State of California
Franchise Tax Board

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Net Receipts Tax Analysis

Memorandum

You have asked for any concerns or thoughts that the staff of the Franchise Tax Board may have regarding the adoption and imposition of a net receipts tax by California. As we understand the proposal, it would be similar to the system utilized in the State of Michigan, where the tax is imposed on all gross receipts of the taxpayer, with a deduction for purchases from other firms. The tax is imposed on a unitary group basis utilizing a combined reporting approach. The net receipts of all members are added together (after removing intercompany transactions) and apportioned to the state through the use of a single sales factor apportionment mechanism.

The use of a unitary combined report and apportionment would be the best approach for such a tax as it would allow for the elimination of intercompany sales, which can be manipulated and used for planning, as well as pull in net receipts that would otherwise escape inclusion due to nexus concerns.

The major differences between the proposal suggested for California and the Michigan system would be the scope of the deduction for purchases from other firms, and perhaps the scope of the unitary group. The Michigan system does not allow a deduction for services purchased, but the proposed California system would allow such deductions. Furthermore, the Michigan system appears to be a water's-edge system while California imposes world-wide combined reporting with a water's-edge election mechanism.

After reviewing the Michigan system and the California proposal, staff has the following areas of concern:

1. Scope of the proposal: Should the tax be imposed on financial firms or insurance firms in addition to other types of businesses?

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Staff believes that the proposal should exclude these firms. Insurance companies are exempted from all taxes other than the gross premiums tax by the California Constitution and could not be subject to this new tax without amending the state constitution. Financials could be subjected to the new tax, but without addressing the industry with a specific set of rules, financials could be heavily impacted by the proposal, as the margins of financials are very low, gross receipts can be very high (if they are even tracked), and they may not have much in the way of deductions for purchases from other firms.

2. Use of the Unitary Business method of computing net receipts.

   If the unitary method is utilized, numerous issues arise regarding nexus, combined reporting and apportionment:

   a. Will intercompany sales be eliminated using the same system utilized for the corporate franchise tax? Perhaps not. The franchise tax rules seem overly complex as the franchise tax system is based on deferring intercompany transactions and then recognizing the gain in a later reporting period when a triggering event, such as disaffiliation or disposition of the asset outside the group, occurs. This is unnecessary in the net receipts context, as the net receipts tax is measuring value added in a specific reporting period. When the goods are finally sold to third parties, the gross receipts will be subject to the new tax in that period. Under this proposal, there is no need to track basis or be overly concerned with deferred amounts. This should allow a simpler system to suffice, such as simply subtracting out all sales made to, or purchases from, other members of the group for both the calculation of the tax base and the apportionment formula.
   b. Intrastate Apportionment: Since more than one taxpayer may be present in the state, there will need to be specific rules regarding liability for the tax. In the franchise tax context, the tax is spread among the taxpayer-members through intrastate apportionment. With the new system there should be thought given to utilizing joint and several liability and a consolidated tax obligation to avoid the complexities of the franchise tax system (such as sharing credits, Finnigan/Joyce and tracking individual tax payments).
   c. Will this tax be subject to P.L. 86-272? This is an issue that is unresolved in Michigan at this time. P.L. 86-272 only applies to net income taxes. Therefore, it is important to know how the new tax will be viewed by the courts. Since there is a deduction mechanism (all purchases from other firms) there is an argument that the net receipts tax is a form of tax imposed on net income (albeit with few deductions). If P.L. 86-272 applies, it would be possible to avoid imposition of the tax by creating a nexus remote entity to make sales into the state.
   d. Will this tax require tracking of NOLs? It may be possible that in a given year a taxpayer could have more purchases than it has gross receipts, simply due to the timing of large purchases. If this occurs, should the excess purchases be tracked and allowed as a deduction in the next year? Similar to the discussion regarding intercompany sales, it seems overly complex and unnecessary to allow for NOLs outside of an income tax context. This tax seems more transactional than an income tax and prior period expenses and income should not be relevant. Furthermore, if an NOL is allowed, this makes the tax look more like an income tax and could be supportive of a determination that P.L. 86-272 should apply. Michigan does not allow NOLs in the GRT context.
   e. What apportionment rules should be used for the sales factor? The newly adopted rules for apportionment that take effect in 2011, along with the existing Revenue and

Taxation Code section 25135 rules for tangible property, should suffice as they are all market rules and will properly reflect the level of a taxpayer's California activity.

Additional Concerns Raised:

1. Sham purchases. Could a California business try to evade this tax by sham-purchasing qualified property/services from an out-of-state business with no nexus? Yes, but this would seems no different than a sham transaction in the income tax context and would be disallowed. In addition, if the nexus threshold is low (economic presence), the out of state entity would itself become a taxpayer such that the tax would be collected from them. Also, keep in mind that related party transactions are eliminated.

2. What about leases? Would that be a way to get out of paying this tax – leasing rather than buying? Yes, therefore a lease payment should be deemed a purchase by the lessee and a gross receipt to the lessor. Of course, if the gross receipt is the lease payment, then the tax would still be less to the seller than if they simply sold the item. However the buyer would similarly have a smaller deduction.

3. Is an inventory method for purchases necessary? A rule to provide how to account for purchases in a consistent manner would be desirable. A First in – First out method would accomplish this goal. Michigan allows the taxpayer to use the same inventory method it uses for federal tax purposes. Services and other items that are not properly considered inventory also need a rule, such as deducting them in the year in which the expense was taken or the item capitalized for income tax purposes. The Michigan rule provides that the year of acquisition is the year in which the item may be fully deducted as a purchase against the gross receipts tax. The Michigan rule is as follows:

   > "Purchases from other firms" means all of the following:
   >
   > . . . Assets, including the costs of fabrication and installation, *acquired during the tax year* of a type that are, or under the internal revenue code will become, eligible for depreciation, amortization, or accelerated capital cost recovery for federal income tax purposes.
   >
   > Mich. Comp. Laws Ann. § 208.1113(6). (Emphasis added.)

4. Should Pass-through Entities pay the tax on a separate return or should their receipts flow up to the partners and be taxed at the partner level? The partnership level seems the better approach. Currently, partnerships already provide an information return, so the tax could be imposed on the basis of the information reported on that return. This is the simplest way to assure that pass-through entities report and pay the tax. The partnership has all of the sales and purchase information and there would be no need to pass this information along to partners, avoiding possibly complex partnership allocations. However, if the tax is imposed at the partnership level, there could be a double tax of the receipts, as the receipts could also flow up to the partners and be included on their returns as well. Therefore a credit mechanism for tax paid at the partnership level would be appropriate.

   The Michigan approach is different, as Michigan imposes the tax at the partnership level, but does not allow a credit if the income is passed on to another taxpayer. Michigan does not consider individuals as taxpayers for purposes of the gross receipts tax, therefore there is no double tax if the partner is an individual.

5. How do you define gross receipts? As you are aware, there has been significant litigation in California over the meaning of the term "gross receipts" for apportionment purposes. Starting in 2011, gross receipts under Revenue and Taxation Code section 25120 are defined to not include a whole "laundry list" of items:

   (A) Repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, certificate of deposit, or similar marketable instrument.
   (B) The principal amount received under a repurchase agreement or other transaction properly characterized as a loan.
   (C) Proceeds from issuance of the taxpayer's own stock or from sale of treasury stock.
   (D) Damages and other amounts received as the result of litigation.
   (E) Property acquired by an agent on behalf of another.
   (F) Tax refunds and other tax benefit recoveries.
   (G) Pension reversions.
   (H) Contributions to capital (except for sales of securities by securities dealers).
   (I) Income from discharge of indebtedness.
   (J) Amounts realized from exchanges of inventory that are not recognized under the Internal Revenue Code.
   (K) Amounts received from transactions in intangible assets held in connection with a treasury function of the taxpayer's unitary business and the gross receipts and overall net gains from the maturity, redemption, sale, exchange, or other disposition of those intangible assets. For purposes of this subparagraph, "treasury function" means the pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the taxpayer's trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, and business acquisitions, and also includes the use of futures contracts and options contracts to hedge foreign currency fluctuations. A taxpayer principally engaged in the trade or business of purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function, such as a registered broker-dealer, is not performing a treasury function, for purposes of this subparagraph, with respect to income so produced.
   (L) Amounts received from hedging transactions involving intangible assets. A "hedging transaction" means a transaction related to the taxpayer's trading function involving futures and options transactions for the purpose of hedging price risk of the products or commodities consumed, produced, or sold by the taxpayer.

Should the definition of gross receipts for either the apportionment formula or for the calculation of the tax base be different for this tax? Staff believes there are sound policy reasons to exclude the above items for all purposes. In general these receipts are not receipts for the products or services sold by the taxpayer and consumed in the state. As the receipts tax is a form of consumption tax, when coupled with a sales factor apportionment formula, it seems proper to exclude these activities. These transactions are instead extraneous transactions that could over-inflate the apportionment formula and/or the tax base. Of course, the exclusion of these amounts will reduce the base and could affect the revenue generated by the tax (or would necessitate a higher rate). Michigan, for instance, would impose the tax on discharge of indebtedness, but hedging activities and treasury function activities are excluded. (Mich. Comp. Laws Ann. § 208.1111(1)(p).)

6. Who should administer the new tax? SBE certainly has familiarity with consumption taxes and would be familiar with determining the sales of the taxpayer. However, most of the rules are similar to rules in the franchise tax arena. Unitary determinations, group returns and apportionment are all more familiar to the FTB than the SBE. FTB seems a more suitable agency to administer the tax.

Conclusion

A net receipts tax similar to the tax in Michigan may provide the state with a more stable revenue stream and will allow the consumption of services to be taxed, which is not the case in the current system. The complexities are similar to those that exist in the corporate franchise tax context. Apportionment issues, unitary business issues and combined reporting issues will be common to both the net receipts tax and the corporate franchise tax. There may be some areas that can be simplified for the net receipts tax that will allow for less of a compliance burden, but in the end, the system will still be more complex than a standard gross receipts tax. Please feel free to contact staff if there are additional areas of concern which you wish us to address specifically.

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