Commission on the 21ST Century Economy

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 and corporation income taxes, 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 received 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, purchases 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 equipment. Simple examples of purchases from other firms that would be deductible from gross receipts would include payment for professional services or equipment. Businesses would not be allowed to deduct employee compensation or interest payments.

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 exemption (filing threshold) for firms. Currently we are contemplating setting the filing threshold at $500,000 in California gross receipts. The BNRT would be an entity level tax, not a transaction-by-transaction tax, and would be paid by a business or unitary groups 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.
- 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.

[1] The BNRT would apply to all forms of doing business, including sole proprietorships, pass-through entities (general partnerships, limited partnerships, S corporations 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 institutions.

- The amount paid in California by 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 and trusts 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. 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 be included 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 determine total 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 net receipts of a unitary group (or a single business with multi-state operations) would be apportioned using single-factor sales.[3] 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:

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

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

OPTION

(a) The numerator would consist of sales in California and the denominator equal to sales everywhere.

OR

(b) The numerator would consist of mean sales in California over the most recent five tax years and the denominator equal to mean sales over the most recent five years everywhere.

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

“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 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. 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 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 and other tax benefit recoveries; 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, except as described below.

Assets placed in service during the year would be limited to amortizable, depletable, and depreciable assets. Assets would include purchases that were acquired in connection with the acquisition or construction of real property or other capital assets. The amount that would be deducted each year would be calculated in the following manner:

OPTION

(a) Immediately expensed in the year placed in service.

OR

(b) Depreciated, amortized, or depleted in accordance with federal law as set forth in the Internal Revenue Code effective January 1, 2009, plus interest. Interest will be computed based on the interest rate paid on the Pooled Money Investment Account (PMIA), managed by the Office of the State Treasurer, State of California.[4]

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.

Definition of Financials. Financial institutions would include those businesses:

OPTION

(a) As set forth in R&TC section 23183 and the regulation pursuant thereto.

OR

(b) As set forth in R&TC section 23183, other businesses acting as financial intermediaries such as brokers and dealers, 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:

OPTION

(a) Current law as set forth in existing provisions of the corporation franchise and income tax laws.

(b) Calculation of BNRT based on net income as defined under the provisions of the corporation franchise and income tax laws plus employee compensation.

(c) Calculation of BNRT based on the following: gross receipts for financials would include all those amounts included for non-financials, such amounts realized on the sale

[4] For this purpose, depletion will be calculated using cost depletion rules.

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.

(d) In addition to revenues and purchases in **(c)**, revenues would include bank deposits and all proceeds from financial transactions. Purchases would include loan amounts and financial purchases, except the purchase of own stock.

Transition Issues

Phase-In Period. The BNRT would be phased-in over a five-year period beginning in fiscal year 2011-12. 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 2015-16.

Personal Income Tax, Sales and Use Tax, and Corporation Franchise and Income Tax. During the five-year phase in period, the personal income tax, sales tax and corporation tax rates will be reduced or eliminated. By the end of the transition period, the corporation tax and the state portion of the sales and use tax would be repealed.

Carry-over Credits and Net Operating Losses (NOLs).

OPTION

(a) Existing credits and NOLs under the corporation franchise and income tax could be used to reduce BNRT tax liabilities.

(b) Existing credits and NOLs under the corporation franchise and income tax would expire when the corporate franchise and income tax is repealed.

Deferrals. Items deferred under the corporation franchise and income tax, including expenses, gains and income would continue as under current law during the five-year phase-in period. Their continued treatment after this period would depend on future legislative actions.

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 from Other Firms		
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	3%	
Net Receipts Tax Liability	82	

<u>Example 2</u>

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 from Other Firms	
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 (1)	500	
Subtotal 2	80,500	
Other Costs		
Employee Compensation		90,000
Interest Expense		8,000
Subtotal 3		98,000
Profit		21,500
Total Expenses and Profit	119,500	
Total Net Receipts (Subtotal 1 Less Subtotal 2)	119,500	
California Sales	25,000	
Total Sales	200,000	
California Sales/Total Sales	13%	
Net Receipts Apportioned to California	14,938	
Net Receipts Tax Rate	3%	
Net Receipts Tax Liability	448	

(1) $12 million cost depreciate at MACRS with interest