

Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: DeSaulnier Analyst: David Scott Bill Number: SB 1505

Related Bills: See Legislative History Telephone: 845-5806 Introduced Date: February 24, 2012

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Single Sales Factor/Annual Four Factor Election/Keep Our Promises Fund

SUMMARY

This bill would do the following:

- Make the annual single sales factor election inoperative for taxable years beginning on or after January 1, 2012;
- Allow apportioning trades or businesses to make an annual irrevocable election to use the four-factor method of apportioning income to California, if the tax, before credits, under the four-factor method is greater than or equal to the tax, before credits, using the single sales factor method of apportioning income to California;
- Require all apportioning trades or businesses that are not a qualified business activity, or do not elect to use the four-factor method of apportionment, to use the single sales factor method of apportioning income to California; and
- Require all taxpayers to use the “market rule” for assigning sales other than the sales of tangible personal property.

This analysis will not address the bill's changes to the Military and Veterans Code, as they do not impact the department or state income tax revenue.

RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to provide much needed support and assistance to California Veterans' homes and assistance programs.

EFFECTIVE/OPERATIVE DATE

This bill would become effective January 1, 2013, and the Revenue and Taxation Code changes would each be specifically operative for taxable years beginning on or after January 1, 2012.

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ANALYSIS

FEDERAL/STATE 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.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 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.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.

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.

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

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,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).

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

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

$$\frac{\text{California Sales}}{\text{Total Sales}} = \text{California apportionment factor}$$

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

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.”

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:

- 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 trade or businesses that make an annual irrevocable 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.”

LEGISLATIVE HISTORY

AB 1500 (Perez, et al, 2011/12) would mandate 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 is current in the Assembly Revenue and Taxation Committee.

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 have continued to use the three-factor formula under current law. The qualified cable industry companies would have used the single sales factor, but would have assigned 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 have continued to use the three-factor formula under current law. The qualified cable industry companies would have used 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 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 SB 1505 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	\$1,000

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

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Pro: This bill would bring much needed assistance to California veterans who have come back to California in these tough economic times, as well as provide needed funding for staffing and construction of our Veterans' Homes of California.

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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