Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author:	DeSaulnier/Hancock	Analyst:	Jessica Deitchman	Bill Number:	SB 1372
Related Bills:	See Prior Analysis	Telephone:	845-6310	Amended Date:	April 21, 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 21, 2014, amendments added and modified several definitions and decreased the number of hours used in the "annual full-time equivalent" calculation. As a result of these amendments, one of the Implementation Concerns and one of the Technical Considerations as provided in the department's analysis of the bill as amended April 1, 2014, have been resolved. The revenue estimate remains unchanged and the remainder of that analysis still applies. The outstanding concerns have been restated below for convenience.

Summary of Suggested Amendments

An amendment has been provided to address an error in the bill.

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.

ANALYSIS

<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.

Board Position:			Legislative Director	Date
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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[1] 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.[2]
- "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, including all contracted employees under contract with the employer, 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[3] or authorized to be included in a combined report[4], the calculation of the "compensation ratio" would be made by treating all taxpayers that are required or authorized to be included in the combined report as a single taxpayer.

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

The bill would define the following terms:

- "Contracted employee" means an employee who works for a labor contractor.
- "Labor contractor" means an individual or entity that contracts with a client employer to supply workers to perform labor or services or otherwise provides workers to perform labor or services within the usual course of business for the client employer.
- "Client employer" means an individual or entity that receives workers to perform labor or services within the usual course of business of the individual or entity from a labor contractor.

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[1] As defined in Section 3121(a) of the Internal Revenue Code
[2] Pursuant to Item 402 of Regulation S-K of the Securities and Exchange Commission
[3] Under Section 25101
[4] 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[5], 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[6] 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[7] of the taxpayer for that taxable year has increased, as compared to the total number of contracted employees or foreign full-time employees[8] 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.

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

  - 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.

- “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 30 hours per week
  - Is a salaried employee of the taxpayer and is paid compensation during the taxable year for full-time employment[9]

- “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 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.

TECHNICAL CONSIDERATIONS

On page 3, line 40, strikeout “and” and insert “or”

[9] Within the meaning of Section 515 of the Labor Code.

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

Revenue Estimate

Estimated Revenue Impact of SB 1372 * As Amended April 21, 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: Air Logistics Corporation; Associated General Contractors of California; California Apartment Association; California Bankers Association; California Chamber of Commerce; California Grocers Association; California Manufacturers and Technology Association; California Restaurant Association; California Retailers Association; California Tank Lines, Inc.; Chemical Transfer Company; Council on State Taxation; National Federation of Independent Business; Orange County Business Council; Orange County Taxpayers Association; Silicon Valley Leadership Group; Superior Tank Wash, Inc., TechAmerica; West Coast Leasing; LLC; West Coast Lumber and Building Material Association.

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.

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