

## BILL ANALYSIS

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| Department, Board, Or Commission | Author                 | Bill Number    |
| <b>Franchise Tax Board</b>       | <b>Yee and Huffman</b> | <b>SB 0364</b> |

### SUBJECT

Business Tax Incentive Reporting Information And Penalty

### SUMMARY

This bill would require taxpayers that claimed a business tax credit to report certain employment information to the Franchise Tax Board (FTB) and would assess a penalty if the taxpayer's California employment levels decreased by more than 10 percent from the prior year.

### PURPOSE OF BILL

According to the author's staff, the purpose of this bill is to bring needed transparency and accountability to tax breaks given to taxpayers under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL).

### EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative on January 1, 2012, and specifically operative for business tax credits added on or after January 1, 2012. The bill would be specifically operative for taxable years on or after January 1, 2012, for reporting certain employee information.

### ANALYSIS

#### FEDERAL/STATE LAW

Existing state and federal laws provide various tax incentives (credits, deductions, exemptions, and other tax benefits) designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These tax benefits are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Internal Revenue Code sections 267, 318, and 707 provide rules relating to the current year deductibility of losses, expenses, and interest with respect to transactions between related taxpayers, rules for determining the constructive ownership of stock, and rules governing transactions between partners and partnerships, respectively.

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### Assignment of Credits

For taxable years beginning on or after June 30, 2008, CTL allows the assignment of certain eligible credits to taxpayers that are members of a combined reporting group. "Assignment" refers to the ability of a taxpayer that is a member of a combined reporting group to elect to transfer certain unused credits to a related corporation, as specified. The election to transfer any credit is irrevocable once made and is required to be made on the taxpayer's original return for the taxable year in which the assignment is made.

### Penalties

The California Revenue and Taxation Code (R&TC) contains numerous provisions for the assessment of penalties in various situations where taxpayers have failed to comply with the income tax law. Penalties are used to deter certain behavior related to California income tax laws.

### THIS BILL

This bill would require a taxpayer doing business in the state that claims a business tax credit to annually submit certain employment information to the FTB. The information must be on a timely filed original return and includes the number of full-time equivalent employees, as defined, employed by the taxpayer in the state for the current and prior taxable year.

This bill would assess a penalty of \$5,000 (or fractional portion thereof) for each full-time equivalent employee or fractional portion for taxable years beginning on or after January 1, 2012, under the following conditions:

- The taxpayer has used a business tax credit by an act that takes effect on or after the effective date of the act adding this section, and
- The taxpayer has a decrease in total California employment of more than 10 percent measured against the prior year, based on the number of full-time equivalent employees.

The penalty would be limited to the amount of business tax credits the taxpayer claimed on their California franchise or income tax returns for the preceding three taxable years. For example, if a taxpayer generated total business tax credits of \$30,000 for taxable years 2012 - 2014, and then, in taxable year 2015, had a decrease in total California employment of ten full-time equivalent employees more than 10 percent, then the \$50,000 tentative penalty computed on the reduction would be limited to \$30,000—the total amount of the business tax credits claimed in the three taxable years immediately prior to the 2015 taxable year.

The three-year look-back period, for purposes of the penalty limitation, would be limited to post-2011 taxable years. In the case of a 2013 taxable year, the penalty would be limited to credits claimed in 2012 and forward, not the full three years the statute specifies.

The bill defines "business tax credit" to mean a credit, based on qualified wages or the number of employees employed, which would be available for use against the "net tax" or "tax" due to the state, resulting from an act that would be added and takes effect beginning on or after the effective date of this act.

#### Calculation of the Penalty for Net Decrease in Full-time Employees

The penalty would be imposed when there is a greater than 10 percent net decrease in California full-time employee equivalents, as follows:

- Ninety percent of the annual full-time equivalent employees, including any fractional portions, for the preceding taxable year, less
- The total annual full-time equivalent employees, including any fractional portions, for the current taxable year, multiplied by
- Five thousand dollars (\$5,000).
- If the computed reduction in annual full-time equivalent employees is zero or less, the penalty is zero.
- If the taxable year being reported is less than a full 12-month period, the full-time equivalents would be annualized to equal 12 month equivalents.

This bill would provide the following definitions:

- "Qualified wages" would mean employee compensation, including but not limited to, wages subject to Division 6 (commencing with Section 13000) of the Unemployment Insurance Code.
- "Full-time equivalent" would mean either of the following:
  - In the case of an employee paid hourly qualified wages, the total number of hours worked for the taxpayer by the employee (not to exceed 1,820 hours per employee) divided by 1,820.
  - In the case of a salaried employee, the total number of weeks worked for the taxpayer by the employee divided by 52.
- "Qualified taxpayer" would mean any person (including any business entity) engaged in or carrying on a trade, business, profession, vocation, calling, or commercial activity in the state and pays qualified wages to more than 100 annual full-time equivalent employees, including the employees of a trade or business acquired during the calendar year.

In addition, the bill would provide that all employees of the trades or businesses that are treated as related under either Section 267, 318, or 707 of the Internal Revenue Code would be treated as employed by a single person.

The bill requires the taxpayer to report the number of annual full-time equivalent employees employed for the preceding and current taxable years on a timely filed original California tax return. If the taxpayer is part of a group of related taxpayers, then if a new taxpayer is acquired or becomes related, the employees of the acquired member are included in both the prior and current year reported full-time employee equivalent. Conversely, if a related party is sold or otherwise becomes unrelated, then the full-time employee equivalents of that party are excluded from the information reported.

If either the current or preceding taxable year is less than a full 12-month period (short period), the full-time employee equivalents for the “short” period will be adjusted to reflect full 12 month equivalents. This would mean annualizing the number of full-time equivalents.<sup>1</sup>

The bill imposes a penalty of \$5,000 for a taxpayer’s failure to report the information, unless the failure was due to reasonable cause.

## LEGISLATIVE HISTORY

SBX 6 20 (Yee, 2009/2010) was similar to this bill, except that it provided for the recapture of business tax incentives, rather than impose a penalty. The bill was held in the Senate Rules Committee.

SB 1391 (Yee, 2009/2010) was similar to this bill, except that it provided for the recapture of business tax incentives, rather than impose a penalty. The bill failed to pass out of the Senate Appropriations 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. None of these states have a similar penalty for failing to meet employment requirements for taxpayers taking a business tax incentive.

## FISCAL IMPACT

Staff estimates a cost of approximately \$264,000 in the initial year, with ongoing costs of \$23,000 per year, to develop, program, and test revisions to existing systems for this bill.

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<sup>1</sup> For example, a taxpayer has a short period of nine months and computes total FTEs of 180, based on the formula language for hourly and salaried employees. To annualize the 180 FTEs, the taxpayer could divide the 180 by 9 (number of months in the short period), then multiply by 12 (number of months in a normal full taxable year). The result would be 240 FTEs when annualized.

## **ECONOMIC IMPACT**

### **Revenue Estimate**

This bill would not impact the state's income tax revenue because provisions of the current tax law regarding business tax incentives are unchanged.

This bill would place constraints on potential future changes to tax law. The effects of this bill would be incorporated into the revenue estimates for future proposals to add business tax incentives; however, uncertainty exists as to what those future proposals would be and, therefore, an estimate of the revenue effects is impractical.

## **APPOINTMENTS**

None.

## **SUPPORT/OPPOSITION<sup>2</sup>**

Support: California Labor Federation (source)  
State Building and Construction Trades Council of California (co-source)  
American Federation of State, County & Municipal Employees  
California Alliance for Retired Americans  
California Conference Board of the Amalgamated Transit Union  
California Conference of Machinists California Nurses Association  
California Conference of the Amalgamated Transit Union  
California Partnership (120 CBO's)  
California Professional Firefighters  
California Tax Reform Association  
California Teamsters Public Affairs Council  
CalPIRG  
Communication Workers of American, AFL-CIO, District 9  
Engineers and Scientists of California  
Having Our Say Coalition  
International Longshore & Warehouse Union  
National Nurses Organizing Committee  
Service Employees International Union, Local 1000  
Sierra Club California  
Unite Here!  
United Food & Commercial Workers Union, Western States Council

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<sup>2</sup> As reported by the Senate Floor Analysis dated May 31, 2011, at [http://www.leginfo.ca.gov/pub/11-12/bill/sen/sb\\_0351-0400/sb\\_364\\_cfa\\_20110531\\_163417\\_sen\\_floor.html](http://www.leginfo.ca.gov/pub/11-12/bill/sen/sb_0351-0400/sb_364_cfa_20110531_163417_sen_floor.html) [as of August 26, 2011].

## Opposition: BICOM

California Aerospace and Technology Association  
California Chamber of Commerce  
California Grocers Association  
California Manufacturers & Technology Association  
California Taxpayers Association  
Council on State Taxation  
TechAmerica

**VOTES**

|                |          |       |       |
|----------------|----------|-------|-------|
| Concurrence    | 09/02/11 | Y: 22 | N: 15 |
| Assembly Floor | 09/01/11 | Y: 42 | N: 28 |
| Senate Floor   | 06/01/11 | Y: 22 | N: 17 |

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