CALIFORNIA BUDGET PROJECT

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HAVE IT YOUR WAY: SHOULD SOME CORPORATIONS GET TO CHOOSE HOW MUCH OF THEIR INCOME IS TAXED IN CALIFORNIA?

AB 1037 (Frommer), as proposed to be amended, would give corporations in some industries an option to use a different formula for calculating how much of their income is subject to California's corporate income tax. Corporations could use either the new formula, which relies more heavily on the share of a corporation's sales that occur in California, or the existing formula that applies to corporations in most industries. Since corporations could choose between the two approaches, they would obviously use the approach that minimizes the taxes they pay to California.

Background

California's corporate income tax taxes the income generated by corporate activity that is attributable to California. For corporations that only do business within the state, determining the income that is subject to state tax is straightforward. For multi-state corporations, determining the income that is attributable to California is more complex. Traditionally, states have used a formula based on three equally weighted factors to apportion income among states for tax purposes. The traditional formula apportioned income based on the percentage of a corporation's total property, payroll, and sales within a given state. California used this approach prior to 1993. In 1993, California shifted to a formula that gave twice as much weight to the fraction of sales that occur within the state. This approach is called "double weighting" the sales factor. Take, for example, a business with 40 percent of its property and payroll in California, but only 25 percent of its sales within the state. Under current law, 32.5 percent of the corporation's profits would be allocated to California:

Total Profit x (property factor + payroll factor + 2 x sales factor)/ 4 =

Total Profit x (0.40 + 0.40 + 2 x 0.25)/4 = Total Profit x 0.325

The current proposal would allow corporations in some industries to choose between the current "double-weighted" sales formula and an alternative formula that gives four times the weight to sales.

Using the same example as above, the alternative formula would allow a corporation to allocate 30 percent of its profits to California:

Total Profit x (property factor + payroll factor + 4 x sales factor)/ 6 =

Total Profit x (0.40 + 0.40 + 4 x 0.25)/6 = Total Profit x 0.30

If this hypothetical corporation had $1 billion in California profits, it would save $2.2 million in California corporate income taxes by choosing the alternative approach.

Advocates for the traditional three-factor approach note that corporations benefit from a skilled workforce and infrastructure and related services, such as ports, police and fire services, and roads. By emphasizing sales over property and payroll, the proposed approach neglects the public costs of educating workers, building and maintaining infrastructure, and delivering services that allow businesses to prosper.

Who Would Benefit from the Have It Your Way Approach?

The proposed option would be limited to corporations that derive at least 50 percent of their income from activities in specified industries. Alternatively, corporations that earn at least $1 billion, but less than 50 percent of their total gross business receipts, from the same industries would also qualify for the alternative apportionment formula. Qualifying industries would include: wineries, pharmaceutical and medicine manufacturing, semiconductor machinery manufacturing, computer and peripheral equipment manufacturing, communications equipment manufacturing, semiconductor and other electronic component manufacturing, medical equipment and supplies manufacturing, software publishers, telecommunications (including paging, cellular, satellite, cable and other program distribution, resellers, and other telecommunications), motion picture and video industries (except video rental), radio and television broadcasting, cable and other subscription programming, and amusement parks and arcades. In addition, corporations that receive more than 50 percent of their gross receipts from oil and gas extraction, natural gas distribution, oil refining, gas stations, commodity contracts dealing, pipeline transportation, and several other oil and gas-related industries would be eligible to use the new formula.[1]

No other industries would be eligible to use the new formula. Also, this proposal would not benefit corporations that conduct all of their business in California, since they do not apportion their income for tax purposes.

By applying different rules to different industries, AB 1037 violates the basic principle that tax laws shouldn't discriminate between different types of economic activity. Economists argue that policies that provide special treatment to certain industries or activities lead to inefficiency and encourages businesses to consider the tax consequences of their decisions, rather than responding to market conditions.

Why Let Corporations Choose?

Proponents of AB 1037 have previously supported legislation that would have mandated the use of a formula that relies more heavily on sales. That approach, however, creates winners and losers. Some corporations would pay less under a mandatory superweighted sales factor; others would pay more. The current amendments ensure that no corporation pays more and that only public services lose from the reduction in corporate tax revenues.

Corporate Income Is Booming, Tax Payments Fail to Keep Pace with Income Growth

The income reported by California corporations for tax purposes is booming. Between 2001 and 2004, total net income reported for tax purposes increased more than three-fold (Figure 1). The income of apportioning corporations – which includes those corporations that would benefit from the current proposal – increased nearly seven-fold (682.0 percent) during the same period.[2] In contrast, the corporate income tax liability of corporations increased by slightly more than one-third (36.4 percent). Moreover, the total income reported by California residents for personal income tax purposes increased by just 10.7 percent during the same period and the hourly wage of the worker at the midpoint of the earnings distribution increased by 13.3 percent.

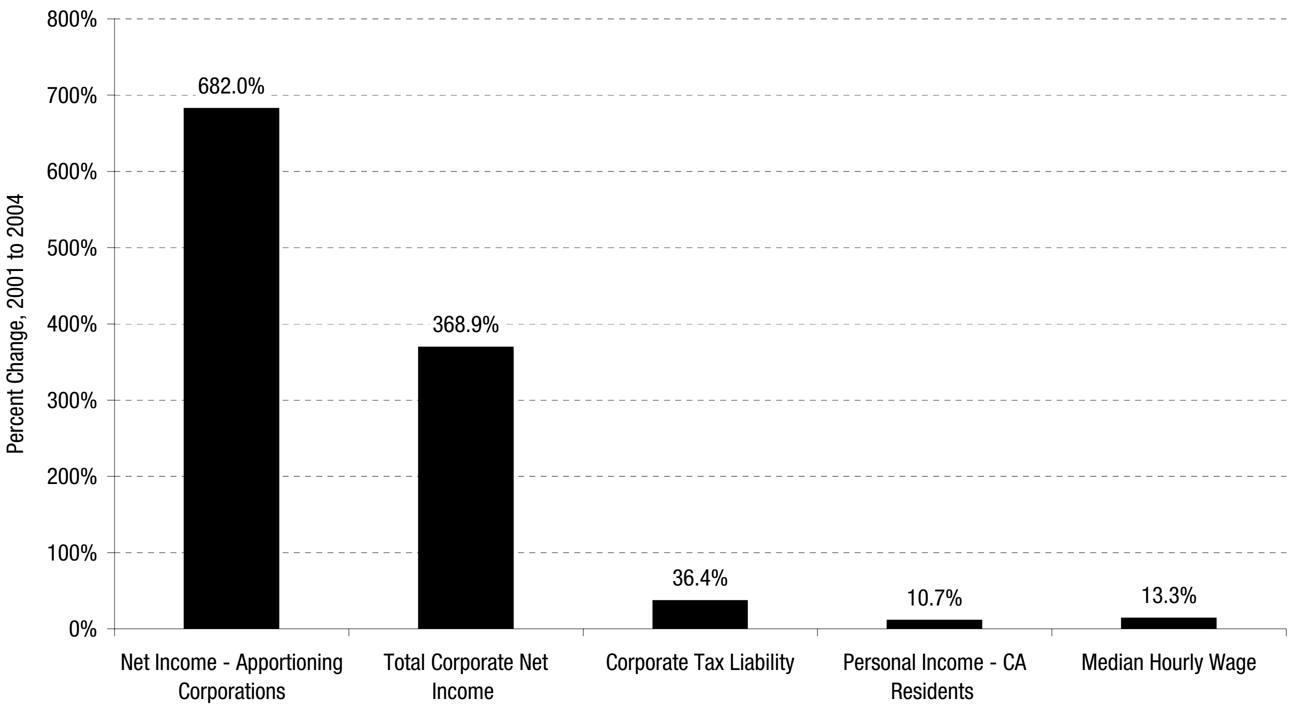
Supporters of a Superweighted Sales Factor Are Lobbying for Federal Law Changes That Would Make It Harder for States to Tax Profits Based on Sales

Many of the corporations that are lobbying for California to adopt a "superweighted" sales method of apportioning income for tax purposes are also supporters of a federal measure – H.R. 1956 also known as the Business Activity Tax Simplification Act – that would mean that the profits of particular corporations would no longer be subject to tax in particular states.[3] Taken together, these changes would substantially reduce corporate taxes paid to states in the aggregate.

Under a formula that relies mostly on sales, a corporation that produces all of its goods in one state, but has all of its customers in other states, would have minimal or no corporate income tax liability in the state where its production occurs. However, if this same corporation did not have physical presence, or nexus, for tax purposes in its customers' states, because the activities it conducted in those states would be no longer deemed nexus-creating under H.R. 1956, then most of this corporation's profit would become "nowhere income" – profit not subject to tax by any state.

H.R. 1956 would make it harder for states to establish nexus, or taxing authority, for state corporate income tax purposes. Specifically, H.R. 1956 would allow some businesses to have a

Figure 1: Apportioning Corporations' Income Growth Far Outstrips That of Personal Income and Wages



Note: All data are for California. Personal income is income reported by California residents for tax purposes.
Source: Franchise Tax Board, Department of Finance, and CBP analysis of Current Population Survey data

physical presence in a state without creating nexus by creating a number of "safe harbors." For example, the bill allows a corporation to have an unlimited amount of employees and property in a state without creating nexus, so long as neither is present in the state on more than 21 days within a particular year. H.R. 1956 also provides that a corporation cannot be subject to a state corporate income tax if its only activity within a state is "solicitation of orders" of tangible goods, followed by delivery of the goods from an out-of-state origination point. The protected "solicitation" may be conducted by advertising alone or by traveling salespeople. H.R. 1956 would expand these provisions to service-producing corporations.

California's revenue loss from these two proposals taken together would likely be much larger than that from either measure alone. Supporters of both changes are seeking to create more "nowhere income," notwithstanding claims that theses measures are only intended to regulate which states can tax a corporation and not to affect the aggregate taxation of corporate income.

How Much Does California Stand to Lose?

Estimates suggest that allowing corporations the option of using the new formula would cost in excess of $100 million per year. Major beneficiaries would include the oil and gas industry, which stands to pay $34 million less in California corporate income taxes, and the film industry, which stands to save some $18 million. AB 1037 also includes a provision that changes the way income from certain transactions involving the treasury function of a corporation's trade or business is classified for tax purposes. How much of the revenue that would be raised by this provision is "new money" is an open question due to pending litigation. If California's Franchise Tax Board prevails in the current litigation, the state will receive certain revenues sooner, but the amount received over time will not change and the only impact of AB 1037 will be the loss attributable to the shift to an elective quadruple sales factor formula.

Jean Ross prepared this Budget Brief. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, individual donations, and subscriptions. Please visit the CBP's website at www.cbp.org.

ENDNOTES

1 These industries currently apportion their income based on a formula that equally weights payroll, property, and sales.

2 Corporations that do business in California and other states and countries are known as apportioning corporations. That is because they apportion some of their income – based on a formula – to California for tax purposes.

3 Supporters of AB 1037 that also support H.R. 1956 include the American Electronics Association, Apple Computer, Cisco Systems, the Motion Picture Association of America, and the Walt Disney Company.