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CHANGES TO THE FEDERAL CORPORATE TAX SYSTEM AND THEIR POTENTIAL IMPACT ON CALIFORNIA

Oksana G. Jaffe, Chief Consultant
California Assembly Committee on Revenue and Taxation
(916) 319-2098
oksana.jaffe@asm.ca.gov

HOW WOULD PROPOSED CHANGES TO THE FEDERAL CORPORATE TAX SYSTEM IMPACT CALIFORNIA?

◉ State Corporate Tax Systems

- State governments traditionally rely on the federal income tax system (definitions, forms, reporting requirements, federal regulations and other administrative pronouncements) in administering their own corporate tax laws.
- In California, corporations doing business in the state or with California income are generally subject to either the 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) or the Corporation Income Tax (if entity does not meet the standard for the franchise tax but derives income from the state).
- For the 2011-12 FY, California's Corporation Tax is projected to bring in approximately \$9.4 billion (11% of total state revenues). Some believe that a state corporate tax system is not cost-effective.

◉ Federal Corporate Tax Reform and California (overview)

- Direct impact on federal tax liabilities of California's residents.
- Indirect impact on state tax liabilities for corporations, either due to state corporate tax linkages to the federal tax system (via conformity) or to changes in taxpayer behavior induced by federal tax reform.
- Direct and indirect impact on the State and local governments. California may have to augment the FTB's budget if the federal CT system is fundamentally reformed and the state does not conform.

HOW WOULD PROPOSED CHANGES TO THE FEDERAL CORPORATE TAX SYSTEM IMPACT CALIFORNIA?

- ◉ Federal Corporate Tax Reform Proposals
 - In 2011, Congress evaluated various options for corporate tax reform. The House Ways and Means Committee had a series of hearings on corporate tax reform, and much discussion was centered on broadening the base (by eliminating various tax incentives) and reducing statutory rates. Discussions also included international tax reforms.
 - *Repeal of the Federal CT* will most likely lead to a repeal, or a substantial revision, of California's corporate tax system. The state will lose all the benefits of federal enforcement efforts, which may lead to increased tax penalties or augmentation of FTB's enforcement budget.
 - *If a Flat Tax or Some Type of a Federal Business Tax* is imposed, California may repeal its CT system and conform to a new federal tax regime (provided the new tax is broad-based, imposed at a low rate and easily implementable).
 - *A Simple Reduction of the Federal CT Rate* will not have much impact on California (other than a potential push to lower the state tax rate). However, a lower tax rate reduces the incentive for taxpayers to engage in tax avoidance. California may benefit because fewer taxpayers will find it cost-effective to engage in creative tax planning.
 - ✓ Most likely, the federal rate reduction will be implemented in conjunction with the corporate tax base broadening, which will impact CA.

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HOW WOULD PROPOSED CHANGES TO THE FEDERAL CORPORATE TAX SYSTEM IMPACT CALIFORNIA?

- *Broadening or Narrowing the Federal Tax Base* (repeal or extension of tax expenditures)
 - The Feds may choose to eliminate, revise or extend certain tax incentives that would *directly* impact the state of California.
 - Exclusion of Interest on State and Local Bonds (federally-subsidized debt, removal of which will significantly raise the borrowing costs for state and local governments).
 - Deduction for State and Local Taxes.
 - Special tax incentives, such as targeted jobs tax credit, new markets tax credit, empowerment zone employment credit, that indirectly benefit state and local governments.
 - The Feds may choose to eliminate, revise or extend certain tax incentives that would *indirectly* impact California through its corporate taxpayers.
 - The research and development credit, accelerated depreciation, etc.
 - CA may not follow the federal lead if the change will have a negative financial impact. Conversely, CA may not be able to broaden its CT base due to a potential increase in the tax burden for some taxpayers (Proposition 26).

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HOW WOULD PROPOSED CHANGES TO THE FEDERAL CORPORATE TAX SYSTEM IMPACT CALIFORNIA?

- Territorial System of Taxation
 - The most detailed proposal to date for a U.S. territorial system was developed by Ways and Means Committee Chairman Camp. It is intended to be revenue neutral over the 10-year budget period. Some of the provisions include:
 - A 95% DRD for qualified foreign-source dividends received by a corporate 10% US shareholder from a CFC, provided the CFC stock has been held for at least one year. No foreign tax credits would be available to offset the remaining tax of 1.25% (based on a 25% corporate tax rate). An 85% DRD would be allowed for dividends distributed from previously untaxed E&Ps, thus, the maximum tax rate on pre-enactment income would be 5.25%.
 - Three alternative options to expand Subpart F income (new subcategory of Subpart F of foreign base company “excess intangible” income, CFC income subject to a low foreign effective tax rate, and a new category for low-taxed worldwide income derived from intangibles, with a corresponding 40% deduction to the domestic corporation for income attributable solely to the foreign exploitation of intangibles).
 - Limitation on deductions for net interest expense of a US corporation that is a US shareholder with respect to a CFC, if both the US corporation and the CFC are members of a worldwide affiliated group.

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HOW WOULD PROPOSED CHANGES TO THE FEDERAL CORPORATE TAX SYSTEM IMPACT CALIFORNIA?

- Territorial System of Taxation
 - Other International Tax Proposals:
 - The Administration FY2012 budget proposes to defer deduction for the portion of domestic interest expense allocable or apportionable to untaxed foreign earnings. It would also limit the foreign tax credit by adopting a blending approach that reflects the rate of foreign tax on unremitted foreign earnings. Proposes the “excess returns” modification to Subpart F income.
 - Senator Wyden’s proposal would repeal deferral and apply a per-country limitation to foreign tax credit.
 - Potential Impact on California
 - US federal tax system is a blend of residence-based and territorial concepts. It taxes U.S. residents on their worldwide income and it taxes non-residents on certain U.S.-source income (ECI, FDAP income or gains). Deferral of active income of U.S. subsidiaries operating abroad is the third largest corporate tax expenditure.
 - California’s corporate tax system is a source-based system, which generally taxes worldwide income, as apportioned to the state. However, California allows corporations to elect to file on a water’s-edge basis.

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HOW WOULD PROPOSED CHANGES TO THE FEDERAL CORPORATE TAX SYSTEM IMPACT CALIFORNIA?

- *The 95% DRD Exclusion* will not affect California's law, but California may see an increase in revenues because of the potential increase in the amount of repatriated earnings brought back to the US and a lower 75% DRD in the case of a water's-edge election (Section 24111 of the R&T Code) than the proposed federal one of 95%. It may even act as an incentive for companies to move back to worldwide combined reporting, instead of a water's-edge election, because intercompany dividends are generally eliminated under the worldwide method.
- A *pure territorial approach* - an exclusion of foreign source income - would be detrimental to California's administration of its CT laws. Federal Form 1120 is a starting point for the CA corporate tax return. If foreign-source income is excluded from that return, CA will have no information readily available to it to identify if the taxpayer should have included that income in its CA return. Thus, it would present certain compliance and enforcement issues for the Franchise Tax Board.
- Expansion of the definition of Subpart F income by creating *additional categories of Subpart F income* will directly impact California because of the state's automatic conformity to the definition of Subpart F income (Sec. 25116, Cal. Revenue and Taxation Code).
- Limitations on Interest Expense Deductions. Existing CA law has its own rules governing interest expense deductions, so the proposed limitations will not have much of an impact on California CT system. (Reg. 24344(c)).

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CAN CALIFORNIA CONFORM?

◎ Tax Conformity

- Several approaches to conformity:
 - "Rolling" conformity (automatic conformity to the latest version of the Internal Revenue Code (IRC)).
 - "Fixed" or "static" conformity (where the IRC is followed as of a certain, fixed date).
 - "Selective" conformity (adoption of only certain provisions or certain provisions as of certain dates). California is a "selective" conformity state.

◎ Advantages of State Tax Conformity

- Uniformity and simplicity promotes ease of compliance and the efficient administration of taxes.
- Reduced compliance costs for both tax agencies and taxpayers.
- Increased predictability when taxpayers and state administrative personnel can rely on federal administrative guidance.
- Minimization of Tax Avoidance.

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CAN CALIFORNIA CONFORM?

- ◉ Challenges of State Tax Conformity
 - Loss of legislative decision-making authority over state tax policy.
 - Delays in legislative action when a state needs to conform to new legislation affirmatively (political gridlock).
 - Loss of control over state revenues.
 - The acceptance of federal administrative guidance as persuasive authority in interpreting California statutes may lead to unanticipated results.