

SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Karnette Analyst: Marion Mann DeJong Bill Number: SB 1015

Related Bills: See Legislative History Telephone: 845-6979 Amended Date: 04/29/1999

Attorney: Patrick Kusiak Sponsor:

SUBJECT: Combined Reporting/Commonly Controlled Groups/Top Tier Corporations

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED February 26, 1999, STILL APPLIES.

OTHER - See comments below.

SUMMARY OF BILL

This bill would allow "top tier" corporate taxpayers to elect to include all the income and apportionment factors of the members of a commonly controlled group in a combined report, regardless of whether the group members are unitary. This bill also would define "unitary business" for non-electors as one whose business activities show operational interdependence (as defined), strong central management (as defined), or a qualified holding company relationship (as defined).

SUMMARY OF AMENDMENT

The April 29, 1999, amendment added the definition of "unitary business" for non-electors.

Except for the last Policy Consideration and the Fiscal Impact, the department's analysis of the bill as introduced February 26, 1999, still applies. A discussion of the definition of "unitary business" is added to Specific Findings and new Policy Considerations and Fiscal Impact are provided. The Implementation and Technical Considerations and Board Position from the prior analysis are reiterated below.

SPECIFIC FINDINGS

This bill would define "unitary business," for corporations which do not make a combined reporting election, as one whose business activities show operational interdependence, strong central management, or a qualified holding company relationship. Thus, this bill would establish a statutory definition of a "unitary business" for commonly controlled groups for which an election to file a single combined report (non-electors) has not been made.

Board Position:

S NA NP
 SA O NAR
 N OUA PENDING

Department/Legislative Director Date

Johnnie Lou Rosas **5/14/1999**

"Operational interdependence" would be established by a substantial amount of one of the following:

- Intercompany sales of products or services.
- Transfer of technical or marketing information.
- Common distribution systems.
- Coordinated purchases of products or services used in the production of other products or services for sale.
- Advertising and sale of products or services under a common tradename.
- Sales to common customers through coordinated sales activities.

The substantial amount condition would be satisfied if (A) the described activities affect more than 10% of the products or services, separately or in the aggregate, which are purchased or sold by a member, or (B) activities of operational interdependency are essential to the business operations of either party to the operational interdependency.

This bill would provide FTB authority to disregard operational interdependency activities if the principal purpose of the activities is to create the appearance of an unitary relationship to avoid tax.

"Strong central management" would exist when the major policy and day-to-day decisions regarding the business operations of the corporations under consideration are made by an individual or individuals who are common officers or directors of those corporations. Policy decisions involving capital structure, capital acquisitions, budget approvals or financing would not be sufficient alone to establish strong central management.

A "qualified holding company relationship" would exist when a holding company is an intermediate holding company, a holding company parent to a unitary group, or a unitary asset holding company. **This bill** would define "holding company," "intermediate holding company," "holding company parent to a unitary group," and "unitary asset holding company."

In the event that a member of a commonly controlled group is unitary with another member, and that member is unitary with still another member, **this bill** would provide that all of those members constitute members of a single unitary group, even if some of the members do not have a direct unitary relationship with one another. However, if the activity of the member with the common unitary relationship would not be sufficient to combine the other members (if that activity had been conducted as a division of either of the other members), the member exhibiting the common unitary relationship would instead be treated as unitary only with that member to which it has the strongest unitary ties.

Policy Considerations

The first two policy considerations raised in the department's analysis of the bill as introduced still apply. The definition of "unitary business" would raise the following additional policy considerations:

- Opponents of efforts to statutorily define a unitary business assert that the definition of unitary businesses has evolved through years of

litigation and is commonly understood by taxpayers. This bill would provide a definition of a unitary business that could cause new confusion to taxpayers and could cause litigation over new issues.

- The objective standard of what constitutes a unitary business provided by this bill would allow corporations to make informed decisions on their filing status and should provide for more directed, less intrusive audits.
- While the definition of "unitary business" provided by this bill may not be responsive to developing business organizations and the current unitary law, it falls within the constraints articulated by the U.S. Supreme Court under the United States Constitution.
- This bill would codify current FTB legal rulings regarding combination of passive holding companies with operating subsidiaries.

Implementation Considerations

This bill specifies that the designated income year shall not begin before January 1, 1997. As drafted, the bill would allow taxpayers to make an election for income years beginning on or after the enactment date of the bill. However, the election must be made before the first day of the designated income year. Taxpayers with income years beginning before the enactment date of this bill would not be able to make the election until the next income year, while taxpayers with income years beginning after the date of enactment could make the election for the 1999 income year. In addition, the definition of "unitary business" would apply for income years beginning on or after January 1, 1999, making it inconsistent with the operative date of the election. Further, the department would need time to provide instructions for making elections to taxpayers. To provide consistency for taxpayers and for ease of administration, the bill should become operative for income years beginning on or after January 1, 2000. As requested by the author's staff, Amendments 4 and 7 would make this change.

Technical Considerations

Amendments are provided to resolve the following:

- Amendments 1 through 3 would clarify the penalty relating to attaching the schedule of member corporations. Amendment 3 would also define "taxpayer member" and "principal member" as those terms are defined in regulations. The bill uses these terms but does not define them.
- Amendment 5 would clarify the 60-month restriction from making an election when the election is terminated or not renewed.
- Amendment 6 would allow FTB (at its discretion) to permit defective elections to be perfected rather than allowing FTB (at its discretion) to treat a defective election as perfected or void. Defective elections are by their nature void; thus, the department does not need discretionary authority to treat a defective election as void.

FISCAL IMPACT

Departmental Costs

To the extent that this provision prevents disputes between taxpayers and the department over whether a group is unitary, cost savings for the department's audit and legal staff may result. The extent of these possible savings cannot be quantified.

Tax Revenue Estimate

Based on limited data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of SB 1015 As Amended 4/29/99 [\$ In Millions]					
	Fiscal Year Cash Flow Impact				
	1999-00	2000-01	2001-02	2002-03	2003-04
Electors	-\$2	-\$2	-\$3	-\$25	-\$41
Non-electors	\$1	\$2	\$3	\$3	\$3
Total	-\$1	minor	minor	-\$22	-\$38

Minor could be a gain or loss of less than \$500,000. The bill would be effective with income years beginning on or after January 1, 1999. Fiscal-year losses beginning in 2002-03 reflect the three to four-year audit cycle that would normally apply in cases where the department would reverse self-assessed taxpayer reporting under current combination standards. Fiscal year losses also allow for taxpayers that combine properly under current standards and that, under this bill, would reduce tax liabilities beginning in the initial year by electing to include nonunitary, commonly controlled members.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The number of corporations that elect or do not elect to combine with commonly controlled corporations and the resultant net tax effect would determine the revenue impact of this bill. This bill as amended April 29, 1999, is identical to AB 601 as amended July 7, 1997.

The April 29, 1999, amendments added language that defined "unitary business" for non-electors. Imposing stricter statutory standards of unitary combination for non-electors would generate some offsetting revenue gains. Some taxpayers that are combining under current unitary standards would not meet the proposed bright line standard. Other taxpayers would temporarily act against their short-term interests to have opportunity to assess the effects of a long-term election.

The following liability year impacts were used to project the timing of cash flow for the bill.

	Income Year Liability Impact				
	1999	2000	2001	2002	2003
Electors	-\$41	-\$52	-\$54	-\$56	-\$58
Non-electors	\$1	\$2	\$3	\$3	\$3
Total	-\$40	-\$50	-\$51	-\$53	-\$55

The income year loss in 1999 is somewhat less than subsequent years because it reflects only calendar year filers. The difference between fiscal year and income year losses is due primarily to audit timing.

BOARD POSITION

Pending.

Marion Mann DeJong
845-6979
Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 1015
As Amended April 29, 1999

AMENDMENT 1

Modify page 2, line 3 through page 3, line 22 as follows:

18650. (a) ~~Taxpayer~~ At least one of the taxpayer members of a commonly controlled group subject to an election under Section 25109 shall attach a schedule listing all corporations which were members of the commonly controlled group at any time during the income year to ~~their~~ its annual income or franchise tax return that includes (in whole or in part) the accounting period of the principal member. The schedule shall disclose all corporations in the commonly controlled group, as described in Section 25105, whether or not the income and apportionment factors of those corporations are properly included in a combined report under Section 25101, 25109, or 25110.

(b) If none of the taxpayer members fail to attach the schedule listing all corporations of the commonly controlled group as required by subdivision (a), or attach an incomplete schedule, the taxpayer members of the commonly controlled group shall be subject to a penalty of one thousand dollars (\$1,000) shall be imposed for each corporation not disclosed.

(c) If ~~any~~ none of the taxpayer members member fails to attach the schedule and fails to provide the schedule required by subdivision (a) upon notice from the Franchise Tax Board, or if none of the taxpayer members demonstrates substantial compliance noncompliance for two or more income years with the schedule filing requirements for two or more income years, the penalty described in subdivision (b) shall be increased to five thousand dollars (\$5,000) for each corporation not disclosed.

(d) ~~For purposes of~~ The penalty imposed under this section:

(1) ~~The penalty may~~ May be assessed against any one or more taxpayer member or members of the group. Each taxpayer member shall be jointly and severally liable for the penalty.

(2) ~~The penalty provided by this section may~~ May be waived, in whole or in part, for reasonable cause.

(3) Shall be due and payable upon notice and demand from the Franchise Tax Board and Article 3 (commencing with Section 19031) of this chapter (relating to deficiency assessments) shall not be applicable.

AMENDMENT 2

On page 6, line 30 after "section" insert:

and Section 18650

AMENDMENT 3

On page 7, modify line 14 as follows:

(5) "Taxpayer member" means a corporation that is required to file a franchise or income tax return under the provisions of this part that is a member of the commonly controlled group subject to an election under this section.

(6) "Principal member" means the member of the commonly controlled group subject to an election under this section whose accounting period is used as a reference period for all members of the commonly controlled group to aggregate and apportion combined report business income of the group.

(7) A newly created corporation shall be deemed to be

AMENDMENT 4

On page 8, line 5, strikeout "1997" and insert:

2000

AMENDMENT 5

On page 8, modify lines 28 and 29 as follows:

under this section for any income year ~~beginning~~ which begins during a 60 months month period starting after the last day of the period of the election ~~period~~ that was

AMENDMENT 6

On page 8, modify lines 34 and 35 as follows:

~~treat permit~~ defective elections under this section ~~as void or permit the election~~ to be perfected during the period of

AMENDMENT 7

On page 15, modify line 24 as follows:

SEC. 5. This act shall be operative for income years beginning on or after January 1, 2000.

SEC. 6. This act provides for a tax levy within the