STATE OF CALIFORNIA
Franchise Tax Board

Analysis of Original Bill

Author: Skinner

Sponsor:

Bill Number: SB 1398

Analyst: Jessica Deitchman

Phone: (916) 845-6310

Introduced: February 16, 2018

Attorney: Bruce Langston

Related Bills: See Legislative History

Subject: Corporation Tax Rates for Publicly Held Corporations/California Competes Tax Credit

Summary

This bill would do the following:

Provision 1: Modify the corporate tax rate.

Provision 2: Create a new tax credit, for publicly-held companies that meet certain criteria. This credit would be allocated and administered by Governor's Office of Business and Economic Development (GO-Biz).

This analysis only addresses the provisions of the bill that impact the department's programs and operations.

Recommendation – No position.

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 publicly-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, 2019.

Economic Impact – Summary Revenue Table

($ in Millions)

Fiscal Year	2018-2019	2019-2020	2020-2021
Provision 1: Modify the Corporate Tax Rate	+ $500	+ $1,700	+ $2,000
Provision 2: Create a New Tax Credit	Unknown	Unknown	Unknown

Provision 1: Modify the Corporate Tax Rate

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 a flat tax rate of 21 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 Corporation Tax Law (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.
2. 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 franchise tax until their net income exceeds $53,300.
3. 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.
4. Bank Tax: Banks and financial institutions doing business in this state are subject to the bank tax rate. 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 (IRC) for "publicly-held corporations" under Section 162(m)(2) of the IRC.

---

[1] Section 162(m)(2) of the IRC.

This Provision

This provision would, for publicly-held corporations for taxable years beginning on or after January 1, 2019, replace the flat tax rate with a tax rate table specifying the applicable tax rate based on the "compensation ratio" for the taxable year.

This provision would define the following terms:

- "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.
- "Compensation" means either:
    - In the case of employees of the taxpayer other than the chief operating officer (COO) or the highest paid employee, wages[2] paid by the taxpayer to the employees of the taxpayer, during the calendar year.
    - In the case of the COO or the highest paid employee of the taxpayer, 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 of 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 taxpayer, in the United States for the calendar year preceding the beginning of the taxable year.
- "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.

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

[2] As defined in Section 3121(a) of the IRC.
[3] Pursuant to Item 402 of Regulation S-K of the Securities and Exchange Commission.

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 50	8.84% upon the basis of net income
Over 50 but not over 100	10% upon the basis of net income
Over 100 but not over 200	11% upon the basis of net income
Over 200 but not over 300	12% upon the basis of net income
Over 300	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. 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 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.

For purposes of determining whether the tax rate increase applies, this provision would 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.

[4] Determined on an annual full-time basis.
[5] Determined on an annual full-time basis.
[6] *Ibid.*
[7] *Ibid.*

    - 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 IRC.

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.

The FTB may prescribe rules, guidelines or procedures 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, and procedures, would be exempt from the provisions of 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.

The provision of the bill requires that all members of a combined report be treated as a single taxpayer for purposes of calculating the compensation ratio. However, because a taxpayer that files on a water's-edge basis is not required to include information from foreign sources, any employees that were employed outside of the United States would not be required to included in the compensation ratio calculation. Further, it is unclear how the state would get foreign employment information on these entities.

The provision of the bill provides that only entities that are "publicly-held" would be required to calculate their tax rate using the compensation ratio. However, the provision of the bill lacks language to provide when and how this determination would be made. For example, what if a company were to become public mid-year would only half of their year be subject to the increased tax rates or the entire year? For clarity, this provision of the bill should be amended to define how this determination would be made.

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

This provision uses the undefined term, i.e. “detailed compensation report.” The absence of a definition to clarify this term could lead to disputes with taxpayers and would complicate the administration of this provision of the bill.

This provision of the bill is silent as to which tax rate should apply if the taxpayer failed to include a detailed compensation report with the original timely filed return. It is recommended that this provision of the bill be amended to specify the author’s intent.

This provision lacks the administrative details necessary for the FTB to capture and report the revenue for GO-BIZ. For example, should amended returns be included in the estimates? Would late return data be included in the tax year the return was filed or the tax year of the return? For Provision 2 of this bill to able to be administered, it is recommended that this provision of the bill be amended to clearly define reporting requirements, when the report should be available, and what should be included in the report.

Technical Considerations

For clarity, we suggest retaining the stricken language on page 3, lines 35-36.

Legislative History

SB 684 (Hancock/Leno, 2015/2016) similar to this provision, would have modified the corporation tax rate for publicly-held corporations to a rate determined by a reference table tied to a “compensation ratio.” SB 684 failed to pass out of the Senate by the constitutional deadline.

SB 1372 (DeSaulnier, 2013/2014) was substantially similar to this provision and would have modified the corporate tax rate for publicly-held companies and created a tax credit for corporations that meet certain criteria. SB 1372 failed to pass out of the Senate by the constitutional deadline.

Other States’ Information

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

Fiscal Impact

The department’s costs to implement this provision have yet to be determined. As the bill moves through the legislative process, costs will be identified.

Economic Impact

Revenue Estimate

This provision would result in the following revenue gain:

Estimated Revenue Impact of this provision of SB 1398 as Introduced on February 16, 2018
For Taxable Years Beginning On or After January 1, 2019
Assumed Enactment after June 30, 2018

($ in Millions)

Fiscal Year	Revenue
2018-2019	+ $500
2019-2020	+ $1,700
2020-2021	+ $2,000

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 provision of the bill or for the net final payment method of accrual.

Revenue Discussion

Using 2011 compensation data from the Forbes and Bloomberg companies, a ratio was computed for the top 500 corporations by using the highest paid employee's compensation compared to the estimated median employee compensation for that business type. Using the FTB data on corporations, the total corporate tax paid by publicly-held companies is estimated to total $6.8 billion in 2019. The total tax is prorated by each compensation ratio bracket specified in the bill and then multiplied by the current corporation tax rate. The estimated tax was then multiplied by the proposed tax rate structure resulting in total tax of approximately $8.5 billion in 2019. The net revenue gain of $1.7 billion is the difference between the estimated tax liability under current law and the estimated tax liability as proposed.

The taxable-year estimates are converted to fiscal-year estimates, then rounded to arrive at the amounts reflected in the above table.

Legal Impact

This provision 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 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 also be challenged as improper discrimination under the foreign 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 Dormant Commerce Clause. This provision's 50 percent rate increase that would be triggered by economic activity outside of the United States is likely to be subject to constitutional challenge.

Support/Opposition

Support: None provided.

Opposition: None provided.

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 publicly-held companies 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-held companies' compensation practices.

Policy Concerns

The compensation ratio would be calculated on total wages paid to the COO (or 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 locate their lower paid employees out of the United States, the taxpayer may receive a lower tax rate than a similarly situated taxpayer that locates all of its employees in the United States.

This provision lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of income tax law changes by the Legislature.

Provision 2: Create New Tax Credit

State Law

For taxable years beginning on or after January 1, 2014, and before January 1, 2025, current state law allows a CA Competes Credit, administered by GO-Biz. The amount of the credit available to a taxpayer for a taxable year is negotiated and set forth in a written agreement between GO-Biz and the taxpayer, and approved by the "California Competes Tax Credit Committee," (the Committee) consisting of the State Treasurer, the Director of the Department of Finance (DOF), the Director of GO-Biz, and one appointee each by the Speaker of the Assembly and Senate Committee on Rules.

The CA Competes Credit is allocated by GO-Biz for fiscal years 2013-14 through and including 2017-18. The amount of credit that may be allocated is the sum of all of the following:

- $30 Million for the 2013-14 fiscal year, $150 Million for the 2014-15 fiscal year, and $200 Million for each fiscal year from 2015-16 through 2017-18, inclusive.
- The unallocated amount of credit, if any, from the preceding fiscal year.
- The amount of any previously unallocated credits that have been recaptured.
- The amount estimated by the Director of Finance, in consultation with the FTB and the California Department of Tax and Fee Administration, to be necessary to limit the aggregate of the estimate amount of exemptions claimed pursuant to Section 6377.1 and of the amounts estimated to be claimed pursuant to Section 17059.2, 17053.73, 23626, and 23689 to no more than $750 million for either the current fiscal year or the next fiscal year.

Upon approval of the written agreement by the Committee, GO-Biz is required to inform the FTB of the terms and conditions of the written agreement. Under current law, except for small businesses, as specified, the FTB is required to review the books and records of taxpayers allocated a CA Competes Credit to ensure that the taxpayer complied with the terms and conditions of the written agreement. The FTB may limit the review of small taxpayers' books and records to those the FTB deems appropriate or necessary in the best interests of the State. The FTB is required to notify GO-Biz if a possible breach of the agreement has occurred and provide detailed information regarding the basis of the possible breach.

This Provision

This provision would, under the CTL for each taxable year beginning on or after January 1, 2019, in taxable years in which there is a qualified amount, allow a tax credit to each qualified taxpayer in an amount determined by the Committee.

This provision would define the following terms:

- "Committee" means the California Competes Tax Credit Committee.[10]
- "Compensation ratio" would be determined for a qualified corporation in the same manner as under Section 23151.
- "GO-Biz" means the Governor's Office of Business and Economic Development.
- "Qualified amount" means the amount equal to the amount of revenue derived by subdivision (g) of Section 23151 in excess of the revenue that would have been derived by the subdivision (f) of Section 23151, as determined by the FTB for the taxable year.
- "Qualified taxpayer" means a corporation subject to the tax imposed by subdivision (g) of Section 23151 that has a compensation ratio that is greater than zero but not more than 100.
- "Small business" means a trade or business that has aggregate gross receipts, less returns and allowances reportable to this state of less than $2,000,000 during the previous taxable year

The amount of credit allowed to a qualified taxpayer would be a portion of the qualified amount set forth in a written agreement between GO-Biz and the qualified taxpayer based on the following factors:

- The number of jobs the qualified taxpayer will create or retain in this state.
- The compensation paid by the taxpayer to its employees, including wages and fringe benefits.
- The amount of investment in this state by the qualified taxpayer.
- The overall economic impact in this state of the qualified taxpayer's project or business.

The written agreement entered into by GO-Biz and the qualified taxpayer would be required to include:

- Verification that the taxpayer is a qualified taxpayer.
- The amount of credit that the qualified taxpayer is allocated.

GO-Biz would be required to do the following:

- Give priority to a qualified taxpayer whose business is located in an area of high unemployment or poverty.
- Negotiate with a qualified taxpayer the amount of credit allowed to the qualified taxpayer based on the factors, as specified.
- Provide a negotiated written agreement to the committee for its approval.[11]

---

[10] Established pursuant to Section 18410.2.
[11] Pursuant to Section 18410.2

- Inform the FTB of the terms of the written agreement upon its approval by the Committee.
- Adopt regulations as necessary or appropriate to carry out the purposes of this section.

The FTB would be required to provide to GO-Biz an estimate of the qualified amount on or before January 1, 2020, and on or before January 1st of each year thereafter.

This provision would specify that for each fiscal year:

- 25 percent of the qualified amount shall be reserved for small businesses.
- No more than 20 percent of the qualified amount that may be allocated may be allocated to any one qualified taxpayer.

This provision states that it is the intent of the Legislature to comply with Section 41.

Implementation Considerations

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

This provision uses the undefined term, i.e., "the amount of revenue derived." The absence of a definition to clarify this term could lead to disputes with taxpayers and would complicate the administration of this bill. The author may want to amend this provision of the bill to clearly define the terms.

Because taxpayers file their returns up to 10 months after the end of their taxable year, it is unclear how the taxpayer or the department would have the information available for GO-Biz to determine which taxpayers were qualified for the credit. For ease of administration, it is recommended that the qualifications be based on the prior taxable year and the GO-Biz credit's operative date be no earlier than January 1, 2021.

Technical Considerations

For clarity, the following amendment is recommended:

On page 7, lines 12-13, strike "be determined for a qualified corporation in the same manner as under Section 23151" and insert: "have the same meaning as defined in clause (i) of subparagraph (C) of paragraph (3) of subdivision (g)"

Legislative History

AB 162 (Cervantes, 2017/2018) would have modified the definition of small business for purposes of the California Competes Tax Credit. AB 162 failed to pass out of the Assembly by the constitutional deadline.

AB 2055 (Gipson, 2015/2016), would have modified the items for GO-Biz to consider when allocating the credit to give special consideration to those installing zero or near-zero emissions equipment. AB 2055 failed to pass out of the Assembly by the constitutional deadline.

AB 961 (Gallagher, 2015/2016), would have modified the amount of funding for the California Competes Tax Credit. AB 961 failed to pass out of the Assembly by the constitutional deadline.

AB 1560 (Quirk-Silva, et al., Chapter 378, Statutes of 2014), modified the funding for the California Competes Tax Credit.

AB 93 (Assembly Committee on Budget, Chapter 69, Statutes of 2013), repealed the geographically targeted economic development area tax incentives and the New Jobs Tax Credit under the Personal Income Tax Law (PITL) and CTL, created a New Hiring Tax Credit, established the California Competes Tax Credit Committee, and created the California Competes Tax Credit under the PITL and CTL.

Other States' Information

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York* laws do not provide a credit comparable to the credit this provision would allow. The laws of these states were selected due to their similarities to California's economy, business entity types, and tax laws.

Fiscal Impact

The department's costs to implement this provision bill have yet to be determined. As the bill moves through the legislative process, costs will be identified.

Economic Impact

Revenue Estimate

This provision would create a new credit, under the CTL, for publicly-held companies that meet certain criteria. This credit would be allocated and administered by GO-Biz. This provision 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.

Support/Opposition

Support: None provided.

Opposition: None provided.

Arguments

Proponents: Some may argue that adding another credit administered by GO-Biz would allow the Committee to incentivize business in California to pay better wages.

Opponents: Some may argue that because there is already a credit administered by GO-Biz, adding another credit would do little to encourage additional business.

Policy Concerns

This provision lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of income tax law changes by the Legislature.

The only way a publicly-held corporation will avoid the higher tax is to have an agreement with GO-Biz to get an offsetting credit. However, it is unclear if a foreign corporation will qualify for the credit being administered by GO-Biz. Therefore, this may be considered discriminatory for foreign corporations that are doing interstate business.

Legislative Staff Contact

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

Jame Eiserman
Revenue Manager, FTB
(916) 845-7484
jame.eiserman@ftb.ca.gov

Diane Deatherage
Legislative Director, FTB
(916) 845-6333
diane.deatherage@ftb.ca.gov