



Bill Analysis

Author: Skinner, et al.	Sponsor:	Bill Number: SB 37
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SUBJECT

Corporation and Bank and Financial Institution Tax Rate Increase

SUMMARY

This bill would increase the corporation and bank and financial institution tax rates, under the Corporation Tax Law (CTL), for corporations and banks and financial institutions with net income of \$10 million or more, to a rate as discussed below. In addition, that new tax rate would be increased by a multiple of 1.5 times that rate, dependent on comparisons of United States (U.S.) full-time employees versus contracted employees or U.S. employees versus foreign full-time employees, as discussed below.

This analysis only addresses the provisions that would impact the department.

RECOMMENDATION

No position.

SUMMARY OF AMENDMENTS

The January 16, 2020, amendments clarified that the provisions of this bill apply to all corporations and banks and financial institutions filing a combined report, clarified the application of the additional 50 percent tax rate increase, and added definitions of previously undefined terms. These amendments resolved all of the previously identified implementation considerations discussed in the department's analysis of the bill, as amended on April 3, 2019, created additional implementation considerations, a technical consideration, and another policy concern.

REASON FOR THE BILL

The reason for the bill is to allow California to increase the corporate and bank and financial institution franchise tax rate to address wage inequity by instituting a progressive tax structure that incentivizes large corporations and banks and financial institutions to reduce the wage gap between regular employees and top executives, and to maintain full-time employees in the U.S.

ANALYSIS

This bill would increase the corporation franchise tax rate for corporations with net income of \$10 million or more, for taxable years beginning on or after January 1, 2020, to a rate determined by reference to a table provided in the bill. The table would specify the applicable tax rate based on the "compensation ratio" calculated for that taxable year. In addition, the applicable tax rate could be increased dependent on a specified decrease in full-time or contracted employees located in the U.S. versus foreign full-time employees. The tax rate structure modified by this bill applies to corporations, banks and financial institutions, but is inapplicable for S corporations.

This bill would define the following terms:

- "Client employer" would mean 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" would mean either:
 - For employees of the taxpayer other than the Chief Executive Officer (CEO), Chief Operating Officer (COO), or the highest paid employee, wages paid or incurred by the taxpayer to the employees of the taxpayer during the calendar year. (Wages are defined in Internal Revenue Code (IRC) section 162(a)(1), relating to ordinary and necessary trade or business expenses, and excludes any excessive remuneration as defined in IRC section 162(m).)
 - For the CEO, COO, or the highest paid employee of the taxpayer, total compensation as reported in the Summary Compensation Table reported to the U.S. Securities and Exchange Commission (SEC) pursuant to Regulation S-K of the SEC, Item 402.
- "Compensation Ratio" for a taxable year would mean a ratio where:
 - The numerator is the greatest of the compensation of the CEO, COO, or the highest paid employee of the taxpayer averaged over the three calendar years preceding the beginning of the taxable year.
 - The denominator is the median compensation of all employees employed by the taxpayer, including all contracted employees under contract with the taxpayer, in the U.S. for the calendar year preceding the beginning of the taxable year.
 - For taxpayers that are required or authorized to be included in a combined report, pursuant to Revenue and Taxation Code (R&TC) sections 25101, 25101.15, 25102, 25104, and 25110, 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.

- "Contracted employee" would mean an employee who works for a labor contractor.
- "Corporation" shall not include a non-corporate business entity that has elected to be classified for federal income tax purposes as a C corporation.
- "Detailed compensation report" means a report that includes every employee of a corporation and the compensation and location for each employee.
- "Labor contractor" would mean 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 corporation subject to a modified tax rate would be required to furnish a detailed compensation report to the Franchise Tax Board (FTB) with its timely filed original return.

The applicable tax rate as specified in the table would be determined as follows:

If the compensation ratio is:	Then, the applicable tax rate is:
Over zero but not over 50	10.84%
Over 50 but not over 100	11.84%
Over 100 but not over 200	12.84%
Over 200 but not over 300	13.84%
Over 300	14.84%

The tax rate shown in the above table would then be multiplied by 1.5 if either of the following conditions are met:

- 1) The total number of full-time employees employed by the taxpayer in the U.S. for a taxable year is reduced by more than 10 percent, as compared to the total number of full-time employees employed by the taxpayer in the U.S. for the preceding taxable year, and the total number of contracted employees employed by the taxpayer for a taxable year has increased, as compared to the total number of contracted employees of the taxpayer for the preceding taxable year.
- 2) The total number of full-time employees employed by the taxpayer in the U.S. for a taxable year is reduced by more than 10 percent, as compared to the total number of full-time employees employed by the taxpayer in the U.S. for the preceding taxable year, and the total number of foreign full-time employees of the taxpayer for that taxable year has increased, as compared to the total number of foreign full-time employees 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 would be zero.

For purposes of determining whether the tax rate increase applies, this provision would define the following terms:

- “Annual full-time equivalent” would mean either of the following:
 - For a full-time employee paid hourly qualified wages, “annual full-time equivalent” would mean 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.
 - For a salaried full-time employee, “annual full-time equivalent” would mean the total number of weeks worked for the qualified taxpayer by the employee divided by 52.
- “Foreign full-time employee” would mean a taxpayer’s full-time employee that is employed at a location other than the U.S.
- “Full-time employee” would mean 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.

The FTB would be authorized to prescribe rules, guidelines or procedures to carry out the purpose of this subdivision, including any guidelines regarding the determination of wages, average compensation, and the compensation ratio. These rules, guidelines, and procedures would be exempt from the provisions of the Administrative Procedures Act.

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, 2020. In addition, the tax rate increase proposed by this bill, would be inoperative for any taxable year beginning on or after January 1 of any calendar year in which the federal corporation tax rate is 35 percent or more.

Federal/State Law

Federal Law

Under federal law, a corporation is required to file an annual income tax return whether or not it has taxable income. The applicable federal tax rate varies depending on the type of corporation.

State Law

Existing state law, under the CTL, subjects a corporation to a corporation franchise tax or a corporation income tax.

- 1) Corporation Franchise Tax: In general, every corporation that is either qualified to do business in this state or is doing business in this state (whether organized in-state or out-of-state) is subject to the corporation franchise tax determined under R&TC section 23151. 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. The corporation franchise tax rate is 8.84 percent. The measured tax is determined by multiplying the applicable tax rate by the corporation's net income for tax purposes. Under existing law, a corporation is subject to a minimum franchise tax of \$800 when it is more than its measured tax.
- 2) Corporation Income Tax: In general, a corporation that is not organized in or qualified to do business in California, and is not "doing business" in California, but is deriving income from California sources, is subject to the corporation income tax. This tax rate is also set at 8.84 percent by reference to the corporation franchise tax rate. The corporation income tax also applies to certain non-corporate business entities.

A bank or financial institution's rate of tax is determined under R&TC section 23186, which states that its tax rate is that determined under R&TC section 23151, plus 2 percent. An S corporation's tax rate is determined under R&TC section 23802, which provides for a separate tax rate.

Implementation Considerations

The provisions of this bill would increase the tax rate based on a net income level of \$10 million or more, and that new tax rate would be increased by a "multiple of 1.5 times that rate," dependent on a comparison of U.S. versus foreign full-time employees. This bill does not specify whether the "multiple of 1.5 times the rate" could apply independent of the first tax increase. For clarity and ease of administration, it is recommended that the bill be amended to clarify that the "multiple of 1.5 times the rate" would not apply if the corporation or the bank and financial institution has net income below \$10 million.

The term "qualified wages" is undefined in R&TC section 23151(g)(5)(C)(i). 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 the bill to clearly define the term.

Also, the term "qualified taxpayer" is undefined in R&TC section 23151(g)(5)(C)(i). "Qualified taxpayer" could be replaced with "taxpayer" to maintain consistency throughout the section. For consistency, it is recommended that the bill be amended.

This bill authorizes FTB to prescribe rules, guidelines, and procedures that are necessary and appropriate to carry out these provisions in R&TC section 23151(g)(6). For FTB's administration of these provisions, the following language is recommended in place of R&TC section 23151(g)(6):

(6) (A) The Franchise Tax Board may issue any regulations necessary or appropriate to implement the purposes of this section.

(B) Chapter 3.5 (commencing with Section 11340) of Part 1 of Division 3 of Title 2 of the Government Code shall not apply to any standard, criterion, procedure, determination, rule, notice, or guideline established or issued by the Franchise Tax Board.

Technical Considerations

In R&TC section 23151(g)(3)(C)(i), the term "greater" is used when comparing the compensation of the CEO, COO, or the highest paid employee of the taxpayer. Because the compensation of three employees is being compared, the term "greatest" should be used instead of "greater."

In addition, this bill authorizes FTB to prescribe rules, guidelines, and procedures that are necessary and appropriate to carry out these provisions in R&TC section 23151(g)(6). For FTB's administration of these provisions and consistency with other provisions of the R&TC, the following language is recommended in place of R&TC section 23151(g)(6):

(6) (A) The Franchise Tax Board may issue any regulations necessary or appropriate to implement the purposes of this section.

(B) Chapter 3.5 (commencing with Section 11340) of Part 1 of Division 3 of Title 2 of the Government Code shall not apply to any standard, criterion, procedure, determination, rule, notice, or guideline established or issued by the Franchise Tax Board.

Policy Concerns

The compensation ratio requires comparison of U.S. wages paid to the CEO, COO, or the highest paid employee to all other employees. If a taxpayer were to locate their top paid employees in the U.S. and locate their lower paid employees outside of the U.S., the taxpayer may receive a lower tax rate than a similarly situated taxpayer that locates all of its employees in the U.S.

The tax rate structure modified by this bill applies to corporations and banks and financial institutions, but is inapplicable for S corporations. If the author intends for the tax rate increase to apply to all corporations and banks and financials with net income of \$10 million or more, the author should amend the language to include S corporations and the impact to the 1.5 percent rate of tax imposed on S corporations.

This bill lacks a sunset date, which is generally provided to allow periodic review of the effectiveness of income tax law changes by the Legislature.

LEGISLATIVE HISTORY

SB 1398 (Skinner, 2017/2018), similar to this provision, for publicly-held corporations, would have modified the flat franchise tax rate with a tax rate table specifying the applicable tax rate based on a "compensation ratio" for the taxable year, and would have created a new tax credit for publicly-held corporations that met certain criteria. SB 1398 failed to pass out of the Senate by the constitutional deadline.

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.

PROGRAM BACKGROUND

None noted.

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.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue gain:

Estimated Revenue Impact of SB 37 as Amended on January 16, 2020
Assumed Enactment after June 30, 2020

(\$ in Billions)

Fiscal Year	Revenue
2020-2021	\$4.8
2021-2022	\$4.5
2022-2023	\$4.2

This estimate does not include an adjustment for the provision of the bill pertaining to an increase in the tax rate by a factor of 1.5 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 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 (including banks) 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 taxpayers with net income subject to taxes of \$10 million or more is estimated to total \$8.0 billion in 2020. 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 income subject to tax is then multiplied by the proposed tax rate structure resulting in total tax of approximately \$11.4 billion in 2020. The net revenue gain of approximately \$3.9 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

None noted.

APPOINTMENTS

None noted.

SUPPORT/OPPOSITION

Support

American Federation Of State, County And Municipal Employees Local 3299; Berkeley Federation of Teachers, Local 1078, AFL-CIO; CA Conference Board of the Amalgamated Transit Union; California Conference of Machinists; California Labor Federation; California School Boards Association; California State PTA; California Teachers Association; California Voices For Progress; Canyon Democrats; Colusa County Democratic Central Committee; Contra Costa AFL-CIO Labor Council; Courage Campaign; Democrats of the Desert; Engineers and Scientists of CA, IFPTE Local 20, AFL-CIO; Inlandboatmen's Union of the Pacific; La Jolla Democrat Club; Professional and Technical Engineers, IFPTE, Local 21, AFL-CIO; San Francisco Labor Council; San Mateo County Central Labor Council; South Beach District 6 Democratic Club of San Francisco; Stanislaus and Tuolumne County's Central Labor Council; Stonewall Young Democrats; UDW/AFSCME, Local 3930; United Teachers of Pasadena; UNITED-HERE, AFL-CIO; Utility Workers of America; Wellstone Democratic Renewal Club. (As per SB 37 Senate Committee on Governance and Finance Report, dated January 10, 2020.)

Opposition

Advanced Medical Technology Association (ADVAMED); Bay Area Council; Biocom; Building Owners and Managers Association of California; California Bankers Association; California Business Properties Association; California Business Roundtable; California Chamber of Commerce; California Forestry Association; California Independent Petroleum Association (CIPA); California Life Sciences Association; California Manufacturers & Technology Association; California Railroads; California Restaurant Association; California Retailers Association; California Taxpayers Association (CALTAX); California Trucking Association; Chamber of Commerce Alliance of Ventura and Santa Barbara Counties; Chino Valley Chamber of Commerce; Contra Costa Taxpayers Association; Council on State Taxation; Family Business Association of California; Fontana Chamber of Commerce; Greater Coachella Valley Chamber of Commerce; Greater Ontario Business Council; Hesperia Chamber of Commerce; Inland Empire Economic Partnership (IEEP); International Council of Shopping Centers; Kern County Taxpayers Association; Moreno Valley Chamber of Commerce; Murrieta Wildomar Chamber of Commerce; Naiop of California, the Commercial Real Estate Development Association; National Federation

of Independent Business (NFIB); Orange County Business Council; Orange County Taxpayers Association; Rancho Cucamonga Chamber of Commerce; Redlands Chamber of Commerce; San Gabriel Valley Economic Partnership; Santa Maria Valley Chamber of Commerce; Securities Industry and Financial Markets Association; Silicon Valley Leadership Group; Solano County Taxpayers Association; Spidell Publishing, Inc.; Technet; Upland Chamber of Commerce; Valley Industry and Commerce Association; Victor Valley Chamber of Commerce; West Coast Lumber & Building Material Association; Western States Petroleum Association. (As per SB 37 Senate Committee on Governance and Finance Report, dated January 10, 2020.)

ARGUMENTS

To be determined.

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