



Analysis of Amended Bill

Author: Skinner, et al.

Sponsor:

Bill Number: SB 37

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Amended: April 3, 2019

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Related Bills: See Legislative
History

Subject: Bank and Corporation Tax Rate Increase

Summary

This bill would increase the corporation tax rate, under the Corporation Tax Law (CTL), for corporations with net income of \$10 million or more.

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

Recommendation – No position.

Summary of Amendments

The April 3, 2019, amendments removed provisions of the bill related to the Penal Code, added a co-author, and added provisions that would increase the corporation franchise tax rate for corporations with net income of \$10 million or more. Dependent on a specified “compensation ratio,” the modified rate would vary from 10.84 percent to 14.84 percent. In addition, the tax rate would be increased by an additional 50 percent for taxpayers with a specified decrease in full-time employees located in the United States (U.S.). The amendments also added uncodified language regarding the bill’s purpose, goals and objectives.

This is the department’s first analysis of the bill.

Reason for the Bill

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

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, a portion of this bill, relating to the increase of the applicable tax rate for a corporation

with net income of \$10 million or more, 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

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.

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 Revenue and Taxation Code (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, only if 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 income tax rate 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.

This Bill

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 tax rate could be increased dependent on a specified decrease in full-time employees located in the U.S.

The tax rate structure modified by this bill applies to banks and financials, 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, wages¹ paid by the taxpayer to the employees of the taxpayer during the calendar year.
 - 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).²
- “Compensation Ratio” for a taxable year would mean a ratio where:
 - The numerator is the greater 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 employer, 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,³ 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.
- “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.

¹ As defined in Internal Revenue Code (IRC) section 3121(a).

² Pursuant to Regulation S-K of the SEC, Item 402.

³ Under R&TC sections 25101 and 25101.15.

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 be increased by 50 percent if both 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
- 2) The total number of contracted employees or foreign full-time employees of the taxpayer for that taxable year has increased, as compared to the total number of contracted employees or 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.⁴

The FTB would be authorized to 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

Department staff has identified the following implementation considerations for purposes of a high-level discussion; additional concerns may be identified as the bill moves through the legislative process. Department staff is available to work with the author’s office to resolve these and other concerns that may be identified.

For clarity, we suggest retaining the stricken language on page 4, lines 5-6.

The bill refers to a “corporation,” which also includes other entities in addition to C corporations. If the author’s intent is that this bill would apply only to C corporations, the author should amend the definition of corporation under R&TC section 23038 for purposes of this section to limit the application of the rates set forth in this bill accordingly.

The term “wages” is defined in IRC section 3121 (a), relating to employment taxes. The FTB does not administer employment taxes. This amount is not reported on California franchise and income tax returns. As such, the FTB may be unable to verify “wages” as defined under this section. 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. It is recommended that the author amend the definition of wages to mean compensation under the IRC.

In addition, the definition of wages are those wages “paid” by the taxpayer. For corporations using the accrual method of accounting, wages, including bonuses, may not have been paid during the taxable year, but may have been incurred. The author may wish to amend this to “paid or incurred.”

⁴ Within the meaning of Labor Code section 515.

Within definitions, the compensation ratio discusses taxpayers in a combined report as determined under R&TC sections 25101 and 25101.15. Taxpayers also file combined reports under R&TC sections 25102, 25104, and 25110. If the author intends to include all applicable combined reports, the language should be amended.

This bill uses the undefined term “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. In addition, the bill is silent as to which tax rate should apply if the taxpayer fails 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.

The bill refers to the number of contracted employees “or” foreign full-time employees compared to the total number of contracted employees “or” foreign full-time employees from the prior year. The use of the word "or" in this formula may lead to confusion. It is unclear whether the comparison must be between contracted employees versus the contracted employees in prior year, or a comparison between the foreign full-time employees versus the foreign FTB in a prior year, or a combination thereof. It is recommended that this provision of the bill be amended to specify the author's intent.

The bill provides a 50 percent increase to the applicable tax rate in specified circumstances. It is unclear as to whether the applicable rate would be increased by 50 percent (i.e., 14.84 percent increased to 64.84 percent) or if it would be increased by 50 percent of the applicable rate (i.e., 14.84 percent increased to 22.26 percent). It is recommended that this provision of the bill be amended to specify the author's intent.

The FTB would need to determine whether the taxpayer's salaried employees meet the definition of Labor Code section 515. As the FTB does not administer the Labor Code, the department may lack the expertise to make this determination. It is recommended that this bill be amended to include a certifying agency.

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.

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.

Florida, Illinois, Michigan, and Minnesota all have a flat corporation tax rate of 5.5 percent, 7 percent, 6 percent, and 9.8 percent, respectively.

Massachusetts has a flat corporation tax rate of 8 percent, however, the rate is applied to the corporation's gross income, not net income.

New York, also has a flat corporation tax rate of 6.5 percent, with two exceptions. Qualified emerging technology companies apply a reduced tax rate of 5.5 percent, and qualified manufacturers pay no tax.

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 April 3, 2019
Assumed Enactment after June 30, 2019

(\$ in Billions)

Fiscal Year	Revenue
2019-2020	\$1.0
2020-2021	\$3.5
2021-2022	\$4.1

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 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 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 \$7.1 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 was then multiplied by the proposed tax rate structure resulting in total tax of approximately \$10.6 billion in 2020. The net revenue gain of approximately \$3.5 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 treat taxpayers differently due to a higher tax rate for those companies that decreased employment in the U.S. by more than 10 percent and increased the number of full-time employees outside of the U.S. This could raise constitutional concerns under the Foreign Commerce Clause of the U.S. Constitution because it could appear to improperly favor U.S. activity over foreign commerce.

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 banks and financials, but is inapplicable for S corporations. If the author intends for the tax rate increase to apply to all banks and corporations, the author should amend the language to include 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.

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