DEPARTMENT OF FINANCE BILL ANALYSIS

AMENDMENT DATE: July 7, 2011 **BILL NUMBER:** SB 116
POSITION: Neutral, note concerns **AUTHOR:** K. De Leon

BILL SUMMARY: Income Taxes: Hiring Credit/Single Sales Factor/etc.

This bill would do the following:

(1) Require the use of a mandatory single sales factor (SSF) apportionment formula, with an exception, as specified;
(2) Change the cost of performance/market rule for cable companies;
(3) Exempt purchases used in manufacturing from sales and use tax;
(4) Expand the 2009 jobs tax credit from $3,000 to $4,000 to employers with 50 or fewer employees;
(5) Create a new education tax credit;

FISCAL SUMMARY

Based on revenue estimates provided by the Franchise Tax Board (FTB), and the Board of Equalization (BOE), this bill would result in revenue gains of $1.544 billion in 2011-12, $1.577 billion in 2012-13, $1.539 billion in 2013-14, and $1.568 billion in 2014-15. (See Fiscal Analysis for a breakdown and Revenue Discussion.)

According to the BOE, there will be non-absorbable costs associated with programming, modifying returns, notifying affected retailers, preparing a special publication and exemption certificate, auditing claimed exceptions, and answering inquiries from the public and taxpayers. In addition, due to errors on returns, BOE anticipates additional workload in the returns processing area. The additional cost to the department is estimated at $558,000 in 2012-13, $516,000 in 2013-14, $516,000 in 2014-15, and $646,000 in 2015-16. (See Fiscal Analysis for a breakdown)

FTB notes that the additional cost to the department associated with implementing this measure will be identified, and an appropriation requested, if necessary, as the bill continues through the legislative process.

COMMENTS

This bill would enact an important correction to the way multi-state corporations are taxed by imposing a mandatory versus elective SSF apportionment formula.

However, Finance notes the following concerns:

> The exception to the mandatory SSF creates a change in tax law solely for the purpose of allowing corporations to have a more favorable financial statement with no substantial change in underlying economic activity. In effect, it enables corporations to overstate their financial assets.
>
> The carve-out for the cable industry with regard to the cost of performance/ market rule for sourcing the sales of intangibles and services benefits only one industry, setting a precedent for other industries to seek similar treatment.

Analyst/Principal	Date	Program Budget Manager	Date
(0724) R. Lawrence		Mark Hill	

Department Deputy Director	Date

Governor's Office:	By:	Date:	Position Approved_______ Position Disapproved

AUTHOR	**AMENDMENT DATE**	**BILL NUMBER**
K. De Leon	July 7, 2011	SB 116

While Finance recognizes that the sales and use tax exemption for manufacturing equipment and the jobs tax credit expansion have merit from a policy perspective they do reduce the revenue gain from this bill.

AUTHOR	AMENDMENT DATE	BILL NUMBER
K. De Leon	July 7, 2011	SB 116

ANALYSIS

A. Programmatic Analysis

Sales and Use Tax Exemption

Under existing law business entities engaged in manufacturing that makes purchases of equipment and supplies for use in the conduct of manufacturing activities are required to pay tax on their purchases to the same extent as any other person either engaged in business in California. No special tax treatment is currently provided for purchases of equipment used by these entities in their manufacturing activities.

This bill would exempt from sales and use tax tangible personal property primarily used in any stage of the manufacturing, processing, refining, fabricating, or recycling, beginning at the point where raw materials are received by the qualified person, through to its final completed form, including packaging if required. Starting in 2012-13, an existing company would get a 1-percent General Fund Sales and Use Tax exemption for equipment, and a new trade or business would receive a 5-percent exemption.

"Manufacturing" means the activity of converting or conditioning tangible personal property by changing the form, composition, quality, or character of the property for ultimate sale at retail or use in the manufacturing of a product ultimately to be sold at retail.

"Primarily" means tangible personal property used 50 percent or more of the time in the manufacturing activity described.

"Processing" means the physical application of the materials and labor necessary to modify or change the characteristics of tangible personal property.

"Qualified person" means either a new trade or business that is primarily engaged in those lines of business classified in Industry Groups 3111 to 3399 of the North American Industrial Classification System (NAICS), or a trade of business, other than a new trade or business, classified in Industry Groups 3111 to 3399 of the NAICS. A trade or business that has conducted business activities in this state for a period of three years or more is no longer considered a new trade or business.

Expansion of the 2009 Jobs Tax Credit

Under current state law, Chapter 17, Statutes of 2009, Third Extraordinary Session (X3 SB15), allows a credit for taxable years beginning on or after January 1, 2009, for a qualified employer in the amount of $3,000 for each qualified full-time employee hired in the taxable year, determined on an annual full-time basis equivalent. The calculation of annual full-time basis would be the total number of hours worked for the taxpayer by the employee (not to exceed 2,000 hours per employee) divided by 2,000. A qualified employer is a taxpayer employing 20 or less employees. This credit is allocated by the FTB and has a cap of $400 million for all taxable years. The credit remains in effect until December 1 of the calendar year after the year in which the cumulative credit limit has been reached and is repealed after that date. Any credits not used in the taxable year may be carried forward up to eight taxable years.

FTB recently updated their revenue methodology to reflect new data on taxpayer usage of the current Jobs Tax Credit. This update is based on analysis of tax returns filed during March and April of this year that indicates a minimal increase in taxpayer participation in the Jobs Tax Credit program in taxable year 2010. As a result, the amount of credit available under the $400 million cap is greater than previously estimated in FTB's analysis of the March 31, 2011 version of this bill which had projected that all credits would be exhausted during the 2011 taxable year.

This bill would, effective with the taxable year beginning on or after January 1, 2011, increase the hiring credit from $3,000 to $4,000, and define a qualified employer to mean an employer with 50 or fewer employees.

The cutoff date is the earlier of the following dates: (1) the last day of the calendar year quarter FTB estimates it will have received timely filed returns achieving the cumulative total of $400 million for all taxable years or (2) December 31, 2012.

DISCUSSION

This proposed expansion to the jobs credit in this bill is identical to the Administration's 2011-12 May Revision proposal to expand the jobs tax credit with the aim of making the credit more usable to businesses. The May Revision proposal was as follows:

- Increase the credit from $3,000 to $4,000 per new employee.
- Offer the credit to employers with fewer than 50 employees, as opposed to the current 20, and sunset the credit at the end of 2012.
- Implement a public awareness effort by the Business, Transportation, and Housing Agency, so that businesses will be aware of and actually take advantage of the credit.

The proposal was not adopted as part of the 2011 Budget Act.

Current credit use: As of July 2, 2011, the total Personal Income Tax and Business Entity returns claiming the Jobs tax credit was 10,081, and the amount of credits claimed was $59.5 million.

There has been a low amount of credit generated so far, relative to the amount of credit that could, conceptually, have been claimed. Finance believes that the primary reasons for this underutilization are that businesses are not aware of the credit, and the documentation requirements on eligible small business are too onerous to warrant seeking the credit.

Create a New Education Tax Credit

This bill would provide a tax credit equal to 75 percent of the amount contributed during the taxable year by a taxpayer to either the K-12 Investment Tax Credit Program Special Fund, or the Higher Education Investment Tax Credit Program Special Fund. The aggregate amount of the credit that may be allocated is $1 billion beginning with the 2012 calendar year and for each calendar year thereafter. The credits will be claimed on a timely filed tax return and will be allocated on a first-come-first-served basis. In cases where the credit claimed exceeds the net tax, the excess may be carried over to reduce the net tax over a period of six years if necessary until the credit exhausted.

The FTB would be required periodically to provide information on its website pertaining to the amount of credits claimed on timely filed tax returns.

The K-12 Investment Tax Credit Program Special Fund is created with all revenue continuously appropriated without regard to fiscal year, as follows:

(a) First, to school districts in an amount equal to any amounts suspended, deferred, otherwise not appropriated to each school district resulting from a suspension of the minimum funding obligation, determined pursuant to Article XVI of the California Constitution.

AUTHOR	AMENDMENT DATE	BILL NUMBER
K. De Leon	July 7, 2011	SB 116

(b) Surplus moneys are to be allocated to the Superintendent of Public Instruction for education purposes

The Higher Education Investment Tax Credit Program Special Fund revenues upon appropriation by the Legislature are to be allocated in equal parts to:

(a) Regents of the University of California
(b) Trustees of the California State University
(c) Board of Governors of the California Community Colleges

Recipients of funds under the K-12 Investment Tax Credit Program, and the Higher Education Investment Tax Credit Program are required to maintain a website under each program listing taxpayers that contributed to the program.

DISCUSSION

This bill would provide additional special funds for education, however it could create a shift in funding from K-14 education to higher education. To the extent that the bill reduces the amount of General Fund proceeds of taxes through a tax credit, the Proposition 98 Guarantee would decrease by approximately 40 percent of the amount of tax credit claimed. The additional special fund money would go to not only K-12 and community colleges who receive Proposition 98 funds, but also to the University of California and the California State University who do not receive Proposition 98 funds. Depending on how contributions are split between the K-12 and Higher Education special funds, this bill could either increase or decrease K-12 total funding. The special fund money that goes to K-12 would be allocated in proportion to existing Proposition 98 obligations, but would not reduce these obligations. Depending on the magnitude of the tax credit, the bill could potentially create pressure to rebench Proposition 98 and/or reduce General Fund support for higher education so that the creation of a special fund would have no net effect on total education funding.

Since these contributions would fund education exclusively, it is likely that it would qualify the taxpayer for a federal charitable contribution deduction. This would likely open the door for every other state to fund their education budget the same way, and trigger an immediate response at the federal level to prevent it.

Mandatory Single Sales Factor (SSF)

Existing state law uses an apportionment formula to determine the amount of business income attributable to California. The apportionment formula consists of property, payroll, and sales factors. For taxable years on or after January 1, 1993, the apportionment formula for most taxpayers has been a three factor formula consisting of property, payroll, and sales (double-weighted). An exception to this rule exists for taxpayers of an apportioning trade or business that derives more than 50 percent of their gross business receipts conducting "qualified business activities."

Double Weighted Sales Formula (4 factor formula):

$$\frac{(\text{Ca Property/Total Property}) + (\text{Ca Payroll/Total Payroll}) + (2 \times (\text{Ca Sales/Total Sales}))}{4}$$

"Qualified business activities" are trades or businesses which derive more than 50 percent of their gross business receipts from conducting agricultural business activity, banking or financial business activity, or extractive business activity. These taxpayers are required to apportion income to this state based on a three-factor, equal weighted formula, consisting of the property factor, payroll factor, and the sales factor (single weighted).

Single Weighted Sales Formula (3 factor formula):

$$\frac{\text{(Ca Property/Total Property)} + \text{(Ca Payroll/Total Payroll)} + \text{(Ca Sales/Total Sales)}}{3}$$

Beginning in the 2011 tax year, businesses apportioning income to this state are allowed to choose whether to use the standard three factor apportionment formula consisting of the property factor, payroll factor, and sales (double-weighted) or to use the single sales factor (SSF).

Single Sales Factor Formula:

$$\frac{\text{Ca Sales}}{\text{Total Sales}}$$

Assigning Sales to California (**Prior to January 1, 2011**)

Sales of tangible personal property are assigned to California if

- the product is delivered or shipped to a purchaser in this state, and the taxpayer (seller) is taxable in this state.
- the product is delivered or shipped from California to a purchaser out of state, and the taxpayer (seller) is not taxable in the state of destination.
- the goods are shipped from California, in the case of tangible personal property sold to the U.S. Government.

Sales of intangibles and services are assigned to California if

- the income producing activities that gave rise to the receipts are performed wholly within California. If they are performed within and outside the state, the sales are assigned to California if the greater cost of performance of the income producing activity is performed in this state.
- the services are performed in California. If personal services are performed in more than one state, the receipts from the services are assigned to California based on the ratio of time spent performing such services in the state to total time spent in performing such services everywhere.
- in the case of sales from the sale, rental, lease, or licensing of real property and the receipts derived from the rental, lease, or licensing of tangible personal property, the property is located in California.

Assigning Sales to California (**On or after January 1, 2011**)

Sales of tangible personal property are assigned to California if

- the product is delivered or shipped to a purchaser in this state, and the taxpayer (seller) or any member of the taxpayer's combined reporting group is taxable in this state.
- the product is delivered or shipped to a purchaser out of state and neither the taxpayer (seller) nor any other member of the combined reporting group is taxable in the state of destination.
- the goods are shipped from California, in the case of sales of tangible personal property to the U.S. Government.

Sales of intangibles and services are assigned to California

AUTHOR	**AMENDMENT DATE**	**BILL NUMBER**
K. De Leon	July 7, 2011	SB 116

• to the extent the purchaser of the service receives the benefit of the service in California. (Market Rule)
• to the extent the property is used in California. In the case of marketable securities, sales are assigned to California if the customer is in California. (Market Rule)
• if, in the case of sales from the sale, lease, rental, or licensing of real property, the real property is located in California.
• if in the case of sales from the rental, lease, or licensing of tangible personal property, the property is located in California.

Under current law beginning on or after January 1, 2011, an apportioning trade or business that does not make the election to use the single sales factor apportionment formula must use the pre-2011 income producing cost of performance rules to assign all sales other than sales of tangible personal property.

An apportioning trade or business that has made a single sales factor election must use the post-2010 rules operative for years beginning on or after January 1, 2011, commonly referred to as the “market rule,” to assign all sales other than sales of tangible personal property, namely sales of intangibles and services.

This bill would require all business income of an apportioning trade or business, except qualified business activities, to be apportioned to this state based on the SSF alone, beginning on or after January 1, 2011. The qualified activities, that is, trades or businesses which derive more than 50 percent of its gross business receipts from conducting agricultural business activity, banking or financial business activity, or extractive business activity, will continue to be exempt from the SSF formula requirement.

DISCUSSION

The SSF provision in this bill is identical to the Administration’s Mandatory SSF Apportionment proposal in the 2011-12 May Revision. The MR 2011-12 proposal required all corporations (except those engaged din qualified agricultural, extractive, or banking activities) to use the SSF formula to apportion income to this state.

Election of a Three Factor Formula (an exception to the SSF)

This bill would allow an exception to the mandatory SSF apportionment formula in cases where the tax owed under the three factor formula consisting of the property factor, payroll factor, and sales factor (double weighted) is greater than the tax owed under the SSF. In such cases the taxpayer may choose either the SSF or the three factor formula.

Changes the Cost of Performance/Market Rule for Cable Companies

Under this bill for taxable years beginning on or after January 1, 2011, a qualified taxpayer that apportions income is allowed to assign 50 percent of qualified sales to this state. The remaining 50 percent would be excluded from California sales from the single sales factor calculation.

A “qualified taxpayer” means a taxpayer member and all other corporations included in the combined reporting group that is also a qualified group.

A “qualified group” refers to those corporations with business income that is permitted or required to be included in specified combined reports and satisfy the following:

(a) Has satisfied the minimum investment requirement in California for the taxable year.

(b) For the taxable year beginning in calendar year 2006, the combined reporting group derived more than 50 percent of its United States network gross business receipts from the operation of one or more cable systems.

"Minimum investment" means qualified expenditures of not less than $250 million by a combined reporting group during the calendar year.

"Qualified expenditures" means any combination of expenditures to this state for tangible property, payroll, services, franchise fees, or any intangible property distribution or other rights paid or incurred by or on behalf of a member of a combined reporting group.

DISCUSSION

The proposal would carve out a single industry for special tax treatment because it invests in California. While this may promote job growth in this state, by veering from a system of taxation which applies rules uniformly to all taxpayers, it may set a precedent that is not good policy.

This bill would take effect immediately as an urgency statute.

B. Fiscal Analysis

Based on revenue estimates provided by the FTB and the BOE, this bill would result in revenue gains of $1.544 billion in 2011-12, $1.577 billion in 2012-13, $1.539 billion in 2013-14, and $1.568 billion in 2014-15. (See Fiscal Analysis for a breakdown.)

Revenue Impact of SB 116

	2011-12	2012-13	2013-14	2014-15
Sales & Use Tax Exemption		-$207,400,000	-$218,800,000	-$230,800,000
Job Tax Credit	-$45,000,000	$22,000,000	$45,000,000	$55,000,000
Education Credit	-$420,000,000	-$900,000,000	-$950,000,000	-$950,000,000
Mandatory SSF	$1,300,000,000	$1,100,000,000	$1,100,000,000	$1,000,000,000
Special Sales Rule - Cable	-$38,000,000	-$38,000,000	-$37,000,000	-$39,000,000
Total	$797,000,000	-$23,400,000	-$60,800,000	-$164,800,000
Special Fund Ed. Revenue	$747,000,000	$1,600,000,000	$1,600,000,000	$1,733,000,000
Net Revenue Impact	**$1,544,000,000**	**$1,576,600,000**	**$1,539,200,000**	**$1,568,200,000**

Revenue Discussion: Education credit

The FTB's revenue estimate assumes annual donations of $1.6 billion, which translates into $267 million of donations that will not receive the 75 percent credit due to the annual aggregate credit cap of $1 billion. [($1 billion/0.75 = $1.333 billion. $1.6 billion - $1.333 billion = $267 million)]

The FTB assumes that the credit cap is likely to impact the decisions of only a fraction of those making donations since most taxpayers will simply shift their current donations to this bill's credit qualifying donation. In these cases, the taxpayer has nothing to lose if the cap is reached because they'll still be able to deduct the donation.

Finance notes that is unlikely, given the limitation to the number of credits available and the risk that those who donate may not receive the credit, that there would be sufficient incentive for potential contributors to switch from their current contributions. It is more likely that the majority of the contributors will be new and that their incentives to invest will be dampened to some degree by the risk of not receiving the credit. Therefore, the assumed level of donations may be overstated.

Administrative Costs:

According to the FTB, two new provisions, the new jobs credit and education contribution credit, would require the department to track the credits and would impact the department's printing, processing and storage costs for tax returns. The associated costs to the FTB will be identified and as the bill continues through the legislative process and an appropriation will be requested, if necessary.

According to the BOE, there will be non-absorbable costs associated with programming, modifying returns, notifying affected retailers, preparing a special publication and exemption certificate, auditing claimed exceptions, and answering inquiries from the public and taxpayers. In addition, due to errors on returns, BOE anticipates additional workload in the returns processing area. The additional cost to the department is estimated at $558,000 in 2012-13, $516,000 in 2013-14, $516,000 in 2014-15, and $646,000 in 2015-16.

Code/Department Agency or Revenue Type	SO LA CO RV	PROP 98	FC	(Fiscal Impact by Fiscal Year) (Dollars in Thousands) 2011-2012	FC	2012-2013	FC	2013-2014	Fund Code
1104/Corp Tax	RV	Yes	U	$797,000	U	$184,000	U	$158,000	0001
1149/Sale Use Tax	RV	Yes		--	U	-$207,400	U	-$218,800	0001
1999/Pend New Rev	RV	No	U	$747,000	U	$1,600,000	U	$1,600,000	0499
0860/Equalization	SO	No		--	C	-$558	C	-$516	0001
1730/FTB	SO	No		--------------------- See Fiscal Summary ---------------------					0001

Fund Code	Title
0001	General Fund
0499	Pending New Special Funds