Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	DeSaulnier and Hancock	Analyst:	Jessica Deitchman	Bill Number:	SB 1372
Related Bills:	None	Telephone:	845-6310	Amended Date:	August 21, 2014
		Attorney:	Bruce Langston	Sponsor	

SUBJECT:	Corporation Tax Rates/Tax Credit/Publicly Held Corporations

SUMMARY

This bill would modify the corporate tax rate and create a new tax credit under the Corporation Tax Law (CTL) for publicly held companies that meet certain criteria.

RECOMMENDATION

No position.

Summary of Amendments

The August 21, 2014 amendments added a new tax credit for publically held companies that meet certain criteria. This analysis replaces the department's analysis as amended on April 29, 2014

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 additional tax incentives to publically held companies that pay their average employee higher wages.

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.

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.

Board Position:						Executive Officer	Date
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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.

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

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

THIS BILL

Corporate Tax Rate Modification

This bill would modify the corporation tax rate for publicly held corporations for taxable years beginning on or after January 1, 2015, to a rate determined by a reference 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, including all contracted employees under contract with the employer, in the United States for the calendar year preceding the beginning of the taxable year.

A taxpayer would be required to 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.

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.

The applicable tax rate percentage would be determined as follows:

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 would 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,[4] employed by the taxpayer in the United States for a taxable year is reduced by more than 10 percent, as

[4] Determined on an annual full-time basis.

compared to the total number of full-time employees[5] 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[6] of the taxpayer for that taxable year has increased, as compared to the total number of contracted employees or foreign full-time employees[7] 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.
- “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.[8]
- “Publicly held corporation” means a publicly held corporation as defined in Section 162(m)(2) of the Internal Revenue Code.

For taxpayers that are required or authorized to be included in a combined report,[9] the calculation of the compensation ratio would be made by treating all taxpayers that are required to be or authorized to be included in a combined report as a single taxpayer.

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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] Within the meaning of Section 515 of the Labor Code.
[9] Under California Revenue and Taxation Code section 25101 and 25101.15.

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.

New Tax Credit

For each taxable year beginning on or after January 1, 2015, in taxable years in which there is a "qualified amount," there would be allowed to each "qualified taxpayer" a credit in an amount determined by the "committee."

The bill provides the following definitions:

- "Qualified amount" means the amount equal to the amount of revenue derived by the change in the tax rates, as calculated using the "compensation ratio" that is in excess of what revenue would have been derived without the change in tax rates, as determined by the FTB, for the taxable year.
- "Qualified taxpayer" means a corporation subject to the tax that has a compensation ratio that is greater than zero but not more than 100. (The publicly held companies that pay a reduced corporate tax rate of 7 percent, 7.5 percent, or 8 percent because they met the compensation ratios established by this bill).
- "Committee" means the California Competes Tax Credit Committee established pursuant to Section 18410.2.

The amount of credit allowed to a qualified taxpayer would be a portion of the qualified amount as set forth in a written agreement between the California Governor's Office of Business and Economic Development (GO-Biz) and the qualified taxpayer. The GO-Biz must inform the FTB of the terms of the written agreement upon approval of the written agreement by the committee.

Additionally, on or before January 1, 2016, and each year thereafter, the FTB would provide to the GO-Biz an estimate of the qualified amount. This bill would require the FTB to determine on or before January 1, 2016, and each January 1, thereafter, an estimate of the 'qualified amount' -- the amount of revenue resulting from this bill that exceeds the amount that would have been derived but for this bill's change to the corporation tax rate. If a qualified amount exists for a taxable year, this bill directs the Committee to award corporation tax credits to firms with compensation ratios between 0 and 100 according to the table above (The tax rate for these taxpayers was reduced from 8.84 percent to 7 percent, 7.5 percent, or 8 percent, depending on the taxpayer's compensation ratio).

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 requires the FTB to determine on or before January 1, 2016, and each January 1, thereafter, an estimate of the amount of tax resulting from the increase in tax rates that this bill provides, as compared to the amount of tax that would have been remitted without this bill’s change to the Corporation Tax rate. Because a corporation’s income, CEO pay, and various other factors change drastically year to year, it is unclear how the FTB could determine how much tax would have been paid, even as estimate, without a substantial in-depth review. Because it is unclear how the FTB would meet this obligation with the deadlines listed, it is recommended that the bill be amended to either remove this requirement or to adjust the deadline so that the FTB has time to complete the review needed to get the information required.

Further, the bill requires that the credit be allocated by the GO-Biz on the “qualified amount.” Because of the timing of when taxable years end and returns are filed, there is no way of knowing how much credit will be available to allocate because the tax returns for the prior year will not have been filed and it will be impossible to predict how much additional tax came in as a direct result of the increase to the tax rate. It is recommended that the bill be amended to provide either a delay in determining the qualified amount, or to provide some other measure for the amount of credits that can be allocated.

TECHNICAL CONSIDERATIONS

The bill includes language that authorizes the Committee to recapture the credit when certain requirements are not met. However, the bill lacks statutory language to require a recapture. It is recommended that the bill be amended to either remove the language that suggests intent to recapture, or add the statutory language that would be required to have a recapture provision.

LEGISLATIVE HISTORY

Review of legislative history found no comparable bills that included these tax rate specifications.

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. Until the implementation considerations are resolved, the department is unable to determine the associated costs.

ECONOMIC IMPACT

The bill would allow the GO-Biz to allocate the new tax credit to publicly held companies that pay a reduced corporate tax rate of 7 percent, 7.5 percent, or 8 percent because they met the compensation ratios established by this bill. The bill fails to specify the amount of credits that will be assigned, therefore, the FTB defers to the Department of Finance and the GO-Biz for an estimate of the new tax credit as included in the August 21, 2014, amendments.

The revenue estimate for the proposed graduated tax rate is shown below:

Estimated Revenue Impact of the Rate Increase Only of SB 1372 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 as compared to contracted and foreign full-time employees. This employment data is unavailable and therefore, the impact of this provision cannot 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 by 50 percent for those companies that decreased employment in the United States by more than 10 percent and increased the number of full-time employees outside of the United States. This bill could raise constitutional concerns under the Foreign Commerce Clause of the United States Constitution because it could appear to improperly favor United States activity over foreign commerce. See Kraft Gen. Foods, Inc., v. Iowa Dept. of Revenue and Finance, 505 US 71 (1992). In addition, the increase in the tax rate for taxpayers that reduce employment in the United States while increasing employment outside the United States could be challenged as improper discrimination under the dormant commerce clause. 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 as compared with activity outside of California in order to qualify for an investment incentive discriminated against interstate commerce, and therefore violated the federal dormant commerce clause. This 50 percent rate increase is likely to be subject to constitutional challenge.

SUPPORT/OPPOSITION[10]

Support: AFSCME, California Labor Federation, California Tax Reform Association, Courage Campaign.

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., California Taxpayers Association, 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, the Chamber of the Santa Barbara Region, West Coast Leasing; LLC, West Coast Lumber and Building Material Association.

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.

This bill lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of the credit by the Legislature.

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[10] As provided in the Senate for Analysis as amended August 21, 2014.