Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	DeSaulnier and Hancock	Analyst:	Jessica Deitchman	Bill Number:	SB 1372
Related Bills:	See Legislative History	Telephone:	845-6310	Amended Date:	April 1, 2014
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Corporation Tax Rates/Publicly Held Corporations

SUMMARY

This bill would modify the corporate tax rate under the Corporation Tax Law (CTL) for publicly held companies.

RECOMMENDATION

No position.

Summary of Amendments

The April 1, 2014, amendments removed provisions of the bill related to educational assistance, and replaced them with the provisions discussed in this analysis. This is the department's first analysis of the bill.

Summary of Suggested Amendments

Technical amendments have been provided to address inconsistencies in the bill.

REASON FOR THE BILL

The reason for the bill is to address the state's need to encourage publicly held companies to pay their average employee higher wages, to encourage work force expansion in the United States relative to a foreign location, and to provide an additional tax incentive of lower corporate tax rates for those that already do so.

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, 2015.

Board Position:			Executive Officer	Date
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ANALYSIS

FEDERAL/STATE LAW

Federal Law

Under federal law, all corporations are required to file an annual tax return whether or not they have taxable income. Corporations with taxable income are taxed at graduated tax rates that vary from 15 percent to 35 percent.

Current federal law[1] defines a publicly held company as any corporation issuing any class of common equity securities that are required to be registered under section 12 of the Securities Exchange act of 1934

State Law

Existing state law levies three primary taxes under the CTL.

1. Corporate Franchise Tax: Every corporation either qualified to do business in this state or doing business in this state (whether organized in-state or out-of-state) is subject to the corporation franchise tax. The franchise tax is not a tax on income. Rather, it is a tax, measured by net income, for the privilege of doing business within the state. Between 1987 and 1997, the corporate franchise tax rate was 9.3 percent. In 1997, the corporate franchise tax rate was reduced to 8.84 percent. The S corporation franchise tax rate is 1.5 percent.

   Under existing law, taxpayers are subject to a minimum franchise tax of $800 only if it is more than their measured tax. Currently, only taxpayers whose net income is less than approximately $9,045 pay the minimum franchise tax because their measured tax would be less than $800 ($9,045 x 8.84% = $799). S corporations pay only the minimum tax until their income exceeds $53,300.

2. Corporate Income Tax: In general, corporations that are not organized in or qualified to do business in California and not "doing business" in California, but are deriving income from California sources are subject to the corporate income tax. This tax is also set at 8.84 percent by reference to the corporate franchise tax rate. The corporate income tax also applies to certain non-corporate business entities. However, the minimum franchise tax does not apply to entities subject to the corporate income tax.

3. Bank Tax: Banks and financial institutions doing business in this state are subject to the bank tax rate. The in-lieu tax rate is in lieu of personal property taxes and local business taxes, from which banks and financial institutions are exempt. The bank tax rate equals the sum of the corporate franchise tax rate plus 2 percent.

[1] Section 162 (m)(2) of the Internal Revenue Code

Also, under existing state law**,** the tax on limited partnerships, limited liability partnerships (LLPs), limited liability companies (LLCs) not classified as corporations, and real estate mortgage investment conduits (REMICs) is set at $800 by reference to the minimum franchise tax.

California conforms to the definition provided in the Internal Revenue Code for "publicly held corporations."

<u>THIS BILL</u>

This bill would modify the corporation tax rate for publicly held corporations for taxable years beginning on or after January 1, 2015, to reference a table provided in the bill. The table would specify the applicable tax rate based on the "compensation ratio" calculated for that taxable year.

The bill defines the following terms:

- "Compensation" means either:
  - In the case of employees of the taxpayer other than the chief operating officer (COO) or the highest paid employee, means wages[2] paid by the taxpayer to the employees of the taxpayer, during the calendar year.
  - In the case of the COO and the highest paid employee of the taxpayer, means total compensation as reported in the Summary Compensation Table reported to the Securities and Exchange Commission[3]
- "Compensation Ratio" for a taxable year means a ratio where:
  - The numerator is the amount equal to the greater of the compensation for the COO or the highest paid employee of the taxpayer for the calendar year preceding the beginning of the taxable year.
  - The denominator is the amount equal to the median compensation of all employees employed by the taxpayer in the United States for the calendar year preceding the beginning of the taxable year.

For the taxpayers that are required to be included in a combined report[4] or authorized to be included in a combined report[5], the calculation of the "compensation ratio" shall be made by treating all taxpayer that are required or authorized to be included in the combined report as a single taxpayer.

A taxpayer shall furnish a detailed compensation report to the Franchise Tax Board (FTB) with its timely filed original return.

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[2] As defined in Section 3121(a) of the Internal Revenue Code
[3] Pursuant to Item 402 of Regulation S-K of the Securities and Exchange Commission
[4] Under Section 25101
[5] Under Section 25101.15

The applicable tax rate percentage would be:

If the compensation ratio is:	The applicable tax rate is:
Over zero but not over 25	7% upon the basis of net income
Over 25 but not over 50	7.5% upon the basis of net income
Over 50 but not over 100	8% upon the basis of net income
Over 100 but not over 150	9% upon the basis of net income
Over 150 but not over 200	9.5% upon the basis of net income
Over 200 but not over 250	10% upon the basis of net income
Over 250 but not over 300	11% upon the basis of net income
Over 300 but not over 400	12% upon the basis of net income
Over 400	13% upon the basis of net income

The tax rate shown in the table shall be increased by 50 percent if both of the following conditions are met:

1. For those taxpayers that the total number of full-time employees[6], employed by the taxpayer in the United States for a taxable year is reduced by more than 10 percent, as compared to the total number of full-time employees[7] employed by the taxpayer in the United States for the preceding taxable year, and
2. The total number of contracted employees or foreign full-time employees[8] of the taxpayer for that taxable year has increased, as compared to the total number of contracted employees or foreign full-time employees[9] of the taxpayer for the preceding taxable year.

For taxpayers who first commence doing business in this state during the taxable year, the number of full-time employees, contracted employees, and foreign full-time employees for the immediately preceding prior taxable year shall be zero.

The bill would also define the following terms:

- "Annual full-time equivalent" means either of the following:
    - In the case of a full-time employee paid hourly qualified wages, "annual full-time equivalent" means the total number of hours worked for the qualified taxpayer by the employee, not to exceed 2,000 hours per employee, divided by 2,000.
    - In the case of a salaried full-time employee, "annual full-time equivalent" means the total number of weeks worked for the qualified taxpayer by the employee divided by 52.

[6] Determined on an annual full-time basis
[7] Determined on an annual full-time basis
[8] Determined on an annual full-time basis
[9] Determined on an annual full-time basis

- "Contracted full-time employee" means an individual engaged by the taxpayer to provide a specific set of services established pursuant to the terms and conditions of a written employment contract that delineates the length of employment, the salary and bonuses to be paid, and the benefits that accrue to that individual.
- "Foreign full-time employee" means a taxpayer's full-time employee that is employed at a location other than the United States.
- "Full-time employee" means a taxpayer's employee that satisfies either of the following requirements:
  - Is paid compensation by the taxpayer for services of not less than an average of 35 hours per week
  - Is a salaried employee of the taxpayer and is paid compensation during the taxable year for full-time employment[10]
- "Publicly held corporation" means a publicly held corporation as defined in Section 162(m)(2) of the Internal Revenue Code.

The FTB may prescribe rules, guidelines or procedure necessary or appropriate to carry out the purposes of this subdivision, including any guidelines regarding the determination of wages, average compensation, and compensation ratio. These rules, guidelines, procedures, would be exempt from the rules for regulations in the Administrative Procedures Act.

IMPLEMENTATION CONSIDERATIONS

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

Because the compensation paid to contracted employees would be required to be paid to an "individual," payments made to a business entity that they pays the contracted employee would be excluded from the calculation of full time equivalents. If this is contrary to the author's intention, the bill should be amended.

Because the bill fails to specify otherwise, any business entity that reorganizes its corporate structure solely for the purpose of reducing its "compensation ratio" could qualify for the reduction in tax rates. If this is contrary to the author's intent, this bill should be amended.

The bill fails to include a requirement for comparison of tax rates with a baseline. This could result in manipulation of the tax rates from year to year by shifting employees. If this is contrary to the author's intent, this bill should be amended.

[10] Within the meaning of Section 515 of the Labor Code

TECHNICAL CONSIDERATIONS

The bill uses term “contracted employee” in the bill and later defines the term “contracted full-time employee.” If it is the author’s intent to use the term “contracted full-time employee,” the references to “contracted employee” should be amended to be consistent throughout the bill.

On page 4, line 2, strike “and” and insert “or”

LEGISLATIVE HISTORY

AB 1769 (Dababneh, 2013/2014) would exempt certain small business limited liability companies from the minimum franchise tax for up to two taxable years. AB 1769 was introduced on February 14, 2014.

AB 1889 (Hagman, 2013/2014) would exempt certain small business entities from the minimum franchise tax for up to the first two taxable years. AB 1889 was introduced on February 19, 2014.

AB 2428 (Patterson, 2013/2014) would eliminate the minimum franchise tax for new business entities for up to five taxable years. AB 2428 was introduced on February 21, 2014.

AB 2466 (Nestande, 2013/2014) would either exempt or reduce certain small, veteran owned business entities from the minimum franchise tax. AB 2466 was introduced on February 21, 2014.

SB 641 (Anderson, 2013/2014) would eliminate the minimum franchise tax for certain new corporations for the first four taxable years. SB 641 is currently in the Senate Appropriations Committee.

AB 166 (Cook, 2011/2012) would have eliminated the minimum franchise tax. AB 166 failed passage out of the Assembly by the constitutional deadline.

AB 368 (Morrell, 2011/2012) would have reduced the minimum franchise tax to $400 for qualified small businesses. AB 368 failed passage out of the Assembly by the constitutional deadline.

AB 821 (Garrick, 2011/2012) would have reduced the minimum franchise tax from $800 to $100 for a small business for the first ten years of operation. AB 821 failed passage out of the Assembly by the constitutional deadline.

AB1605 (Garrick, 2011/2012) would have exempted specified entities from the minimum franchise tax or annual tax and reduced the minimum franchise tax or annual tax to $99 for specified entities that commence business on or after January 1, 2013. AB 1605 failed passage out of the Assembly by the constitutional deadline.

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

AB 2126 (Garrick, 2009/2010) would have reduced the minimum franchise tax to $100 for qualified small businesses. AB 2126 failed passage out of the Assembly Revenue and Taxation Committee.

OTHER STATES' INFORMATION

Review of Florida, *Illinois, Massachusetts, Michigan*, *Minnesota*, and *New York* laws found no comparable tax rate specifications. These states selected and reviewed due to their similarities to California's economy, business entity types, and tax laws.

FISCAL IMPACT

This bill would require changes to the department's forms and instructions, processing, and programming. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Estimated Revenue Impact of SB 1372 * As Amended April 1, 2014 Assumed Enactment After June 30, 2014 ($ in Millions)		
2014-15	2015-16	2016-17
+ $100	+ $320	+ $340

*This estimate does not include an adjustment for the provision of the bill pertaining to a 50 percent increase in tax for taxpayers with a specified decrease in U.S. employees and that has an increase in the total number of contracted and foreign full-time employees. This employment data is unavailable and therefore, the impact of this provision is unable to be determined.
This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

LEGAL IMPACT

This bill would increase the tax rate for those companies that increased employment outside of the United States. This bill could raise constitutional concerns under the Commerce Clause of the United States Constitution because it could appear to improperly favor United States activity over foreign commerce. On August 28, 2012, (*Cutler* v. Franchise Tax Board), the Court of Appeal issued a unanimous opinion holding that California's Qualified Small Business Stock statutes were unconstitutional. Specifically, the Court of Appeal held that the statutory scheme's requirement of a large California presence in order to qualify for an investment incentive discriminated against interstate commerce, and therefore violated the federal dormant commerce clause. While no court decision has yet invalidated, as a general matter, providing an incentive for in-state or United States only activity, i.e., property placed in service in the United States, employees employed in the United States, etc., this carve out may be subject to constitutional challenge.

SUPPORT/OPPOSITION

Support: California Labor Federation.

Opposition: California Chamber of Commerce.

ARGUMENTS

Proponents: Some may argue that modifying the corporate tax rate based on a ratio of the amount of wages paid to employees and the COO would enhance standards of living and improve the state's economy by encouraging businesses to pay their employees higher wages to reduce the applicable tax rate.

Opponents: Some may argue that modifying the corporate tax rate based on a ratio of wages paid to employees relative to the COO would have no impact on publicly traded companies' compensation practices.

POLICY CONCERNS

The compensation ratio would be calculated on total wages paid to the COO (and highest paid employee) relative to the wages paid to all other employees in the United States. If a taxpayer were to employ only their top paid employees in the United States and send their lower paid employees out of the United States, they may receive a lower tax rate than those that have all employees in the United States.

LEGISLATIVE STAFF CONTACT

Jessica Deitchman
Legislative Analyst, FTB
(916) 845-6310
jessica.deitchman@ftb.ca.gov

Mandy Hayes
Revenue Manager, FTB
(916) 845-5125
mandy.hayes@ftb.ca.gov

Gail Hall
Legislative Director, FTB
(916) 845-6333
gail.hall@ftb.ca.gov