Commission on the 21ST Century Economy

Revised Preliminary Overview

Business Net Receipts Tax

The following provides an overview of a tax the Commission on the 21st Century Economy is considering as part of a package of tax reforms. The tax being examined is based on the subtraction-method value-added concept of taxation and tentatively termed a Business Net Receipts Tax (BNRT). This report aims to provide guidance about the nature of the tax and its application.

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Introduction

The BNRT is designed to tax the value a business adds to its production of products and services in California and thus attempts to approximate the benefits of services and programs utilized by the business. A value added tax could accomplish several objectives as a component of the state's revenue system, including:

Broaden the tax base. The BNRT is a business-level tax and would broaden the tax base of California. It would tax all types of business organizations, including corporations, pass-through entities and sole proprietorships. It would subject businesses that provide services to a tax on the consumption of these services. The tax would include businesses that make a market in California but may have no physical presence in the state, consistent with existing law.

Improve tax competitiveness. The BNRT would allow for the reduction in the rate of the existing sales tax, and thus reduce the degree of multiple taxation of certain business inputs. The BNRT would also allow for a reduction in the marginal rates of California personal income taxes and the elimination of the corporation tax by imposing instead a low rate of tax on all productive activity in the state.

Stabilize tax revenue. The BNRT would be used to reduce the state's reliance on more volatile sources of revenues, such as the personal and corporation income taxes. In addition, the tax would grow along with state economic growth and is likely to be more stable and more reflective of the state's underlying economy than some existing sources of state revenue.

General

Calculation of Tax. The base on which the tax is imposed is the net receipts of a business. In simple terms, net receipts is calculated first by aggregating the gross receipts, which is the gross amount the business receives from all sources, such as sale or exchange of property, performance of services or the use of property or capital in a trade or business. Next, all purchases, such as those from all other firms, are aggregated and then subtracted from gross receipts, resulting in the business's net receipts. This would then be multiplied by the BNRT rate to calculate the tax liability of the business.

The formula, in general terms, would look as follows:

(1) Gross Receipts - Purchases from Other Firms = Net Receipts

(2) Net Receipts * BNRT Rate = BNRT Liability

Examples of gross receipts would be the payment to a business for providing professional services or selling materials and equipment. Simple examples of purchases from other firms that would be deductible from gross receipts would include payment for professional services or the cost of capital equipment. Businesses would not be allowed to deduct most employee compensation and non-financial businesses would not be allowed to deduct interest payments. A research and development credit equal to ***x*** percent of qualified expenditures on research and development ***y*** percent for basic research could be applied against the BNRT liability.

Entity Application. The BNRT would apply to all business entities that are considered to be "doing business" in California. Such businesses would include sole proprietorships, pass-through entities and corporations.[1] It would not include federal, state and local governments or non-profits, including health and education services. There would be a small business filing threshold set at $500,000 in gross receipts. In addition, net receipts of $250,000 or less would effectively be excluded from the BNRT base through a credit mechanism. This exclusion would be phased-out based on a graduated schedule. The BNRT would be an entity level tax, not a transaction-by-transaction tax, and would be paid by a business through quarterly estimated payments through the business's tax year.

Economic Presence Test. Businesses subject to the BNRT would include all entities deemed to be "doing business" in California. We are contemplating that a business entity would be deemed to be doing business in California if any of the following conditions hold:

- The business is organized or commercially domiciled in California.

[1] The BNRT would apply to all forms of doing business, including sole proprietorships, pass-through entities (general partnerships, limited partnerships, S corporations, limited liability companies, limited liability partnerships and entities that check the box to be treated as partnerships for tax purposes), and corporations (C corps and business entities that check the corporations box for tax purposes. The tax would not apply to insurance companies, which would remain subject to the gross premiums tax. It would apply only to unrelated business activities of exempt organizations.

- Sales of the business in California exceed the lesser of $500,000 or 25 percent of a taxpayer's total sales.
- The real property and tangible personal property of the business in California exceed the lesser of $50,000 or 25 percent of a taxpayer's total real property or tangible personal property.
- The amount paid in California by entity to the employee for compensation exceeds the lesser of $50,000 or 25 percent of the total compensation paid by the taxpayer.

This definition of "doing business" is consistent with California Revenue & Taxation Code (R&TC) section 23101, effective January 2011.

Tax Rate. The BNRT would be levied at the rate of ***x*** percent on the net receipts of all non-financial institutions and the rate of ***y*** percent on all financial institutions (as discussed below).

Multistate Businesses

Unitary Method. For single businesses operating inside and outside of California, the BNRT would rely on the unitary method. The unitary method would also apply to groups of affiliated businesses that effectively operate as a single integrated business. Business entities could operate one or more unitary businesses, and each of the unitary businesses would be accounted for separately. All types of business entities could be included in the unitary group, including pass-through entities and sole proprietorships. Estates, except to the extent that the estate continues to operate a business of a taxpayer, and trusts, other than business trusts, would not be subject to the tax and would not be included in a unitary group.

Combination. The business net receipts of a unitary group would be the sum of the net receipts of each entity that are included in the unitary business group. For purposes of the calculation of the net receipts for each of the members of the unitary group, transactions within the group would be eliminated using rules similar to those used under the existing Corporation Income Tax Law. The net receipts of each of the members of the unitary group would be calculated and aggregated.

Water's Edge. A unitary group would file on a water's-edge basis. Worldwide reporting would not be allowed. The water's-edge group would be similar to current law.[2] Thus, affiliated businesses organized in the U.S are considered inside the water's edge, while businesses organized outside of the U.S. would generally be considered outside the water's-edge and not be included (except to the extent of their U.S. activities). Businesses with activities in tax haven jurisdictions would also include these activities in the water's edge return.

Business/Non-Business Receipts. As in the current corporate income tax system, business receipts and non-business receipts are considered differently for purposes of determining the BNRT. Business receipts are those receipts that arise from the conduct of a trade or business. This type of receipt would be apportioned based on the formula set forth below. Staff recommends that non-business receipts would not be apportioned, but rather allocated in full to a single location using the current non-business rules. All non-business net receipts would be added to the apportioned business net receipts to

[2] Sub-part F corporations would not be included in the water's-edge group.

determine total net receipts from California subject to the tax. Non-business activities would constitute a gross receipt but not be included in the sales factor.

Apportionment. Combined aggregate business net receipts of a unitary group (or a single business with multi-state operations) would be apportioned using single-factor sales.[3] Nonbusiness net receipts allocated to California would be combined with apportioned net receipts to determine aggregate net receipts subject to tax. If any member of the unitary group has nexus in California, all sales in this state by any of the members of the unitary group would be included in the numerator of the single factor sales (*Finnigan* Rule). For purposes of calculating the sales factor, the numerator would consist of sales in California and the denominator equal to sales everywhere. Occasional sales, as defined under current law, would be eliminated from the numerator and the denominator of the apportionment factor (but remain in the tax base).

Sales of tangible property would be assigned to California based on California Revenue & Taxation Code (R&TC) section 25135, as it will read effective January 1, 2011. Sales of services and intangibles would be assigned to California according to revised California R&TC section 25136, as it will be effective January 1, 2011.

Calculated aggregate net receipts would then be multiplied by the BNRT rate to calculate the tax liability of the business.

The formula can be depicted as follows:

(1) Gross Receipts of X - Purchases from Other Firms by X = Net Receipts of X

(2) Gross Receipts of Y - Purchases from Other Firms by Y = Net Receipts of Y

(3) Net Receipts X + Net Receipts Y = Net Apportioned Receipts Total

(4) Net Apportioned Receipts Total * (California Sales of X/Sales Everywhere) = California Apportioned Net Receipts of X

(5) Net Apportioned Receipts Total * (California Sales of Y/Sales Everywhere) = California Apportioned Net Receipts of Y

(6) California Apportioned Net Receipts of X + Non-Business receipts of X =

California Total Net Receipts of X

(7) California Apportioned Net Receipts + Non-Business receipts of Y = California Total Net Receipts of Y

(8) California Total Net Receipts for X * BNRT Rate = BNRT Liability for X

(9) California Total Net Receipts for Y * BNRT Rate = BNRT Liability for Y

[3] Business receipts of the unitary group would be subject to apportionment. Non-business receipts would be allocated rather than apportioned.

"Sales" will be defined consistent with the definition of gross receipts for the tax base discussed below, with certain exceptions, such as occasional sales and non-business items.

Gross Receipts and Purchases for Non-Financials

Gross Receipts. The definition of gross receipts is in general to be interpreted broadly, but within the context of goods and services sold by the taxpayer and consumed in the state. Thus, gross receipts for non-financial businesses would include amounts received on the sale or exchange of property, the performance of services, or the use of property or capital, including rents and royalties, in the trade or business of the taxpayer. Realization of gross receipts would be based on current law under the corporation income tax. Gross receipts would not include any receipts included in the measure of tax paid by any other taxpayer.

Gross receipts would exclude extraneous transactions that are not related to the sale of products or services, largely resulting from financial transactions. For example interest and dividends received would be excluded, as would principal received upon maturity of a bond, or the repayment of the principal of a loan. Specifically, the following would be excluded: interest income received; repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, certificate of deposit, or marketable instrument; the amount of principal received under a repurchase agreement or other transaction properly characterized as a loan; proceeds from issuance of taxpayer's own stock or from the sale of treasury stock; damages or other amounts received as the result of litigation; property acquired by an agent on behalf of another; tax refunds; pension reversions; contributions to capital (except for sales of securities by securities dealers); income from discharge of indebtedness; the price of commodities or other goods that are traded for similar or other goods, whether such trading is done for hedging or other purposes; the value of assets transferred in a like-kind exchange; amounts received from the maturity, redemption, sale, exchange, or other disposition of intangible assets held in connection with a treasury function of a taxpayer; amounts received from trading in stocks, bonds, derivative financial instruments including futures, forwards, and options; amounts received from selling accounts receivable if the sales that generated those accounts receivable are included in the taxpayer's gross receipts; amounts received from selling land and other assets that are not subject to depreciation, amortization, or depletion except to the extent of the gain on the sale of these assets; and, amounts received from the selling of all or part of a business except to the extent of the gain on the sale.

Purchases. The definition of purchases for non-financial businesses would include only rents, royalties, inventory purchased for resale, materials and supplies, services purchased during the year, and assets placed in service during the year. Each of these would be expensed and deducted from gross receipts.

Net Receipts. Net receipts are calculated by subtracting purchases and allowable asset expenses from gross receipts of the business. Purchases and allowable asset expenses in excess of gross receipts would result in zero net receipts. Purchases and allowable asset expenses in excess of gross receipts during the year could be carried forward and allowed as deductions from gross receipts in the ensuing period, not to exceed five years.

For pass-through entities, net receipts liabilities would be payable at the entity or partnership level. The BNRT liability would be deductible against the pass-through entity's income for purposes of calculating a partner's income tax liability. Thus, the personal income tax liability would be based on the pass-through income net of BNRT paid at the entity level. Similarly, for sole proprietorships, the BNRT liability would be deductible against the owner's income for purposes of calculating the owner's income tax liability.

Gross Receipts and Purchases for Financials

The BNRT is intended to reflect a value-added concept. For financial and investment companies, which buy and sell financial assets, to include financial and investment companies in the BNRT might require a different method of tax calculation than what other entities would use. The current plan is to include such financials institutions within the BNRT; however, the Commission recognizes the additional and complex issues that financials raise with respect to the design of the BNRT, some of which warrant further study. One alternative is to continue to tax financials as they are taxed under current law.

Definition of Financials. Financial institutions would include those businesses as set forth in R&TC section 23183, plus other businesses acting as financial intermediaries such as brokers and dealers, and other businesses with financial transactions linked to their non-financial commercial activities.

Calculation of Tax. Taxation of financial institutions as defined above would be based on the following: gross receipts for financials would include all those amounts included for non-financials, such as amounts realized on the sale or exchange of property, the performance of services, or the use of property or capital, including rents and royalties, in the trade or business of the taxpayer. In addition, gross receipts would include interest amounts received pursuant to financial transactions. Purchases would include all those purchases set forth under non-financials, above, as well, and interest expenses on financial transactions.

Transition Issues

Phase-In Period. The BNRT would be phased-in over a five-year period beginning in 2012. In the initial fiscal year, the tax rate for the BNRT would be ***x*** (***z*** for financial institutions) and increasing in increments until it reached the rate of ***y*** (***w*** for financial institutions) in fiscal year 2016.

Personal Income Tax, Sales and Use Tax, and Corporation Tax. During the five-year phase-in period, the personal income tax rates would be reduced and then the tax restructured. The state sales and use tax would have scheduled rate reductions during this period. The corporation tax would be eliminated in the initial year of the plan. By the end of the transition period, the state portion of the sales and use tax would be eliminated.

Carry-over Credits and Net Operating Losses (NOLs). Existing credits and NOLs under the corporation franchise and income tax could be used on a limited basis to reduce BNRT tax liabilities. Annual utilization of used NOLs and carryover credits from the Corporation Tax Law could not exceed five percent of the BNRT liability for the reporting entity. In addition, any unused NOLs and carryover credits from the Corporation Tax Law would be allowed to carry forward for up to 20 years under the BNRT as transition NOLs and credit carryovers, until exhausted, and any such amounts not used would expire at the end of that period.

Depreciation. Taxpayers would continue to use current depreciation, amortization and depletion allowance schedules for property acquired prior to 2012 to calculate the annual purchase deduction with respect to those assets under the BNRT after 2011.

Deferrals. Items being deferred under the Corporation Tax Law as of its repeal date, including expenses, gains and income would be recognized or deducted under the BNRT using the same methods and rules as under current law.

Capital Assets. In the case of capital assets acquired prior to the repeal date of the Corporation Tax Law, only the gain realized on the sale or other disposition of such assets will be includible in gross receipts, without regard to any non-recognition or other deferral rules under the existing Corporation Tax Law. Calculation of such gains shall be made using the basis rules under the existing Corporation Tax Law prior to its repeal.

Examples

Example 1

Small Business A1
Landscaping and Supplies
Activities Only in California

	$000	
Gross Receipts		
Landscaping Services Provided	2,500	
Sale of Supplies and Materials	1,000	
Consulting Services Provided	1,250	
Rental Income from Sublease	250	
Subtotal 1	5,000	
Purchases		
Building Rental	600	
Purchase of Supplies and Materials	1,500	
Utilities and Office Costs	120	
Purchased Services	60	
Subtotal 2	2,280	
Other Costs		
Employee Compensation		2,260
Interest Expense		60
Subtotal 3		2,320
Profit		400
Total Expenses and Profit	2,720	
Total Net Receipts (Subtotal 1 Less Subtotal 2)	2,720	
California Sales/Total Sales	100%	
Net Receipts Apportioned to California	2,720	
Net Receipts Tax Rate	4.5%	
Net Receipts Tax Liability	122	

Example 2

Medium Business A2
Professional Engineering Services
Nationwide

	$000	
Gross Receipts		
Direct Engineering Services	85,000	
Sales of Technical Manuals	25,000	
Lease from Technical Design Software	50,000	
Royalties from Proprietary Designs	40,000	
Subtotal 1	200,000	
Purchases		
Office Lease	6,000	
Utilities and Office Costs	3,000	
Equipment and Software Purchases	12,000	
Travel and Miscellaneous	15,000	
Professional Services	35,000	
Liability and Property Insurance	5,000	
Lease of Software	4,000	
Deductible Real Estate Purchases	12,000	
Subtotal 2	92,000	
Other Costs		
Employee Compensation		90,000
Interest Expense		8,000
Subtotal 3		98,000
Profit		10,000
Total Expenses and Profit	108,000	
Total Net Receipts (Subtotal 1 Less Subtotal 2)	108,000	
California Sales	25,000	
Total Sales	200,000	
California Sales/Total Sales	12.5%	
Net Receipts Apportioned to California	13,500	
Net Receipts Tax Rate	4.5%	
Net Receipts Tax Liability	608	