ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

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Related Bills: See Legislative History | Telephone: 845-3410 | Introduced Date: 01/25/2000

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Apportionment of Business Income/Extractive Business Activity

SUMMARY

This bill would amend the Bank and Corporation Tax Law (B&CTL) to require taxpayers that are engaged in extractive business activities to apportion their business income using the double-weighted sales factor formula.

EFFECTIVE DATE

As a tax levy, this bill would take effect immediately and apply to income years beginning on or after January 1, 2000.

LEGISLATIVE HISTORY

SB 184 (1999), sponsored by the Franchise Tax Board, would have amended the Bank and Corporation Tax Law to allow top tier corporations of a commonly controlled group, whose members are engaged in an extractive business activity, to elect whether the members of its group would apportion their business income using the single- or double-weighted sales factor.

PROGRAM HISTORY/BACKGROUND

Prior to 1993, the B&CTL strictly conformed to the Uniform Division of Income for Tax Purposes Act (UDITPA), which provides for the use of an apportionment formula when assigning business income to a state for tax purposes. This formula is the simple average of three factors: property, payroll and sales. Each factor is the ratio of in-state activity to that same activity everywhere. In 1993, the B&CTL was amended to require that the sales factor be double-weighted, thus making the apportionment formula based on four factors. Some taxpayers, however, still are required to use the three-factor formula – those taxpayers that derive more than 50% of their gross business receipts from an extractive or agricultural business. In 1994, the exception to the four-factor formula was expanded to include taxpayers that derive more than 50% of their gross business receipts from savings and loan, banking, or financial business activities.

The requirement for double-weighting the sales factor reflects a determination that sales represent a more significant contribution to a taxpayer's net income than do the other two factors. Incidentally, double-weighting the sales factor shifts some tax burden to companies with large sales in California relative to their investment in property and payroll, thereby reducing the tax burden of corporations that have made substantial investment in property and payroll in California relative to sales.

Board Position:			Department Director	Date
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The following chart illustrates how double weighting sales may affect taxpayers with the same total factors, but different amounts of sales in California.

Scenario A

Factor	CA	Total
Sales	10	1,000
Payroll	100	1,000
Property	100	1,000

	Calculation		% of Income Taxable in CA
3-Factor:	$\frac{.01 + .10 + .10}{3}$	=	7%
4-Factor:	$\frac{.01 + .01 + .10 + .10}{4}$	=	5 1/2%

Scenario B

Factor	CA	Total
Sales	100	1,000
Payroll	100	1,000
Property	100	1,000

	Calculation		% of Income Taxable in CA
3-Factor:	$\frac{.10 + .10 + .10}{3}$	=	10%
4-Factor:	$\frac{.10 + .10 + .10 + .10}{4}$	=	10%

Scenario C

Factor	CA	Total
Sales	1,000	1,000
Payroll	100	1,000
Property	100	1,000

	Calculation		% of Income Taxable in CA
3-Factor:	$\frac{1.00 + .10 + .10}{3}$	=	40%
4-Factor:	$\frac{1.00 + 1.00 + .10 + .10}{4}$	=	55%

When the apportionment formula was modified to require a double-weighted sales factor, a segment of taxpayers engaged in extractive and agricultural business were adversely impacted and objected. To resolve this issue, the 1993 and 1994 amendments provided exceptions to the general rule so that certain taxpayers were required to continue to single-weight sales.

SPECIFIC FINDINGS

Existing state law provides for the use of an apportionment formula when assigning business income of a multistate or multinational business to California for tax purposes. The general rule, applicable to most corporations, requires a formula that is the average of property, payroll, and double-weighted sales. The factors then are divided by four. Each factor is the ratio of in-state activity to that same activity everywhere

For corporations that derive more than 50% of their gross business receipts from agricultural, extractive, savings and loan, and banking and financial business activities, the apportionment formula is the average of three factors — the sales factor is single-weighted.

Property represents the capital investment in the business by the participants, payroll represents the contributions of labor to the earning of income, and sales represents market contributions. Sales of tangible personal property generally are assigned on a destination basis. Sales either to jurisdictions where the taxpayer is not taxable or to the United States government are "thrown back" to the place of origin. For financial institutions, such as banks and savings and loans, the sales factor primarily consists of interest income received from loan payments.

California business income is multiplied by the apportionment percentage to determine the amount of income apportioned to this state for tax purposes.

This bill would remove from the exception to the four-factor formula those taxpayers that are engaged in extractive business activities. This change would thereby require extractive businesses to apportion their business income using the four-factor, double-weighted sales formula.

Policy Considerations

The exception to the four-factor formula for extractive business activities has resulted in the creation of detailed and complex rules and regulations beyond that required for the general apportionment rules.

No other state besides California carves out extractive business activities from their generally applicable apportionment formula.

The rationale for enacting the double-weighted sales formula was to create an incentive to locate (or retain) businesses and jobs in California while selling goods and services across the country. The effect of the exception eliminates this incentive for extractive businesses, despite the fact that many such businesses have major investments in California and choose to engage in significant business activities beyond actual extraction in the state.

Implementation Considerations

Implementing this bill would require some changes to existing tax forms and instructions, which could be accomplished during the department's normal annual update. In addition, this bill would eliminate the difficult task for department audit personnel in determining whether a taxpayer is engaged in an extractive business.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department’s costs.

Tax Revenue Estimate

The net revenue impact for this bill is estimated to be a minor loss, less than $500,000 annually beginning with the 2000/01 fiscal year.

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 revenue impact of this bill would depend on the amount of tax liabilities calculated by applying the proposed four-factor apportionment formula to corporations in the extractive industry as compared with those corporations based on the current three-factor formula.

Two samples of corporate tax returns for income years ending in 1996 and 1997 were used for this analysis. For each corporation in the extractive industry, tax liabilities under current and proposed apportioning formulas were computed. Revenue impact was estimated as the difference between the computed tax liabilities. The impact for each individual corporation was then statistically weighted and aggregated to derive an estimate of total revenue impact for the year. The final impact is estimated as the average of the 1996 and 1997 impacts. The estimated impact was extrapolated into future years using the Department of Finance projection of corporate revenues.

Based on 1996 and 1997 data, about 40 corporations within the extractive industries would pay more tax under this bill. The amount of tax increase is $10 million. About 20 corporations within the extractive industries would pay less tax. The amount of tax decrease is just over $10 million.

BOARD POSITION

Pending.