Franchise Tax Board **ANALYSIS OF ORIGINAL BILL**

Author:	Lara	Analyst:	Jessica Deitchman	Bill Number:	SB 567
Related Bills:	See Legislative History	Telephone:	845-6310	Introduced Date:	February 17, 2017
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Changes to Charitable Reminder Trusts/Eliminate Step-up in Basis/Cap Highly Compensated Executives Pay at $1,000,000/Sunset Water's-Edge Election

SUMMARY

This bill would do the following:

Provision No. 1: Modify Charitable Remainder Annuity Trust (CRAT) Percentage

Provision No. 2: Eliminate the "step-up" in basis for inherited property for certain taxpayers

Provision No. 3: Cap Deduction for Highly Compensated Executives Pay at $1,000,000

Provision No. 4: Sunset the Water's-Edge Election

The bill would make a number of non-substantive technical changes and expresses legislative intent to enact legislation for taxable years beginning on or after January 1, 2017, to modify the way payments are taxed to related parties, as defined in Section 267, 318, or 707 of the Internal Revenue Code (IRC).

RECOMMENDATION – NO POSITION

PURPOSE OF THE BILL

The reason for the bill is to eliminate tax loopholes allowed by current law.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately. The specific operative dates of these provisions vary and are addressed separately for each provision.

ECONOMIC IMPACT – SUMMARY REVENUE TABLE ($ in Millions)

Fiscal Year	2017-18	2018-19	2019-20
Provision 1: Modify Charitable Remainder Annuity Trust Percentage	**See Economic Impact Section below**	**See Economic Impact Section below**	**See Economic Impact Section below**
Provision 2: Eliminate Step-up in Basis for Inherited Property for Certain Taxpayers	**+ $1.0**	**+ $3.9**	**+ $7.9**
Provision 3: Cap Deduction for Highly Compensated Executives Pay at $1,000,000	**+ $110**	**+ $100**	**+ $100**
Provision 4: Sunset the Water's-Edge Election	**+ $600**	**+ $900**	**+ $1,400**
$ In Millions Total	**+ $711**	**+ $1,390**	**+ $1,508**

PROVISION NO. 1: Modify Charitable Remainder Annuity Trust Percentage

OPERATIVE DATE

This provision would be specifically operative for taxable years beginning on or after January 1, 2018.

FEDERAL/STATE LAW

For federal and California purposes, a Charitable Remainder Trust (CRT) is generally a trust that:

- Is funded by a donor's irrevocable contribution of cash or property,
- Provides the donor and/or other designated beneficiaries an income stream for a specified period, commonly for the life of one or more beneficiaries, and
- Contributes the remainder of the trust to charity.

A CRAT is a type of CRT that is required to pay, at least annually, a fixed dollar amount of at least 5 percent, but not greater than 50 percent[1], of the initial fair market value (FMV) of the trust's assets to at least one non-charitable beneficiary for the life of an individual or for a period of 20 years or less, with the remainder distributed to a charitable beneficiary.

[1] IRC 664 (d)(1)(A).

The remainder to be distributed to charity must be at least 10 percent of the initial FMV of all the property contributed to the trust. The donor is allowed a charitable-contribution deduction in the year of the contribution for the present value of the remainder. A CRT is generally not required to pay tax on current income until that income is distributed, unless the trust has Unrelated Business Taxable Income (UBTI). If a CRT has UBTI in any tax year, then for both federal and state purposes, the CRT is subject to an excise tax equal to the amount of UBTI.

THIS PROVISION

This provision would, under the Personal Income Tax Law (PITL), for taxable years beginning on or after January 1, 2018, modify the definition of a CRAT by increasing the remainder value of the trust required to be contributed to charity from at least 10 percent to at least 40 percent of the initial net FMV of all property placed in the trust.

IMPLEMENTATION CONSIDERATIONS

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

Because this provision fails to specify otherwise, the new requirement would apply to all existing CRATs as of the provision's operative date, as well as trusts created on or after that date. If the author intends for the provision to apply to trusts formed on or after January 1, 2018, this bill should be amended.

LEGISLATIVE HISTORY

Research of California legislation found no proposed or enacted legislation similar to this provision.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. All of these states' law conform to the federal percentage a CRAT is required to contribute to charity.

FISCAL IMPACT

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This provision would result in the following revenue loss:

Estimated Revenue Impact of SB 567 Provision No. 1: Modify Charitable Remainder Annuity Trust Percentage As Introduced February 17, 2017 Assumed Enactment After June 30, 2017		
2017-18	2018-19	2019-20
a/	a/	a/

a/ The estimated revenue impact of increasing the remainder interest from at least 10 percent to at least 40 percent, would be a revenue loss, in an unknown amount.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

When a CRAT is set up, the donor of the assets to the trust is allowed a charitable contribution deduction in the year of the contribution of the asset for the present value of the remainder interest. The revenue impact of this proposal would be dependent upon the FMV of the donation in the year of the contribution. In determining the FMV of the charitable contributions to a CRAT, the FMV of the contribution is reduced by the present value of the CRAT's annuity payments.

The FTB lacks the tax data necessary to calculate the present value of the annuity payment or the value of the remainder interests. However, it is probable this proposal would result in a net revenue loss since it is likely many taxpayers would have the means to increase their charitable contribution to meet the minimum remainder requirements. The remaining taxpayers may already meet the minimum remainder requirements or may restructure their trusts to meet the remainder interest specified in this proposal. This would increase the total charitable deductions claimed resulting in a net revenue loss.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may argue that this provision would require those that set up CRATs to donate a more equitable portion of the trust's assets.

Opponents: Some may argue that modifying the applicable percentage of assets required to be donated in a CRAT for state purposes would cause confusion because the federal requirement remains unchanged.

POLICY CONCERNS

This provision of the bill would require specific rules for CRATs for which federal law has no counterpart, thus increasing nonconformity.

PROVISION NO. 2: Eliminate Step-up in Basis for Inherited Property for Certain Taxpayers

OPERATIVE DATE

This provision would be specifically operative for property acquired or inherited from decedents who died on or after January 1, 2018.

FEDERAL LAW

Basis in Property Received

In General

Gain or loss, if any, on the disposition of property is measured by the taxpayer's amount realized (i.e., gross proceeds received) on the disposition, less the taxpayer's basis in such property. Basis generally represents a taxpayer's investment in property, with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

Basis in Property Received by Lifetime Gift

Property received from a donor of a lifetime gift generally takes a carryover basis. "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above FMV, by any gift tax paid by the donor. The basis of a lifetime gift, however, generally cannot exceed the property's FMV on the date of the gift. If the basis of property is greater than the FMV of the property on the date of the gift, then, for purposes of determining loss, the basis is the property's FMV on the date of the gift.

Basis in Property Received from a Decedent

Property passing from a decedent generally takes a "stepped-up" basis. In other words, the basis of property passing from such a decedent's estate generally is the FMV on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). This step-up in basis generally eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death. If the value of property on the date of the decedent's death was less than its adjusted basis, the property takes a stepped-down basis when it passes from a decedent's estate. This stepped-down basis eliminates the tax benefit from any unrealized loss.

Basis in Property Received from a Decedent who Dies during 2010

The rules providing for stepped-up basis in property acquired from a decedent dying in 2010, allow for an election to use a modified carryover basis regime. Under this regime, recipients of property acquired from a decedent at the decedent's death receive a basis equal to the lesser of the decedent's adjusted basis or the FMV of the property on the date of the decedent's death. The modified carryover basis rules apply to property acquired by bequest, devise, or inheritance, or property acquired by the decedent's estate from the decedent, property passing from the decedent to the extent such property passed without consideration, and certain other property to which the prior law rules apply, other than property that is income in respect of a decedent. Property acquired from a decedent is treated as if the property had been acquired by gift. Thus, the character of gain on the sale of property received from a decedent's estate is carried over to the heir. For example, real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir.

Consistent Basis Reporting Between Estate and Person Acquiring Property from Decedent

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015[2] amends IRC section 1014 generally to require consistency between the estate tax value of property and basis of property acquired from a decedent. Under the provision, if the value of property to which the provision applies has been finally determined for estate tax purposes, the basis in the hands of the recipient can be no greater than the value of the property as finally determined. If the value of such property has not been finally determined for estate tax purposes, then the basis in the hands of the recipient can be no greater than the value reported in a required statement. The provision applies to property the inclusion of which in the decedent's estate increased the liability for estate tax on such estate, but does not include any property of an estate if the liability for such tax does not exceed the credits allowable against such tax. For purposes of the provision, the value of property has been finally determined for estate tax purposes if: (1) the value of the property is shown on an estate tax return, and the value is not contested by the Secretary before the expiration of the time for assessing estate tax; (2) in a case not described in (1), the value is specified by the Secretary and such value is not timely contested by the executor of the estate; or (3) the value is determined by a court or pursuant to a settlement agreement with the Secretary.

STATE LAW

California conforms to IRC section 1014 for purposes of determining the basis of property acquired from a decedent as of the "specified date" of January 1, 2015.

THIS PROVISION

Under the PITL, this provision would, for property acquired or inherited from decedents who died on or after January 1, 2018, preclude a "step-up" basis adjustment and require the use of the decedent's carryover basis for individuals with adjusted gross income (AGI) in the taxable year of the decedent's death of:

- $2,000,000 or greater in the case of a joint return or surviving spouse,
- $1,500,000 or greater in the case of a head of household, and
- $1,000,000 or greater for all other filers.

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[2] Public Law 114-41, applies to property with respect to which an estate tax return is filed after July 31, 2015.

Under the Corporation Tax Law (CTL), taxpayers other than individuals, with total income of $1,000,000 or greater for the taxable year of the decedent's death, would be precluded from the step-up basis adjustment.

In addition, for both the PITL and CTL, the basis of property acquired or inherited from decedents who died on or after January 1, 2018, would no longer be increased for any federal estate tax paid on the property.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

This bill uses terms that are undefined, i.e., "total income" and "taxable year of decedent's death." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this bill. For clarity and ease of administration, it is recommended that the bill be amended.

LEGISLATIVE HISTORY

Research of California legislation found no proposed or enacted legislation similar to this provision.

OTHER STATES' INFORMATION

Florida, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York* laws follow the federal stepped-up basis rules for property inherited from a decedent. 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 bill have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue gain:

Estimated Revenue Impact of SB 567 Provision No. 2: Eliminate Step-up in Basis for Inherited Property for Certain Taxpayers As Introduced on February 17, 2017 Assumed Enactment After June 30, 2017 ($ in Millions)		
2017-18	2018-19	2019-20
+ $1.0	+ $3.9	+ $7.9

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

This revenue estimate is based on the proration of the Joint Committee on Taxation's (JCT) federal tax expenditure estimate for the personal income tax exclusion of capital gain at death (JCT did not score this exclusion for corporations). In January 2017, the JCT estimated the federal revenue impact of the exclusion to be $35 billion in 2018. To determine California's share of the federal loss, federally reported data was used to calculate that 14 percent of nationally reported capital gain income was from California, then federal and state tax rates were analyzed to estimate a federal/state tax rate adjustment of 53 percent, resulting in an estimated revenue impact of $2.6 billion. It is assumed that 20 percent, or $525 million by value, of estates would be settled in the year of death, 30 percent in the year following, and the remainder over the next five years. Of the amount settled in the year of death, it is assumed that 2 percent, or $11 million, would be inherited by taxpayers that would no longer be allowed to step-up the basis in their inherited property. When property is inherited, it may be sold in the year inherited, the next year, or any other year after that (or potentially never). For purposes of this estimate, it is assumed 15 percent of inherited property would be sold in the year the property is received and a small percent would be sold each year thereafter, or potentially never sold, resulting in $1.7 million in estimated revenue gain in taxable year 2018, $5 million in taxable year 2019, $10 million in taxable year 2020, and increasing each year thereafter.

The calendar year estimates are converted to fiscal years and then rounded to arrive at the amounts shown in the above table.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may argue that placing an AGI limit on taxpayers otherwise allowed to increase the basis of inherited property is a more equitable way to distribute the tax burden among California's taxpayers

Opponents: Some may argue that the idea of shifting the tax burden to taxpayers that have the ability to pay is onerous and has gone too far.

PROVISION NO. 3: Cap Deduction for Highly Compensated Executives Pay at $1,000,000

OPERATIVE DATE

This provision would be specifically operative for taxable years beginning on or after January 1, 2017.

FEDERAL/STATE LAW

Generally, for federal and state purposes, an employer is allowed a deduction for reasonable salaries and other compensation. Whether compensation is reasonable is determined on a case-by-case basis. The reasonableness standard has been used primarily to limit payments by closely-held companies where dividends may be disguised as deductible compensation.

In 1993, federal law capped the maximum amount of salaries paid to certain executives that a publicly held corporation could deduct. Under the Revenue Reconciliation Act of 1993,[3] for purposes of the regular income tax and the alternative minimum tax, the otherwise allowable deduction for compensation paid or accrued with respect to a covered employee (defined below) of a publicly held corporation is limited to no more than $1 million per year.

Definition of Publicly Held Corporation

For purposes of this provision, a corporation is publicly held if it is required to register under the Securities Exchange Act of 1934. In general, the Securities Exchange Act requires a corporation to register if: (1) the corporation's stock is listed on a national securities exchange, or (2) the corporation has $5 million or more of assets and 500 or more shareholders. A corporation is not considered publicly held under the provision if registration of its equity securities is voluntary.

Covered Employees

For purposes of this provision, a covered employee is defined by reference to the Securities and Exchange Commission rules governing disclosure of executive compensation. A person is a covered employee if: (1) the employee is the chief executive officer of the corporation (or an individual acting in such capacity) as of the close of the taxable year, or (2) the employee's total compensation is required to be reported for the taxable year under the Securities Exchange Act of 1934 because the employee is one of the four highest compensated officers for the taxable year (other than the chief executive officer).

Compensation Subject to the Deduction Limitation

Unless specifically excluded, the deduction limitation applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. If an individual is a covered employee for a taxable year, the deduction limitation applies to all compensation not explicitly excluded from the deduction limitation, regardless of whether the compensation is for services as a covered employee and regardless of when the compensation was earned. The $1 million cap is reduced by excess parachute payments (as defined in IRC section 280G) that are not deductible by the corporation.

The deduction limitation applies when the deduction would otherwise be taken. Thus, for example, in the case of a nonqualified stock option, the deduction is normally taken in the year the option is exercised, even though the option was granted with respect to services performed in a prior year.

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[3] Public Law 103-66.

Certain types of compensation are not subject to the deduction limit and are not taken into account in determining whether other compensation exceeds $1 million. The following types of compensation are not taken into account: (1) remuneration payable on a commission basis; (2) remuneration payable solely on account of the attainment of one or more performance goals if certain outside director and shareholder approval requirements are met; (3) payments to a tax-qualified retirement plan (including salary reduction contributions); (4) amounts that are excludable from the executive's gross income (such as employer provided health benefits and miscellaneous fringe benefits (IRC section 132)); and (5) any remuneration payable under a written binding contract which was in effect on February 17, 1993, and all times thereafter before such remuneration was paid and which was not modified thereafter in any material respect before such remuneration was paid.

Commissions

In order to qualify for the exception for compensation paid in the form of commissions, the commission must be payable solely on account of income generated directly by the individual performance of the executive receiving such compensation. Thus, for example, compensation that equals a percentage of sales made by the executive qualifies for the exception. Remuneration does not fail to be attributable directly to the executive merely because the executive utilizes support services, such as secretarial or research services, in generating the income. However, if compensation is paid on account of broader performance standards, such as income produced by a business unit of the corporation, the compensation would not qualify for the exception because it is not paid with regard to income that is directly attributable to the individual executive.

Other Performance-Based Compensation

In general. Compensation qualifies for the exception for performance-based compensation only if (1) it is paid solely on account of the attainment of one or more performance goals, (2) the performance goals are established by a compensation committee consisting solely of two or more outside directors, (3) the material terms under which the compensation is to be paid, including the performance goals, are disclosed to and approved by the shareholders in a separate vote prior to payment, and (4) prior to payment, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied. Treasury regulations contain detail rules and examples of performance-based compensation that qualifies for the exception.

Compensation Payable under a Written Binding Contract

Remuneration payable under a written binding contract which was in effect on February 17, 1993, and at all times thereafter is not subject to the deduction limitation. The fact that a plan was in existence on February 17, 1993, is not by itself sufficient to qualify the plan for the exception for binding written contracts. This exception ceases to apply if the contract was materially modified or renewed.

THIS PROVISION

This provision would modify existing federal conformity to the deduction limitation on excess compensation for highly compensated executives. Exceptions for commissions, other performance-based compensation and compensation payable under a written binding contract would not apply under state law.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

TECHNICAL CONSDERATIONS

To correct a cross referencing error the following amendment is recommended:

On page 4, line 14, before "(m)(4)(C)" insert "162".

LEGISLATIVE HISTORY

Research of California legislation found no proposed or enacted legislation similar to this provision.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. The review of these states' tax laws indicates that these states conform to federal law on the deductibility of highly compensated executives in excess of $1 million.

FISCAL IMPACT

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue gain:

Estimated Revenue Impact of SB 567 Provision No. 3: Cap Deduction for Highly Compensated Executives Pay at $1,000,000 As Introduced February 17, 2017 Assumed Enactment After June 30, 2017 ($ in Millions)		
2017-18	2018-19	2019-20
+ $110	+ $100	+ $100

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

This revenue estimate is based on a proration of the Economic Policy Institute's (EPI) estimate for the deduction of executive compensation. Using EPI data, the estimated federal impact of the deduction for executive performance based compensation would be $6.0 billion in 2017.

To determine the impact on California, nationally reported data was used to calculate that 7 percent of federal income was from California. Then the estimate was reduced by 74 percent to reflect the differences between federal and state tax rates for a total of $110 million. It is assumed that the reduced deduction amount would be offset by a 25 percent increase in the usage of available state net operating losses and credits available, resulting in an estimated revenue gain of $80 million in 2017.

The tax year estimates are converted to fiscal years and then rounded to arrive at the amounts shown in the above table.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may argue that limiting the deduction for performance and commission-based pay would discourage companies from paying their executive exorbitant wages.

Opponents: Some may argue that limiting a deduction for total wages paid to certain employees would unfairly disadvantage those business that pay their executives in this manner.

PROVISION NO. 4: Sunset Water's-Edge Election

OPERATIVE DATE

This provision would, for taxable years beginning on or after January 1, 2017, eliminate a taxpayer's ability to make a new water's edge election, and for taxable years beginning on or after January 1, 2023, would terminate all existing water's edge elections.

FEDERAL LAW

Under federal law, a United States (US) corporation is generally taxed on all its income, regardless of source, and is allowed a tax credit for any taxes paid to a foreign country on its foreign-source income. Foreign corporations are generally excluded from filing a federal tax return, except a foreign corporation is taxed on all of its income from US sources. Examples of U.S.-source income are:

1. Income earned by a foreign corporation's sales office located in the US,
2. Royalties paid from a US corporation to a foreign corporation, and
3. Interest paid from a US corporation to a foreign corporation.

STATE LAW

If a taxpayer does not make a water's-edge election, it must use the worldwide combined reporting method to file its state taxes, and its unitary business income from both domestic and foreign operations is considered in the calculation of state tax. A share of that business income is apportioned to California. The amount to be apportioned to California is determined by a formula. In general, the formula measures relative levels of business activity in the state using a single sales factor. The single-sales factor from both domestic and foreign activities is used in the calculation of the apportionment formula.[4]

In addition to the single sales factor method for determining California income, some taxpayers can use a 3 or 4[5] factor method for the apportionment formula. This formula considers the taxpayer's California and worldwide property, payroll and sales.

As an alternative to the worldwide combined reporting method, California law allows corporations to elect to determine their business income on a "water's-edge" basis. In general, the water's-edge method excludes foreign corporations from the calculation of business income. There are exceptions to this general rule as certain affiliated foreign corporations, if unitary with an entity that is a member of the water's-edge group, are includable in the water's-edge combined report (group tax filing).

A water's-edge election must be for an initial term of 84 months and remains in effect thereafter, year to year, until terminated by the taxpayer. If a taxpayer terminates its water's-edge election, it is required to file on a worldwide basis for at least 84 months before making another water's-edge election.

Generally, California conforms to the federal rules for US-source income discussed in the "federal law" section above.

THIS BILL

This provision would, under the CTL, preclude a taxpayer from making a water's-edge election for taxable years beginning on or after January 1, 2017.

Existing water's-edge elections would be allowed to remain in place through the 84-month election period in accordance with their contract terms. The last water's-edge election, made for taxable years prior to January 1, 2017, would expire as of taxable years beginning on or after January 1, 2023. Thus, the last water's-edge returns would be filed for taxable year 2022.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would require changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

TECHNICAL CONSIDERATIONS

Subsequent legislation may be required to eliminate references to the water's-edge provisions in other Revenue and Taxation Code sections. This could be accomplished via the Legislative Counsel's annual code maintenance bill.

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[4] For taxable years beginning on or after January 1, 2013, all apportioning trade or businesses, except those that derive more than 50 percent of their gross receipts from qualified business activities, shall apportion their business income to California using a single-sales factor.
[5] When using the 4-factor method, the taxpayer's sales-factor is doubled.

LEGISLATIVE HISTORY

ABX3 32 (Calderon, 2007/2008) was similar to this bill and would have repealed the water's-edge provisions. For taxable years beginning on or after January 1, 2008, taxpayers would no longer have been allowed to elect to determine their income on a water's-edge basis. Existing elections would have been terminated for taxable years beginning on or after January 1, 2008. ABX3 32 failed to pass out of the Assembly by the constitutional deadline.

SB 1876 (Alpert, 2003/2004) was similar to this bill and would have repealed the water's-edge provisions. For taxable years beginning on or after January 1, 2004, taxpayers would no longer have been allowed to elect to determine their income on a water's-edge basis. Existing elections would have been terminated for taxable years beginning on or after January 1, 2004. SB 1876 was held in the Senate Appropriations Committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, and tax laws.

Research was performed to determine if these states had water's-edge provisions similar to California.

Florida lacks water's-edge provisions similar to California for reporting members of a combined group's taxable income. Members of a federal affiliated group in which the parent is subject to tax in Florida may elect to file a consolidated return.

Illinois lacks water's-edge provisions similar to California but exclude a member from a combined reporting group if that member's business activity outside the US is 80 percent or more of its total business activity.

Massachusetts uses a water's-edge method similar to California for reporting members of a combined group's taxable income. Members of a combined group may elect to use the worldwide method of reporting taxable income.

Michigan lacks water's-edge provisions similar to California but has adopted the protections of federal Public Law 86-272 for excluding a foreign operating entity from the calculation of its corporate income tax.

Minnesota lacks water's-edge provisions similar to California but excludes subsidiaries that are incorporated outside of the US from the unitary group's business income. The unitary group includes 100 percent of dividend income received from a foreign subsidiary in its business income and is allowed a deduction of 80 percent of the dividend income.

New York lacks water's-edge provisions similar to California but taxes foreign corporations that are engaged in doing business in New York City (NYC), employing capital in NYC in a corporate form or capacity, owning or leasing property in NYC in a corporate form or capacity, or maintaining an office in NYC.

FISCAL IMPACT

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue gain:

Estimated Revenue Impact of SB 567 Provision No. 4: Sunset Water's-Edge Election As Introduced February 17, 2017 Assumed Enactment After June 30, 2017 ($ in Millions)		
2017-18	2018-19	2019-20
+ $600	+ $900	+ $1,400

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

Based upon FTB tax data and available tax policy studies, there would be an estimated $2.6 billion revenue loss in the 2017 taxable year attributable to returns filed on a water's-edge basis rather than worldwide combined reporting.

Because no water's-edge elections could be made beginning with the taxable year 2017, this estimate assumes the number of water's-edge electors would begin decreasing in the 2017 taxable year as existing water's-edge contracts expire or are otherwise terminated, and would be reduced to zero by the 2023 taxable year. This would result in an estimated revenue gain of $260 million in 2017, increasing to an estimated $3.4 billion in 2023, when the election is fully phased out.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some could argue that determining a multinational business's taxable income on a worldwide basis is the most accurate method of accounting for business activity in the globalized economy.

Opponents: Some may argue that the worldwide method is an administrative burden that may result in tax on more than 100 percent of a multinational company's income because other countries have a different method of assigning income.

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