BILL ANALYSIS

Date of Hearing: April 18, 2005

ASSEMBLY COMMITTEE ON REVENUE AND TAXATION
Johan Klehs, Chair

AB 1037 (Frommer) - As Amended: April 12, 2005

Majority vote. Tax Levy. Fiscal Committee

SUBJECT : Corporation tax: Apportionment: Sales factor

SUMMARY : Includes only the overall net gain arising from treasury functions for purposes of computing the sales factor, despite any contrary treatment in the Multistate Tax Compact. Specifically, this bill :

1)Limits gross receipts arising from a treasury function to the overall net gain, including interest and dividends, realized from transactions undertaken as part of a treasury function.

2)Defines "treasury function" as the pooling, management, and investment of liquid assets for the purpose of satisfying the cash flow needs of the trade or business including, but not limited to, providing a reserve for business contingencies and business acquisitions.

3)Defines "liquid asset" as readily marketable intangibles including, but not limited to, stocks, bonds, debentures, options, warrants, futures contracts, foreign currency, and mutual funds. Specifically:

a) Excludes from the definition of "liquid asset" currency held in bank accounts if that currency is used by the business in the conduct of its trade or business unless that currency is an instrument that may be purchased or sold for a gain.

b) States that an intangible is considered marketable if it is traded on an established stock or securities exchange or market and is regularly quoted by brokers or dealers.

c) Provides that an equity interest in a business entity that is unitary with the taxpayer or that has a substantial business relationship with the taxpayer is not considered a marketable security.

4) Defines "state" as any state of the United States (U.S.), the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the U.S. and any foreign country or political subdivision thereof.

EXISTING LAW : California follows the Uniform Division of Income for Tax Purposes Act (UDITPA), as modified, to determine the amount of a taxpayer's income, derived from activities from within and outside of California, which is attributable to California in order to determine the taxpayer's California franchise tax. California, in accordance with UDITPA, uses an apportionment formula to determine the business income attributable to California.

The California apportionment formula is an average four factors (property, payroll, and double-weighted sales) and each factor is the ratio of the measure of that activity within California to all the business' activity. The property factor includes real property and tangible personal property owned or rented by the taxpayer. The payroll factor includes all forms of compensation paid to employees. The sales factor includes all gross receipts from the sale of tangible and intangible property.

The "sales factor" is defined by statute to include all gross receipts of the taxpayer other than nonbusiness income. Currently, no statutory definition of "gross receipts" exists. Controversies have arisen regarding inclusion of certain activities in the sales factor. Specifically, the issue involves activities involving the treasury function of a business. Treasury function activities of a taxpayer are investments in intangible assets (stock, bonds, certificates of deposits) intended to provide temporary returns for liquid assets for the purpose of meeting the taxpayer's cash flow needs. The Franchise Tax Board (FTB) staff takes the position that interest, dividend and gains from intangibles belong in the sales factor; in general, the principal amount of debt returned should not be included in the calculation of gross receipts.

In general, treasury function activities are performed at a taxpayer's headquarters. Only taxpayers that are headquartered in California include treasury function items in the numerator of the sales factor, as well as in the denominator. All other taxpayers include the treasury function items only in the denominator. For non-California taxpayers, inflating the denominator of the double-weighted sales factor results is a significantly reduced sales factor, and resulting in a reduced apportionment factor, resulting in reduced income apportioned to California, resulting in a reduced California franchise tax liability.

FTB staff's practice to include only net gains from treasury function activity has long been supported by the Board of Equalization. As recent as 2004, the FTB staff's position has been sustained by a California Court of Appeals. The California Supreme Court has accepted the case for review, but a decision has not yet been rendered. Until the Supreme Court acts, the matter is unresolved. However, a number of taxpayer controversies continue. Tax controversies, even when the tax agency is ultimately sustained, results in cash flow issues for the state.

FISCAL EFFECT : Based upon cash flow acceleration, FTB estimates that the impact on the General Fund will be a revenue increase of $95 million in fiscal year (FY) 2005-06 and $990 million in FY 2006-07.

Proposition 98 Fiscal Effect : Committee staff estimate that the impact to K-14 school funding will be a revenue increase of $51.3 million in FY 2005-06 and $48.6 million in FY 2006-07.

COMMENTS :

1)This bill is sponsored by the State Controller, Steve Westly, who states:

> As the State Controller and Chairman of the Franchise Tax Board, I believe it essential to ensure our California tax laws do not unfairly disadvantage businesses located in California. This bill closes a potential loophole that out-of-state businesses have been using to try and lower their tax liability. While I fully support the Franchise Tax Board's interpretation of the law, this bill will settle the issue once and for all.

2)According to FTB, taxpayers that include debt principal repayment from treasury function activities in the sales factor are usually large, apportioning out-of-state corporations. FTB reports that taxpayers identified as reporting this way in the 2001 tax year reported taxable incomes in excess of $5 million.

3)The FTB states the revenue impact of this bill will reflect cash flow only. Since this bill codifies existing practices of the FTB that have been repeatedly sustained in appeals and in litigation, no new revenues will be received by the state. However, codification of the accepted practices of the FTB should accelerate collection of tax. Taxpayers may be less inclined to file returns with contrary positions or to pursue administrative appeals or litigation in order to delay payment of the tax due.

REGISTERED SUPPORT / OPPOSITION :

Support

State Controller Steve Westly (Sponsor)

Opposition

None in file

Analysis Prepared by : Kimberly Bott / REV. & TAX. / (916) 319-2098