction	-$220	-$370	-$390
2	PIT Business income exclusion	-$140	-$240	-$240
3	Corp rate reduction	-$9	-$18	-$20
	Reduce min tax	-$26	-$55	-$60
4	Mandatory SSF w/ special cable rule	$450	$900	$950
Net Fiscal Impact		**$55**	**$217**	**$240**

PROVISION NO. 1: Increase Standard Deduction by 27 Percent

(Section 17073.5)

OPERATIVE DATE

This provision would be specifically operative for taxable years beginning on or after January 1, 2012.

ANALYSIS

FEDERAL/STATE LAW

Existing federal and state laws allow taxpayers who do not elect to itemize their deductions for the taxable year to deduct from adjusted gross income a basic standard deduction amount in calculating their taxable income.

Both federal and state laws provide annual inflation indexing of the standard deduction. For the 2011 tax year, the state standard deduction for single or married filing separate taxpayers is $3,769 and is $7,538 for married filing joint, head of household, or qualifying widow(er).

THIS PROVISION

For taxable years beginning on or after January 1, 2012, this provision would increase the standard deduction by 27 percent.

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.

LEGISLATIVE HISTORY

SB 330 (Morrow, 2003/2004) and SB 1526 (Monteith, 1997/1998) would have doubled the amount of the standard deduction. SB 330 and SB 1526 both failed to pass out of the Senate Revenue & Taxation Committee.

FISCAL IMPACT

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

PROVISION NO. 2: Business Income Exclusion

(Section 17137)

ANALYSIS

FEDERAL/STATE LAW

The Internal Revenue Code (IRC) defines "gross income" as all income from whatever source derived, including gross income from trade or business activities. California conforms to the federal definition, with modifications. For personal income tax purposes, the reported gross income from a trade or business conducted by an individual taxpayer is measured by gross receipts less allowed or allowable expenses or deductions. The trade or business income reported by an individual taxpayer received from a pass-through entity is the taxpayer's distributive share of the income from the trade or business conducted by the pass-through entity.

THIS PROVISION

This provision would exclude ten percent of the first $50,000 of business income from a trade or business conducted by the taxpayer or the taxpayer's distributive share of business income from a pass-through entity. The maximum aggregate amount of business income, including from activities directly conducted and also including a taxpayer's distributive or prorata share of business income from pass-through entities that may be excluded would be $5,000. Business income is defined as income from a trade or business conducted by the taxpayer or by a pass-through entity (a partnership or "S" corporation).

The gross income excluded would be a tax preference item for alternative minimum tax purposes.

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* and *Texas* do not have an individual income tax. The other states all use federal tax information as the basis for computing business income. The federal Schedule C (business income for a sole proprietor) does not make an adjustment to exclude ten percent.

FISCAL IMPACT

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

POLICY CONCERNS

An exclusion for business income moves the Personal Income Tax system away from the principle of horizontal equity, in which taxpayers with identical amounts of income are taxed the same.

PROVISION NO. 3: Corporation Tax Rate/Minimum Franchise Tax

Sections 23151& 23153

EFFECTIVE/OPERATIVE DATE

This provision would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2012.

ANALYSIS

STATE LAW

Under existing state law, unless specifically exempted by statute, every corporation organized, qualified to do business, or doing business in this state, whether organized in-state or out-of-state, is subject to the Minimum Franchise Tax (MFT). Every corporation that incorporates or qualifies to do business in this state is exempt from the MFT for the first taxable year of existence. This exemption is inapplicable to any corporation that reorganizes or changes solely for the purpose of avoiding payment of the MFT. In addition, the first-year exemption is inapplicable to the annual taxes paid by limited partnerships (LPs), limited liability companies (LLCs) not classified as corporations, limited liability partnerships (LLPs), charitable organizations, regulated investment companies (RICs), real estate investment trusts (REITs), real estate mortgage investment conduits (REMICs), financial asset securitization investment trusts, or qualified subchapter S subsidiaries (Q-Subs).

Corporate taxpayers subject to the franchise tax must pay the greater of the measured "franchise" tax or the MFT. Currently, the franchise tax rate for corporate taxpayers is 8.84 percent. Corporate taxpayers with net income less than approximately $9,040 pay only the MFT because the amount of "franchise" tax owed would be less than $800 ($9,039 x 8.84% = $799).

REMICs are subject to and required to pay the MFT. RICs and REITs organized as corporations are also subject to and required to pay the MFT.

LPs, LLCs not classified as corporations, LLPs, and Q-Subs are required to pay an annual tax equal to the MFT, but are not subject to a "franchise" or income tax.

THIS PROVISION

For taxable years beginning on or after January 1, 2012, this provision would reduce the franchise tax rate to 8.34 percent on the amount of net income equal to or less than $50,000. The remaining net income over $50,000 would continue to be taxed at 8.84 percent. This reduction would not apply to any taxpayer whose income and apportionment factor data are permitted or required to be included in a combined report[1], or to a wholly in-state trade or business conducted by multiple corporations.

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[1] Generally large multistate and multinational apportioning trades or businesses conducted by multiple corporations.

In addition, this provision would change the amount of the MFT from $800 to $750 for taxable years beginning on or after January 1, 2012.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would not significantly impact the department's programs and operations.

LEGISLATIVE HISTORY

AB 166 (Cook, 2011/2012) would have eliminated the MFT. This bill was held under submission in the Assembly Revenue and Taxation Committee.

AB 368 (Morrell, 2011/2012) would have changed the MFT to $400 for qualified small businesses. This bill was held under submission in the Assembly Revenue and Taxation Committee.

AB 821 (Garrick, 2011/2012) would have reduced the MFT to $100 for qualified small businesses for the first 10 years of operation. This bill was held under submission in the Assembly Revenue and Taxation Committee.

AB 327 (Garrick, 2009/2010) would have reduced the MFT from $800 to $100. AB 327 failed to pass out of the Assembly by the constitutional deadline.

AB 2126 (Garrick, 2009/2010) would have reduced the MFT to $100 for qualified small businesses for the first 10 years of operation. AB 2126 failed passage out of the Assembly Revenue and Taxation Committee.

AB 1179 (Garrick, 2007/2008) would have reduced the MFT from $800 to $100. AB 1179 failed passage out of the Assembly Revenue and Taxation Committee.

AB 1443 (Devore, 2007/2008) would have reduced the personal income tax rate from 9.3 percent to 9.25 percent and reduced the corporation tax rate from 8.84 percent to 8.79 percent. This bill was held under submission in the Assembly Revenue and Taxation Committee.

AB 2178 (Garrick, 2007/2008) would have reduced the MFT from $800 to $200. AB 2178 failed passage out of the Assembly Revenue and Taxation Committee.

AB 1419 (Campbell, 1997/1998) would have reduced the MFT from $800 to $100. AB 1419 failed passage out of the Senate Revenue and Taxation Committee.

AB 3499 (Stats. 1996, Ch. 170) reduced the corporate franchise tax rate from 9.3 percent to 8.84 percent for years beginning on or after January 1, 1997.

SB 572 (Stats. 1987, Ch. 1139), among other things, reduced the corporate franchise tax rate from 9.6 percent to 9.3 percent for years ending in 1987 and later.

OTHER STATES' INFORMATION

The states surveyed include *Arizona, Florida, Illinois, Massachusetts, Michigan, Minnesota, Nevada, New York, Oregon, and Utah.* These states were selected due to their geographic proximity to California or their similarities to California's economy, business entity types, and tax laws.

Florida does not impose a minimum tax on business entities, but has a 5.5 percent flat tax rate on corporations.

Michigan does not impose a minimum tax on business entities, but has a 4.95 percent flat tax rate on corporations.

Minnesota does not impose a minimum tax on business entities, but has a 9.8 percent flat tax rate on corporations.

Arizona imposes a $50 minimum tax for corporations and a 6.968 percent flat tax rate on corporations.

Illinois imposes a $25 minimum tax on corporations, and a 7 percent flat tax rate on corporations.

Massachusetts imposes a $456 minimum tax on corporations and a tax rate of 5.3 percent to 12 percent on corporations, based on the type of income being taxed.

Nevada does not impose income tax on business entities conducting business within the state. *Nevada* does require all businesses to pay an annual "business license fee" to the Nevada Department of Taxation for the privilege of doing business within the state. For the first year an entity does business within the state, the entity is required to pay a $200 license fee and is required to pay a $100 license fee for each subsequent year it does business within the state.

New York imposes a minimum tax on *corporations of $25 to $5,000* based on the corporation's in-state receipts. It also imposes a minimum tax of $25 to $4,500 for LPs, LLCs, and LLPs based on their in-state receipts. In addition, there is a minimum flat tax rate of 7.1 percent on corporations.

Oregon imposes a $150 minimum tax on corporations, LPs, LLCs, and LLPs and a 6.6 percent to 7.9 percent tax rate on corporations depending on net income.

Utah imposes a $100 minimum tax on corporations and a 5 percent flat tax rate on corporations.

FISCAL IMPACT

Staff estimates a cost of approximately $82,000 to develop, program, and test revisions to existing information systems for this bill.

PROVISION NO. 4: MANDATORY SINGLE SALES FACTOR

Sections 23101, 25128, 25128.5, 25128.7, 25136, and 25136.1

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.

Doing Business in California

In 2009, 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 are satisfied.[2]

- 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 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.

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[2] 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.

Apportionment Formula

State law uses an apportionment formula to determine the amount of "business" income attributable to California.[3] 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.

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

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,[4] 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."[5] These "qualified business activity" taxpayers are required to use a three-factor, single-weighted sales,[6] apportionment formula (illustrated below).

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

[3] "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.

[4] This formula is sometimes referred to as the "four-factor" formula because of double weighting of the sales and the denominator used is "4."

[5] Extractive, agriculture, savings and loan, and banks and financials.

[6] 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 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.

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 PROVISION

This provision would do the following:

- Makes the single sales factor apportionment formula mandatory for all apportioning trade or businesses, except those in a qualified business activity (extractive, agricultural, savings and loans, and banks and financials) or those apportioning trade 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.

- Repeals the elective single sales factor provisions for years beginning on or after January 1, 2012.

- Removes references to the provisions of the repealed elective single sales factor.

- Revises 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 for taxable years beginning on or after January 1, 2011 and before January 1, 2012, that have made an election to apportion business income using the sales factor, and for taxable years beginning on or after January 1, 2012, to 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.

- Adds 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 2006, derived more than 50 percent of its U.S. network gross business receipts from operations of one or more cable systems.

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 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 law, which allows corporations to annually elect which formula they prefer.

FISCAL IMPACT

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

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Pro: Some may argue that this bill would stimulate the economy and encourage job growth.

Con: Some taxpayers may say that with the state's current fiscal crisis, additional tax expenditures should be avoided.

LEGISLATIVE STAFF CONTACT

David Scott	Anne Maitland
Legislative Analyst, FTB	Interim Legislative Director, FTB
(916) 845-5806	(916) 845-6333
david.scott@ftb.ca.gov	anne.maitland@ftb.ca.gov