California's Tax System – Report #4

Corporate Franchise (Income) Tax Weakness & Possible Remedies: Low Conformity to the Federal Income Tax Law

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This is one in a series of reports on weaknesses in California's tax system. Report #1 listed several structural weaknesses and policy issues that exist in most of California's taxes and the system overall. Subsequent reports provide further details on each of the weaknesses and issues, along with possible remedies. The purpose of this series of reports is to help promote serious discussion on the need to and the ways to bring California's tax system into the 21st century so it may best promote economic growth, be more equitable, efficiently meet state revenue needs, reduce taxpayer frustration, and be understandable and transparent. A blog accompanies these reports to enable online discussion and a website exists to access the reports and the blog:

http://www.cob.sjsu.edu/nellen_a/TaxReform/21st_century_taxation.htm

Introduction to the California Corporation Tax Law

Corporations doing business in California or with California income are generally subject to corporate tax as follows

1. Corporation Franchise Tax (if incorporated or organized in the state, qualified or registered to do business in the state, or doing business in the state)
2. Corporation Income Tax (if does not meet the standard for the franchise tax (is protected by P.L. 86-272[1]), but derives income from the state)

Revenue & Taxation (R&T) Section 23151(a) and (e) provide:

> With the exception of banks and financial corporations, every corporation doing business within the limits of this state and not expressly exempted from taxation by the provisions of the Constitution of this state or by this part, shall annually pay to the state, for the privilege of exercising its corporate franchises within this state, a tax according to or measured by its net income, to be computed at the rate of 8.84 percent upon the basis of its net income for the next preceding income year, or if greater, the minimum tax specified in Section 23153.

The rate for both the franchise tax and the income tax has been 8.84% since years beginning on or after January 1, 1997. From 1987 to 1996, the rate was 9.3% and from 1980 to 1986, the rate was 9.6%. This a flat rate tax (no graduated rates). In contrast, the California personal income tax (PIT) rate structure has six graduated rates from 1% to 9.3% as well as a top rate of 10.3% on income over $1 million. Corporations subject to the franchise tax (not the income tax) with zero or minimal net income will owe a

[1] FTB Publication 1063: *California Corporation Tax Law – A Guide for Corporations*. P.L. 86-272 (1959) prohibits a state from imposing tax on interstate commerce if the business's activities in the state consist only of soliciting orders for sales of tangible personal property where the orders are sent outside of the state for approval and the goods are shipped in from outside of the state.

minimum tax of $800. A flat rate of 10.84% applies to banks and financial corporations and those subject to the franchise tax are also subject to the $800 minimum tax.

The computation of the California franchise or income tax is similar to that for federal taxable income although California law does not conform to all federal income tax provisions (see discussion below). As of July 2007, the corporate income tax conforms to the Internal Revenue Code (federal tax law) as it existed on January 1, 2005, with various exceptions.[2]

Corporations may calculate California net income either by starting with federal tax return information and making adjustments or maintaining records based on California tax law. The reporting form is Form 100.

If a corporation has business activities both in California and outside of California, it must apportion its income to California to determine its California tax liability. California uses an apportionment formula that looks at three factors: payroll, property and sales. Ratios are calculated for each where, for example, California payroll is in the numerator and all payroll is in the denominator. The sales ratio is doubled and added to the payroll and property ratio with the sum divided by four to get the apportionment factor. Not all states follow the same apportionment formula.

The California Corporation Tax Law is administered by the Franchise Tax Board (FTB).

Weakness: There are many federal income tax provisions that California does not conform to under the California Corporation Tax Law.

Remedy: Improve the level and timeliness of conformity to federal income tax rules in order to simplify the California Corporation Tax Law, reduce the likelihood of errors and provide further incentive for corporations to take advantage of federal incentives.

Conformity

When changes are made to the federal income tax (changes to the Internal Revenue Code), California does not automatically adopt such provisions. Instead, legislation is needed to adopt most of the changes. This can be done piecemeal with individual tax bills conforming to a particular federal changes or by one bill that adopts the federal law as of a certain date with specified exceptions.

Some federal changes may not be applicable for state purposes. For example, California does not conform to provisions of the Katrina Emergency Tax Relief Act. Also, legislators may decide not to adopt all of the federal changes or may not do so with the same effective date as the federal change. Thus, deductions or special rules that apply for federal purposes may not apply in calculating California net income. Where corporations are unaware of the differences, they may make errors on their California returns. For some federal incentives, such as bonus depreciation on new equipment, the lack of a California benefit may reduce the likelihood that a corporation will take advantage of the federal incentive, thus weakening the effect of the incentive on the economy. Differences also exist in the types of and calculation of various tax credits.

Examples of areas where California Corporation Tax Law does not conform to federal income tax rules:

- Depreciation rules
- Bonus depreciation
- Expensing of certain environmental remediation costs
- Special deduction for donations of scientific or computer equipment

[2] FTB Conformity Web site at http://www.ftb.ca.gov/forms/updates/conformity.html.

- Exempting small corporations from AMT (alternative minimum tax)
- IRC Section 199 manufacturing deduction
- Net operating loss carryover periods and California generally does not allow for full use of NOLs
- California imposes an entity level tax of 1.5% on Subchapter S corporations while federal income law generally only imposes a single layer of tax when the S income is passed through to shareholders

The FTB is required to provide an annual report to the legislature on changes to the federal law and the estimated revenue impact of California conformity to the changes. The text of this provision follows:

Revenue & Taxation §19522 **-** Report to Legislature of changes in Internal Revenue Code; Proposed changes in section 17024.5

(a)**(**1)

(A) On or before the 10th of January each year, the Franchise Tax Board shall submit to the Legislature a report on all changes to the Internal Revenue Code enacted into law in the prior year. To the extent possible, the report shall contain an estimate of the revenue effect of conforming California law to each of those changes.

(B) In the event that changes to the Internal Revenue Code are enacted after September 15 of any year, the report described in subparagraph (A) shall be submitted to the Legislature within 120 days after signature by the President of the United States, rather than the 10th of January.

(2) The report required by this section shall be made available to the public.

(3) It is the intent of the Legislature that the policy committee of each house of the Legislature hold at least one public hearing on the report required by this section.

(b) For any introduced bill which proposes changes in any of the dates in Section 17024.5, the Franchise Tax Board shall prepare a complete analysis of the bill which describes all changes to state law which will automatically occur by reference to federal law as of the changed date. The Franchise Tax Board shall immediately update and supplement that analysis upon any amendment to the bill. That analysis shall be made available to the public and shall be submitted to the Legislature for publication in the daily journal of each house of the Legislature. The digest of the Legislative Counsel shall indicate that an analysis of the bill shall be prepared by the Franchise Tax Board and printed in the daily journal of each house of the Legislature.

The reports can be quite lengthy and involve many revenue estimates due to the large number of federal changes that often occur. For example, the FTB's report on 2006 federal changes is almost 700 pages. The FTB maintains a conformity web site with the reports and summary information on federal-California differences (http://www.ftb.ca.gov/forms/updates/conformity.html). R&T §17024.5 provides information on the dates and details of California conformity to federal law.

Differences between federal and California income tax rules can cause a variety of problems for taxpayers:

1. Errors: Corporations that not aware that California does not conform to a particular federal provision are likely to calculate their corporate income tax incorrectly, potentially subjecting themselves to penalties and interest.
2. Reduced effectiveness of some federal provisions: Where the federal law provides a taxpayer favorable rule that is not allowed in California, some taxpayers may decide not to take advantage of the federal provision in order to avoid additional California tax liabilities or to avoid having to track different tax attribute amounts for federal and California purposes.
3. Additional recordkeeping: Differences in federal and state rules can also require corporations to keep two sets of records – one tracking federal tax attributes and the other state tax attributes. For example, differences in federal and state depreciation rules requires taxpayers to keep two sets of depreciation records so that they know the federal and California adjusted basis of each piece of property so they can calculate federal and state gain or loss upon disposition of the property.

Challenges

Often, California and federal income tax rules are not identical because the state may have good reasons for not conforming to a particular federal rule. For example, legislators may find that the state would lose too much revenue or have to increase tax rates if it adopted a new or expanded credit or deduction allowed for federal income tax purposes. Thus, it would be difficult to achieve complete conformity with federal income tax rules.

Recommendations

The legislature needs to state how it will conform to new federal tax legislation earlier than it currently does. Confusion results when taxpayers must plan and file returns with different federal and California rules which may conform in a future year. A solution would be to enact legislation that California automatically conforms to federal law changes (other than tax rate changes) effective 30 days after enactment of the federal law. This provides the legislature 30 days to enact legislation to not conform to a particular provision. While the time frame is short, it is usually clear by tracking federal legislation to know when it is likely that a tax bill will pass and be signed by the President. Most details of the legislation are known months in advance providing opportunities for legislators and tax administrators to identify possible provisions where conformity would not be in the best interests of the state. Thus, there is no need to wait until the signing of the federal law to start drafting California legislation. The benefits of this approach would be more deliberate and timely consideration of whether California law will conform to federal law. This will make tax planning and compliance easier for most individuals.

The FTB should review the areas where the California Corporation Tax does not conform to federal rules. The advantages and disadvantages of conforming to the provisions should be analyzed. For example, since 1986, the federal government has allowed more generous depreciation deductions than California has.

Legislators and FTB staff should consider testifying before Congress periodically to encourage tax reductions through rate changes rather than the creation of new tax preferences (which raise conformity issues, as well as complexity to the tax law in general).

California will not want to conform to all federal changes as some may represent significant revenue costs for the state or represent bad tax policy. Legislators may also want to consider areas where non-conformity would be beneficial for the state such as if a federal provision is an unneeded incentive.

Tax Policy Analysis[3]

The following chart explains how better conformity efforts would satisfy the principles of good tax policy. The rating in the last column indicates how better conformity practices would improve the current system.

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[3] This analysis uses a document prepared by the American Institute of Certified Public Accountants (AICPA) Tax Division and altered to the above format by Joint Venture: Silicon Valley Network. The AICPA document, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals* (2001) is available at http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf. The Joint Venture workbook is available at http://www.jointventure.org/PDF/taxworkbook.pdf. The principles laid out in these documents are frequently used tax policy analyses ones. For more information see Nellen, Policy Approach to Analyzing Tax Systems; available at http://www.cob.sjsu.edu/facstaff/nellen_a/Policy%20Approach%20to%20Analyzing%20Tax%20Systems.pdf. Note: The author of this report (Annette Nellen) was the lead author for both the AICPA and Joint Venture documents noted here.

Principle	Application and Analysis	Rating
Fairness		
Equity and Fairness Similarly situated taxpayers should be taxed similarly.	Likely no effect	
Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	Efforts to conform or announce non-conformity closer in time to the passage of federal tax legislation would help taxpayers to know what tax law applies for California purposes.	+
Operability		
Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	Efforts to conform or announce non-conformity closer in time to the passage of federal tax legislation would help taxpayers to know what tax law applies for California purposes.	+
Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	Likely no effect.	
Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	Efforts to conform or announce non-conformity closer in time to the passage of federal tax legislation would help taxpayers to know what tax law applies for California purposes and simplify compliance and tax planning.	+
Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	Efforts to conform or announce non-conformity closer in time to the passage of federal tax legislation would help taxpayers to know what tax law applies for California purposes which would simplify tax planning and compliance.	+
Minimum Tax Gap A tax should be structured to minimize non-compliance."	Better conformity efforts should reduce errors where individuals believe a federal preference applies for California purposes when it does not.	+
Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.	Likely no effect	
Appropriate Purpose and Goals		
Neutrality The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.	Likely no effect.	

Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.	Likely no effect.	

Additional Reading

Franchise Tax Board, *Publication 1063: California Corporation Tax Law – A Guide for Corporations*; available at http://www.ftb.ca.gov/forms/misc/1063.pdf.

R&T Sections 23101 – 23364a – California Franchise Tax

R&T Sections 23501 – 23572 – California Income Tax