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Overview of California's Income Tax Laws: the Personal Income Tax and the Bank and Corporation Tax

Assembly Revenue and Taxation Committee

CALIFORNIA LEGISLATURE

OVERVIEW OF CALIFORNIA'S INCOME TAX LAWS: THE PERSONAL INCOME TAX and THE BANK AND CORPORATION TAX

As Enacted by

AB 53 (Klehs) and SB 572 (Garamendi) of 1987

The California Tax Fairness, Simplification and Conformity Act of 1987

and SB 85 (Alquist) of 1986, California Unitary Reform

and Modified by 1988 Legislation

ASSEMBLYMAN JOHAN KLEHS, CHAIR
ASSEMBLY REVENUE AND TAXATION COMMITTEE

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Sacramento, California

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NOVEMBER 1988
SACRAMENTO, CALIFORNIA

California Legislature
Assembly Committee
on
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PREFACE

The second half of the 1980's has been a significant period in the evolution of California income tax policy.

In 1986, landmark legislation modifying the way California applies tax to multinational corporations was enacted. This legislation, SB 85 (Alquist), culminated nearly a decade of legislative debate on the controversial unitary method of apportionment.

Then, in 1987 the California Legislature passed the most sweeping personal income and corporation tax reform legislation in its history, AB 53 (Klehs) and SB 572 (Garamendi). These two bills, the California Tax Fairness, Simplification, and Conformity Act of 1987, were developed in response to the massive federal Tax Reform Act of 1986.

That California legislation made major changes to the income tax base, eliminated a variety of tax loopholes, increased personal credits, reduced the number of tax rates, and lowered the top personal and corporation tax rates. All in all, 71% of California taxpaying families received tax relief. A 1988 study undertaken by the American Federation of State, County and Municipal Employees (AFSCME) found that after tax reform, California had the most progressive income tax of all the states in the country.

SB 85, AB 53, and SB 572, combined with clean-up and fine-tuning legislation adopted in 1988, substantially changed the face of the California income tax. The purpose of this report is to provide an overview of California's tax law as it now stands on the eve of the 1990's.

This report is intended as a basic reference document for people with an interest in tax law and tax policy. It describes in general terms the major components of the personal income tax and the bank and corporation tax. Many technical features and fine points of the law are excluded in an attempt to keep the material accessible to lay readers. The report reflects the law as it stands in 1988, and generally does not describe provisions that lapsed or were repealed prior to that time, nor does it reflect any amendments made after the end of the 1988 legislative session.

The report is organized into three chapters covering the major components of the personal income and bank and corporation taxes. Material is presented in a simple building-block fashion to serve as a primer for newcomers to the tax field. However, readers desiring to turn directly to particular topics of interest are encouraged to use the detailed Table of Contents as a quick way to find those topics.

A publication entitled "The California Tax Fairness, Simplification and Conformity Act of 1987, AB 53 (Klehs) and SB 572 (Garamendi), A Comparison of Prior and New State and Federal Tax Law," published by the Assembly Revenue and Taxation Committee in November 1987 can be used as a companion to this document.

This report was prepared by Ellen Worcester, Chief Consultant to the Assembly Revenue and Taxation Committee. The efforts of her many colleagues who reviewed and edited this report are greatly appreciated.

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TABLE OF CONTENTS

Chapter I

THE PERSONAL INCOME TAX

1. WHO PAYS THE PERSONAL INCOME TAX

Individuals who are residents of California are liable for the personal income tax. Nonresidents of this state must pay income tax on income derived from sources within California (but generally are allowed a credit from their state of residence to offset any tax they have paid to California on that same income).

In addition to individuals, unincorporated businesses (such as partnerships and proprietorships), estates, and trusts must pay the personal income tax.

About 12.5 million personal income tax returns are expected for the 1988 tax year.

Refer to the Bank and Corporation Tax chapter of this report for a discussion of taxes imposed on corporations.

2. OVERVIEW OF HOW THE PERSONAL INCOME TAX IS CALCULATED

Taxpayers must compute tax liability based on income earned during the year, usually the calendar year. To summarize briefly, taxpayers must add up all sources of nonexempt income, subtract adjustments and deductions to which they are entitled, thereby arriving at "taxable income." Then they apply the appropriate tax rate to taxable income to determine tax. Tax credits are allowed to reduce tax dollar for dollar. Most taxpayers are eligible for the personal credit, and various other credits are also offered. A few taxpayers are liable for certain additional taxes under special circumstances.

These steps in computing tax liability are summarized in the paragraphs below.

The chart on the following page illustrates the steps involved in calculating final tax liability. As the chart shows, the amount of personal income which is actually subject to income tax is much smaller than the taxpayer's total income.

COMPONENTS OF PERSONAL INCOME TAX

INCOME FROM ALL SOURCES

MINUS

EXEMPT INCOME
Nontaxable social security and railroad retirement   Insurance proceeds   Bequests and gifts   Public assistance
IRA and Keogh interest earnings   Interest on government obligations   Scholarships and fellowships

EQUALS

GROSS INCOME
Salaries & wages   Interest   Dividends   Taxable state and local income tax refunds   Alimony received
Business income or loss   Capital gain or loss   Annuities and retirement plan distributions   Rents & royalties
Partnership income or loss   Estates and trusts   Subchapter S distributions   Unemployment compensation
Taxable social security benefits   Other income

MINUS

ADJUSTMENTS TO INCOME
Reimbursed employee business expense   IRA contributions   Self employed health insurance deduction
Retirement plan distributions   Forfeited interest   Alimony paid

EQUALS

FEDERAL ADJUSTED GROSS INCOME

MINUS

FEDERAL INCOME EXEMPT FROM STATE TAX
State income tax refunds   Unemployment compensation   Social security benefits   Nontaxable interest income
Railroad retirement and sick pay   California lottery winnings   IRA distributions   Net operating loss carryovers
Depreciation and amortization adjustments   Capital gains/losses adjustments

PLUS

STATE INCOME EXEMPT FROM FEDERAL TAX
Interest on state and municipal bonds from other states
Depreciation and amortization adjustments   capital gains/losses adjustments

EQUALS

CALIFORNIA ADJUSTED GROSS INCOME

MINUS

DEDUCTIONS
California standard deduction
or
Federal Itemized Deductions
Medical expenses   Taxes paid   Interest paid   Contributions   Casualty and theft losses
Moving expenses   Employee business expenses   Miscellaneous deductions
Minus
State, local, and foreign income taxes paid   Differences in: Contribution carryover, casualty loss carryover, nontaxable income expenses, employee business expense, and investment interest expense

EQUALS

CALIFORNIA TAXABLE INCOME

TAX BEFORE CREDITS

MINUS

TAX CREDITS
Personal   Blind   Elderly   Dependent   Child and dependent care   Military income   Elderly or permanently disabled
Jobs tax   Pollution abatement equipment   Vehicle conversion to alcohol fuel   Enterprise zone credit for wages earned
Joint custody head of household   Ridesharing   Low income housing   Enterprise zone credit for hiring and sales
Program area hiring and sales   Water conservation   Solar pump   Solar energy   Commercial solar energy
Energy conservation   Research and development   Political contribution   Orphan drug
Residential rental and farm sales   Taxes paid to other states

PLUS

OTHER TAXES
Alternative minimum tax   Tax on early use of IRA, Keogh, or annuity contract

EQUALS

TOTAL TAX LIABILITY

SOURCE: Franchise Tax Board

3. RELATIONSHIP OF STATE AND FEDERAL TAX FORMS

California's personal income tax has been modified in recent years to make it quite similar to the federal income tax for most taxpayers. This has allowed substantial simplification of state tax forms. Today, most of the steps in computing income subject to tax are done on the federal Form 1040 (or 1040A or 1040 EZ). Much of that information is transferred to the state Form 540 or 540A, where certain California adjustments are entered, and state tax and credits are computed.

As a result, many of the steps in computing state tax liability, described below, are taken on the federal tax form. Many fewer steps are required on the streamlined state tax forms.

Further comments on the similarities and differences in state and federal income tax laws are provided later in this chapter.

4. WHAT INCOME IS SUBJECT TO TAX AND WHAT INCOME IS EXCLUDED FROM TAX

For purposes of the personal income tax, income is measured or defined in four important categories: exempt income, gross income, adjusted gross income (AGI), and taxable income (TI).

The major sources of income which are taken into account in computing tax liability are as follows:

Exempt Income. Certain categories of income are exempt from tax altogether, and in many cases are not required to be computed or reported on the tax return. These include California lottery winnings, Social Security income, Railroad Retirement income, unemployment compensation, compensation for injury or sickness, public assistance, child support payments, some military compensation, certain employee fringe benefits, gifts and inheritances, scholarships, interest earned on certain government obligations, and others.

Some of these sources which are exempt for California are taxable for federal purposes. The most important income sources which are taxable on the federal return and exempt on the state return are California lottery winnings, a portion of Social Security income, a portion of Railroad Retirement income, unemployment compensation, and interest from U.S. savings bonds and treasury bills. Therefore, these must be subtracted from income figures transferred from the federal tax form.

Gross Income. Gross income is the starting point for calculating tax on the federal return. Gross income includes all sources of income other than exempt income.

Income sources which must be included in gross income for both state and federal purposes are salaries, wages, commissions, tips, alimony received, amounts paid as reimbursement for employee business expenses (for which adjustments are available; see below), dividends, interest earnings, annuities, pensions, gains from the sale of capital assets, net partnership and proprietorship income, net farm income, et cetera. For certain of these sources, the amount of income entered on the tax return may be a negative number if the taxpayer has incurred a loss.

Adjusted Gross Income. After all items contributing to gross income are totalled, some items can be subtracted to compute adjusted gross income. These "adjustments" include reimbursed employee business expenses which have been included in gross income, certain payments into retirement plans (IRAs, Keogh plans, self-employed plans, et cetera), alimony paid, and penalties paid on early withdrawal of savings. The remaining amount is adjusted gross income (AGI).

Taxable Income. Adjusted gross income may be further reduced by either the standard deduction or itemized deductions. These are described in Section 5 below. The remaining amount is taxable income (TI), to which the tax rates are applied to compute tax owed before credits.

5. DEDUCTIONS FROM ADJUSTED GROSS INCOME

All taxpayers are allowed to deduct certain amounts from AGI. In general, the purpose of deductions is to reduce income subject to tax to reflect certain nondiscretionary living costs incurred by all taxpayers which affect the taxpayer's ability to pay.

The value of a deduction to a taxpayer (that is, how much the deduction reduces tax liability) generally may be estimated by multiplying the deduction by the taxpayer's highest marginal tax rate (see Section 8 of this chapter, Tax Rates and Brackets, for a discussion of marginal rates). For example, the approximate state tax savings to a person in the top tax bracket (9.3%) which results from deducting a $100 expense is $9.30 [$100 expense times 9.3% tax rate].

Taxpayers may reduce AGI by either the total of allowed itemized deductions reflecting actual expenditures, or the standard deduction, a fixed dollar amount. Taxpayers may deduct the larger of these two amounts.

Standard Deduction. The tax law allows individual taxpayers a flat deduction amount, intended to approximate expenses which affect the taxpayer's ability to pay tax. In 1988, the standard deduction amounts are as follows:

Single Person and Married Person Filing Separately . . . $1,966

Married Filing Joint Return, Surviving Spouse, and
Head of Household $3,932

These amounts are indexed annually for inflation. (See Section 10 below for a discussion of indexing.)

Standard deduction amounts in federal law are different from California law. In 1988 federal amounts are:

Single Persons $3,000

Married Filing Joint Return $5,000

Head of Household $4,400

Married Filing Separate Return $2,500

Federal law allows persons who are over age 65 or blind to take larger standard deductions: they get an additional $600 if married ($1,200 if both elderly and blind) or an additional $750 if single ($1,500 if both). All the federal standard deduction amounts are indexed annually for inflation beginning in 1989.

Note that unlike federal law, California does not allow larger standard deductions for elderly and blind persons. Instead, state law provides additional exemption credits. Refer to Section 7 of this chapter.

Itemized Deductions. As an alternative to the standard deduction, both state and federal law allow various specific expenses to be deducted from adjusted gross income. These are called itemized deductions. Most such deductions from AGI are allowed so that taxable income better approximates the taxpayer's ability to pay. For example, casualty losses and large medical bills reduce an individual's available income. Other deductions act as incentives for certain behavior (e.g., the deduction for charitable gifts).

An individual whose total deductible expenses are lower than the standard deduction would not itemize, but instead would deduct the standard deduction amount. An individual whose total deductible expenses are higher than the standard deduction would report the total of actual expenditures.

The major itemized deductions permitted include the following expenditures:

- Home mortgage interest on first and second homes, subject to certain limits. The deductible amount is the interest on the portion of the debt equal to the lower of either the market value of the home or the purchase price plus the value of improvements. However, if the borrowed amounts are used for medical or educational expenses, no limits on deductibility of interest apply.

(In 1987 California did not conform to federal modifications of these rules. Federal law allows interest from home mortgage debt to be deducted for the portion incurred when acquiring the home, up to $1 million of debt, plus interest from up to $100,000 of debt on a home equity line of credit.)

- A portion of consumer interest. In 1988, 40% of the amount of consumer interest paid during the year is deductible. In 1989 the amount is 20%, in 1990 10%, and in 1991 and thereafter no consumer interest may be deducted.

- Property taxes.

- Charitable contributions (with an annual cap; amounts above the cap can be carried over and deducted in subsequent years).

- Unreimbursed medical expenses in excess of 7.5% of AGI.

- Unreimbursed casualty and theft losses of over $100; only losses in excess of 10% of AGI may be deducted.

- Unreimbursed moving expenses.

- Certain miscellaneous expenses in excess of 2% of AGI. Examples of miscellaneous expenses are union dues, uniforms, job-related educational expenses, tax return preparation fees, safe deposit box costs, and others.

(Unincorporated businesses which file under the personal income tax may deduct trade or business expenses. These are taken into account when determining business net income, as described above in Section 4 under "Gross Income." Trade and business expenses are not itemized deductions.)

California's rules on itemized deductions are very similar to federal rules. The major difference is that federal law allows an itemized deduction for state income taxes paid, whereas California law does not.

6. FILING STATUS

Taxpayers must file under one of the following statuses: single person, married person filing a separate return, married filing a joint return, unmarried head of household, or surviving spouse. Filing status affects tax liability, because it determines which tax rate schedules and personal exemption credits apply.

A head of household generally is a person who is not married at the end of the tax year and who has a child or other relative living with him or her for more than half the year. Several other specific requirements apply.

California and federal filing statuses are the same. California taxpayers must use the same filing status on their state returns as they use on their federal returns.

Prior to 1987, California allowed a joint custody head of household filing status. That has now been replaced with a joint custody head of household tax credit. (See Section 12 on Other Tax Credits.)

7. PERSONAL EXEMPTION, DEPENDENT, ELDERLY, AND BLIND CREDITS

Every California taxpayer is entitled to personal exemption or dependent credits for all the members of the household. Their purpose is to shelter from tax a minimum amount of income for each person in the household.

The personal credit cannot be claimed by a taxpayer who files a tax return and also is claimed as a dependent on another person's return. (An example would be a college student who earns enough income to file his or her own tax return, but is also claimed as a dependent on the parents' return.)

A dependent credit may be claimed for any relative of the taxpayer (child, stepchild, parent, stepparent, sibling, et cetera) whom the taxpayer supports for over half of the calendar year. A nonrelative who lives in the taxpayer's home and who meets the support rule can also be claimed as a dependent.

No dependent credit may be claimed for the first dependent required to qualify the taxpayer for the head of household filing status (see Section 6).

An additional credit can be claimed for any person in a household who (a) is age 65 or older on the last day of the tax year, or (b) blind. A person who is both elderly and blind is eligible for two additional credits on top of the personal or dependent credit.

The 1988 personal, dependent, elderly, and blind credits are as follows:

Single Person and Married Person Filing Separately . . .	$ 52
Married Filing Joint Return, Surviving Spouse, and Head of Household	$ 104
Each Dependent	$ 52

Additional Credit for Person Over Age 65 . . . . $ 52

Additional Credit for Blind Person . . . . $ 52

These credit amounts are indexed annually for inflation beginning in 1989. (See Section 10 below for a discussion of indexing.)

Federal law is quite different from state law in this area. Instead of exemption credits, federal law allows a personal exemption (like a deduction) for each person in the household (taxpayer, spouse, and dependents). In 1988 the amount is $1,950 per person, in 1989 it is $2,000, and thereafter it will be indexed annually for inflation.

8. TAX RATES AND BRACKETS

California law provides for six progressive marginal tax rates. These rates are 1%, 2%, 4%, 6%, 8%, and 9.3%. These tax rates are applied to taxable income, computed as described above.

The term "marginal tax rate" refers to the rate of tax on the last (or highest) dollar of taxable income. Under a system of progressive marginal tax rates, each increment of additional income a person earns is subject to a higher tax rate. These increments of additional income are called "brackets."

The principle behind progressive marginal tax rates is that people with more income have a greater ability to pay taxes than those with less income. A progressive income tax ensures that persons at higher income levels pay a larger proportion of their total income in tax than do persons with less income.

The California tax rates and income brackets which apply for the 1988 year are shown in Table 1. Note that each filing status has a different set of brackets, but the rates are the same. Table 1 shows that in 1988 the maximum tax rate of 9.3% applied to single taxpayers with taxable incomes of $25,052 or more, and to married taxpayers with taxable incomes of $50,104 or more. The brackets are indexed annually for inflation (see Section 10 below).

Most taxpayers do not use the tax rate schedules to figure out their tax liability. Instead, to simplify computation and prevent math errors, the Franchise Tax Board provides tax tables with the income tax instruction booklet each year. The tables compute for taxpayers the tax due at various levels of taxable income for each filing status.

TABLE 1

CALIFORNIA TAX RATES FOR 1988

IF THE TAXABLE INCOME IS:		TAX BEFORE CREDITS IS:		
Over:	But Not Over:	This Amount:	Plus This Percent:	Of Taxable Income Over:
Single Person and Married Filing Separately:				
$ 0	$ 3,818	$ 0	1 %	$ 0
$ 3,818	$ 0,048	$ 38	2 %	$ 3,818
$ 9,048	$14,278	$ 143	4 %	$ 9,048
$14,278	$19,822	$ 352	6 %	$14,278
$19,822	$25,052	$ 685	8 %	$19,822
$25,052	and over	$1,103	9.3%	$25,052
Married Filing Jointly and Surviving Spouse:				
0	$ 7,636	$ 0	1 %	$ 0
$ 7,636	$18,096	$ 76	2 %	$ 7,636
$18,096	$28,556	$ 286	4 %	$18,096
$28,556	$39,644	$ 704	6 %	$28,556
$39,644	$50,104	$1,369	8 %	$39,644
$50,104	and over	$2,206	9.3%	$50,104
Head of Household:				
$ 0	$ 7,636	$ 0	1 %	$ 0
$ 7,636	$18,096	$ 76	2 %	$ 7,636
$18,096	$23,326	$ 286	4 %	$18,096
$23,326	$28,870	$ 495	6 %	$23,326
$28,870	$34,100	$ 827	8 %	$28,870
$34,100	and over	$1,246	9.3%	$34,100

If a taxpayer is taxed at the highest 9.3% marginal tax rate, it does not mean that he or she owes tax equalling 9.3% of total taxable income. Rather, it means that tax liability equals 1% of the first increment ("bracket") of income, plus 2% of the next increment of income, plus 4% of the next increment of income, and so on. This method of applying progressive marginal tax rates is sometimes called the "ride through the brackets."

This can be seen by looking at the 1988 tax rate schedule shown in Table 1. For example, consider a single taxpayer with taxable income of $14,000. The single schedule in Table 1 indicates that tax due is $143 plus 4% of any amount over $9,048. Tax would be computed as follows:

$143 + 4% x [$14,000 - $9,048 = $4,952] = $341 tax due

In this example, the tax liability of $341 equals 2.4% of total taxable income, even though the taxpayer is in the 4% marginal bracket. (Tax credits would further reduce this tax liability.)

In contrast to California's six-bracket rate schedule, federal income tax law has only two tax rates, 15% and 28%. In addition, a third tax rate of 33% effectively applies to high income taxpayers, because federal law denies the benefit of the personal exemption when income exceeds specified limits. The federal rates and brackets for the various filing statuses are shown in Table 2. These brackets are indexed annually for inflation beginning in 1989 (see Section 10 below).

9. MARRIAGE PENALTY

The federal tax rate structure produces what is called a "marriage penalty" effect on taxpayers. That is, the tax on two single people with equal incomes is less than the tax of two similar people who are married. Put another way, the combined federal tax liability of two single people will go up when they get married, all other things being equal.

This results from the design of the tax brackets as well as the standard deduction. As noted in Section 5 above, the federal standard deduction for two single persons in 1988 is $6,000 ($3,000 times two), while the standard deduction for married couples is only 83% of that, $5,000.

There is no similar "marriage penalty" embodied in the California tax structure. That is, the total state tax liability of two single persons earning equal incomes would not go up if they got married. The state tax rates

TABLE 2

FEDERAL TAX RATES FOR 1988

IF THE TAXABLE INCOME IS:		TAX BEFORE CREDITS IS:		
Over:	But Not Over:	This Amount:	Plus This Percent:	Of Taxable Income Over:
Single Person:				
$ 0	$17,850	$ 0	15%	$ 0
$17,850	$43,150	$2,678	28%	$17,850
$43,150	$89,560	$9,762	33%	$43,150
$89,560	and over	Worksheet method: all income taxed at 28% rate		
Married Filing Jointly and Surviving Spouse:				
$ 0	$ 29,750	$ 0	15%	$ 0
$ 29,750	$ 71,900	$ 4,463	28%	$29,750
$ 71,900	$149,250	$16,265	33%	$71,900
$149,250	and over	Worksheet method: all income taxed at 28% rate		
Head of Household:				
$ 0	$ 23,900	$ 0	15%	$ 0
$ 23,900	$ 61,650	$ 3,585	28%	$23,900
$ 61,650	$123,790	$14,155	33%	$61,650
$123,790	and over	Worksheet method: all income taxed at 28% rate		
Married Filing Separately:				
$ 0	$ 14,875	$ 0	15%	$ 0
$ 14,875	$ 35,950	$2,231	28%	$14,875
$ 35,950	$113,300	$8,132	33%	$35,950
$113,300	and over	Worksheet method: all income taxed at 28% rate		

are designed based on the assumption that the income of the married couple is split evenly between them. Thus, married taxpayers pay exactly twice the state income tax of a single person earning half the married couple's income.

10. INDEXING

The income brackets applying to each tax rate are modified annually to adjust for inflation. This is called "indexing." The personal credit amounts, the standard deduction amounts, and the low income credit bracket amounts are also indexed annually.

Indexing of rate brackets is required by the enactment of Proposition 7, a statutory initiative adopted by the voters in June 1982. (From 1978 through 1982, indexing was done pursuant to legislative action.)

The purpose of indexing is to prevent taxpayers from being pushed into higher marginal tax brackets by increases in income due to inflation, when their real buying power is not increasing.

The indexing adjustment is the percentage difference between the California Consumer Price Index (CCPI) in June of the current year and June of the prior year. Each tax bracket is increased annually by this percentage change, which allows the taxpayer to have more taxable income before being bumped into the next higher tax bracket. Over time with indexing, the bracket breakpoints get higher, and brackets get wider. The object is to keep a taxpayer in the same bracket if his income increases no more than the CCPI.

For example, the effect of indexing on two hypothetical taxpayers would be as follows:

> A taxpayer who gets a cost-of-living wage increase exactly equal to inflation will have more income in dollars, but will have the same buying power as in the previous year. Without indexing, his increased income bumps him into a higher marginal tax bracket causing his income tax to go up. Indexing keeps his tax at the same level as the prior year, since his buying power is the same.
>
> A taxpayer on a fixed income loses buying power in inflationary times. Without indexing, his tax would remain the same even though his income was worthless. Indexing causes his tax to go down, consistent with the decline in buying power.

Federal law begins indexing rate brackets and the standard deduction for the first time in 1989. The indexing measure is slightly different from California's, in that it relies on the U.S. Consumer Price Index, and uses a different 12-month period (August to August).

11. TAX CREDITS

Tax credits are amounts which reduce tax liability dollar for dollar. After the taxpayer computes the tax due at his or her level of taxable income, credits are subtracted to reduce the amount of tax due. Thus, credits operate differently from deductions, whose value in reducing tax liability is the amount of the deduction times the tax rate (see Section 5 of this chapter).

Credits are usually provided to give tax relief for people who incur certain nondiscretionary costs or have limited ability to pay taxes, or to provide incentives to people to engage in certain activities that are socially or economically desirable. Tax reform legislation enacted in 1987 placed sunset dates (i.e., automatic repealers) on many credits in the personal income tax law, to give the Legislature an opportunity to evaluate their impacts.

Except for the Renter's Credit, described in Section 12 below, state tax credits are not refundable if they exceed total taxes due. In some cases, credit amounts which exceed tax liability can be carried forward and claimed against future years' taxes.

Some of the tax credits allowed in state law are similar to credits offered in federal law. However, in most cases the federal credit sizes are larger. This is because the federal tax burden is roughly three times greater than California's. This can be seen by comparing the rate structures: California's top personal rate is 9.3% while the top federal rate is 28%. As a result, many state income tax credits patterned after federal credits are roughly one-third the size of the federal credit.

The major credits allowed in state law are described in Sections 12 and 13 below.

12. RENTER'S CREDIT

California allows an income tax credit to renters which is intended to approximate the property relief provided to homeowners through the property tax homeowner's exemption.

The Renter's Credit is a refundable amount, depending on filing status, as follows:

Single and Married Filing Separately	$ 60
Married Filing Joint Return, Surviving Spouse, and Head of Household	$ 137

Since the credit is refundable, if a qualifying renter claims a Renter's Credit which exceeds his tax liability, the excess amount is refunded to him by check.

To qualify for the Renter's Credit, the taxpayer must be a California resident and must rent and occupy for at least 50% of the year premises in California which are his or her principal place of residence. Even taxpayers without income tax liability are eligible for the refundable Renter's Credit, but must file a tax return to claim it.

There is no Renter's Credit in federal law.

13. OTHER MAJOR TAX CREDITS

Child and Dependent Care Credit

Taxpayers who have child or dependent care expenses which are necessary in order for them to be employed may claim a tax credit. The California credit is a percent of the comparable Child and Dependent Care Credit allowed on the federal return.

For federal purposes, taxpayers with AGI of $10,000 or less may claim a credit of 30% of child care expenses. Where AGI is between $10,000 and $28,000, the credit phases down from 30% to 20%. For taxpayers with AGI of over $28,000, the credit is 20% of expenses. The maximum amount of expenses against which the credit may claimed is $2,400 per year for one child, or $4,800 for two or more children.

On the California return, the Child and Dependent Care Credit is 30% of the credit allowed by federal law, regardless of income. Thus, the effective state credit is between 6% and 9%. The credit will sunset at the end of 1992.

Elderly Credit

Persons who are 65 years or older or who are permanently disabled are eligible for the Elderly Credit, which shelters from tax a certain amount of retirement income. The California credit is a percent of the comparable credit allowed on the federal return.

For federal purposes, qualifying taxpayers enter specified amounts of income, and make adjustments for Social Security benefits, pensions, disability benefits, and others. The federal credit amount of 15% is then applied. Eligibility phases out above certain income levels.

On the California return, the Elderly Credit is 50% of the the credit allowed by federal law. Thus, the effective state credit is 7.5%. Special rules apply to certain government retirees who were under age 65 and retired prior to 1984.

Low Income Credit

California allows a Low Income Credit which cancels all or a portion of the tax liability of taxpayers with very low incomes. The credit is 20%, 40%, 60%, 80%, or 100% of net tax (prior to the Renter's Credit), depending on AGI. The AGI brackets are indexed annually for inflation.

In 1988, the Low Income Credit cancels 100% of tax for single individuals and heads of household with AGI of less than $6,110 and for married couples with AGI of less than $12,230. The credit phases down in 20% increments, reaching zero for single individuals with AGI over $9,930 and married couples with AGI over $19,850.

There is no credit in federal law which is identical to California's Low Income Credit. However, federal law has an Earned Income Credit, which serves a somewhat similar function. It is a refundable credit for low-income workers with children. The credit is 14% of earned income (i.e., wages) of up to $5,714.

Credit for Military Income and Pensions

Persons who receive active or reserve military pay or military pensions are eligible for a California credit of 4% of those amounts, not to exceed $40. However, the credit is available only for those with AGI of less than $27,000. This credit will sunset at the end of 1991.

There is no similar credit in federal law.

Credit for Sales of Farms and Rental Residential Property

California allows a tax credit for a portion of capital gain income received from the sale or exchange of California residential rental property or farm property. The credit amount is 3% of the net gain on property held for one to five years, and 4.5% of the net gain on property held more than five years. The credit will sunset at the end of 1991.

There is no similar credit in federal law.

Joint Custody Head of Household Credit

Taxpayers who qualify as joint custody heads of household may claim a state tax credit which cancels a portion of tax liability. To qualify, the taxpayer must (1) be unmarried at the end of the year, (2) have custody of a dependent for between 146 and 219 days of the year under a custody agreement, and (3) furnish over half of the household expenses. The credit is 30% of the net tax, not to exceed $200. The purpose of this credit is to allow a divorced couple who shares custody of a child (and thus neither of whom gets the tax benefits of the head of household filing status) to share those benefits via the tax credit. The credit is also available to separated married persons who support a dependent parent.

There is no similar credit in federal law.

Political Contributions Tax Credit

California offers a tax credit for a portion of political contributions made during the year. The credit is equal to 25% of amounts contributed, and cannot exceed $25 for individuals, $50 for joint returns. The credit will sunset at the end of 1991.

There is no similar credit in federal law.

Credit for Taxes Paid to Other States

In order to avoid double taxation, a credit generally is allowed to California residents on the California return for net income taxes paid to another state on the same income taxed by California. If the other state taxes at a lower rate than California, the credit has the effect of allowing California to tax only part of the income taxed by the other state.

Credits for Businesses

A number of other credits are available for business taxpayers who file under the personal income tax. Refer to the Bank and Corporation Tax chapter of this report for descriptions of those tax credits.

14. CAPITAL GAINS AND LOSSES

Capital gains are profits from the sale of property and other capital assets. They are classified as a different type of income from "ordinary income," which includes wages, salaries, interest, etc.

Capital assets are defined as all property except the following: inventories, property held for sale in the ordinary course of business, depreciable business property, and real property used in business. Capital assets include real property (land and buildings), personal property, and intangible assets (such as stock).

Capital gains are measured as the difference between what the asset was sold for and what it was originally purchased for. (For real property, any amounts invested in improvements are added to the purchase price; for all properties, costs of sale are deducted from the sales price.) The gain is recognized in the year the asset is sold or exchanged.

Through 1986, capital gains were accorded special income tax treatment, in that gains on assets held longer than one year were partially excluded from tax. However, beginning in 1987, California conformed to federal treatment under which all capital gains are fully included in income subject to tax.

(Refer to Section 13, Other Tax Credits, for description of a tax credit designed to offset part of the tax on capital gains realized from the sale of rental residential and farm properties.)

As in federal law, capital losses are fully deductible against capital gain income realized in the same year. In addition, up to $3,000 of capital losses in excess of capital gains is deductible against ordinary income. If excess capital losses are greater than $3,000, the unused portion may be carried forward indefinitely to offset capital gains in future years and to deduct against ordinary income subject to the $3,000 annual limit.

Gains on principal residences are subject to special rules. A capital gain from the sale of a principal residence is not subject to tax if the proceeds are invested within two years in the purchase of another principal residence of equal or greater value. Also, persons 55 years of age or older may exclude from income up to $125,000 of gain from the sale of a principal residence, one time only. These two exceptions follow identical provisions in federal law.

15. DEPRECIATION

Depreciation deductions allow taxpayers to recover their capital investments in assets over the useful lives of those assets, by deducting annually reasonable allowances for the exhaustion, wear, and tear of property.

Depreciation is allowed for property used in a trade and business or for the production of income (investment). Depreciable property includes most kinds of tangible property and improvements to real property, farm buildings, machinery and other physical assets, and certain intangible assets (e.g., copyrights, licenses, franchises). Depreciation is not allowed for property used for personal purposes, inventory and stock in trade, land, depletable natural resources, and goodwill.

In the personal income tax, California conforms to the federal depreciation system for assets placed in service on and after January 1, 1987. This is called the Modified Accelerated Cost Recovery System, or MACRS. Under MACRS, all depreciable assets are placed in classes. These class assignments determine, first, the assets' useful lives (which are the periods over which they may be depreciated) and second, the method of depreciation which must be used. The amount which is to be depreciated is the property's basis, or its value when acquired. In general, MACRS allows shorter useful lives and more accelerated depreciation methods than would be allowed under other permissible depreciation systems, resulting in larger depreciation deductions.

(For filers under the bank and corporation tax, the MACRS system is not permitted. Refer to the Bank and Corporation Tax chapter of this report for a description of depreciation used by corporate taxpayers.)

16. CARRYOVER OF NET OPERATING LOSSES (NOLs)

Net operating losses incurred in the course of a trade or business may be deducted in part. These provisions are described in Section 8 of the Bank and Corporation Tax chapter of this report.

17. ALTERNATIVE MINIMUM TAX (AMT)

Taxpayers who take advantage of certain tax preferences must compute an alternative minimum tax (AMT) at a 7% rate and pay it if it exceeds the amount of regular tax due. The purpose is to ensure that taxpayers who take advantage of special tax reduction provisions in the tax code pay at least some minimum amount of tax on the preferentially-treated income. These AMT rules are patterned after federal law, which imposes the AMT at a 20% rate. The AMT replaces the add-on preference tax which was a part of California personal income tax law until 1987.

The AMT in the personal income tax is very similar to the AMT in the bank and corporation tax. It is imposed on "alternative minimum taxable income" in excess of an exemption amount. For married persons filing jointly, the exemption is $40,000 and it phases out to zero between $150,000 and $310,000 of alternative minimum taxable income. For single taxpayers, the exemption and phase-out thresholds are half the above amounts.

For a complete description of the AMT, refer to Section 13 of the Bank and Corporation Tax chapter of this report.

(Do not confuse the AMT with the minimum tax, which applies to limited partnerships and certain other special organizations filing under the personal income tax. Refer to Section 19 of this chapter for a description of the minimum tax.)

18. SPECIAL FEATURES OF THE PERSONAL INCOME TAX

Employer Pension Plans

Employers may establish pension plans for their employees. If the plans meet statutory qualification rules, they get certain tax benefits which affect both the employer and the employee.

Employer contributions to qualified plans are not taxable to the employee at the time the contributions are made. Rather, those amounts (plus any interest that has accumulated on those contributions) are taxed when the employee ultimately withdraws them upon retirement.

Federal tax law sets forth limits on the amount of annual contributions or retirement benefit that a qualified pension plan may provide, and California has adopted identical rules. In brief, the limits are either (a) contributions of the lesser of 25% of compensation or $30,000 per year, or (b) contributions necessary to provide a future retirement benefit to the employee of the lesser of 100% of compensation or $90,000 per year. Generally these limitations are indexed.

There are also various other federal requirements imposed in order for an employer's pension plan to be "qualified," covering such factors as participation and coverage, vesting, nondiscriminatory contributions and benefits, when benefits must commence, and many others.

Self-Employed Retirement Plans ("Keogh" Plans)

Self-employed persons are permitted to establish pension plans and make contributions on their own behalf. Deferral of tax on contributions is similar to that for employer pension plans, and limits on the amount of annual contributions are the same.

Individual Retirement Accounts (IRAs)

California follows federal law in allowing an adjustment to income (similar to a deduction) for deposits made during the year to Individual Retirement Accounts (IRAs).

Each employed individual may contribute up to $2,000 per year to an IRA and deduct that amount from gross income. For married couples where both spouses work, the maximum deduction is $4,000; where only one spouse works, the maximum deduction is $2,250.

However, where the taxpayer is covered by a pension plan, eligibility for the IRA deduction is phased out between $25,000 and $35,000 AGI for single taxpayers and between $40,000 and $50,000 AGI for married taxpayers.

Contributions which were deducted in the year made become taxable income when ultimately withdrawn during retirement. Interest earned on balances in IRAs is tax-deferred for all taxpayers, and becomes taxable income when withdrawn. Taxpayers face penalties for withdrawing IRA deposits before age 59-1/2. IRA contributions may be invested in a broad range of investment vehicles and may be moved between investments without penalty.

(It should be noted that prior to 1987, California's rules setting forth eligibility for IRA deductions were more restrictive than federal rules. Some taxpayers are still being audited and receiving assessments as a result of mistakenly claiming larger deductions than were permitted for California.)

"401(k)" Plans and Deferred Compensation

California follows federal law in allowing private-sector employees to defer a portion of their salaries and thereby reduce taxable income under so-called "401(k)" plans. Employees may defer up to 20% of salary, not to exceed $7,000 per year. Those amounts are not included in income for the year in which they are deferred. The $7,000 limit will be indexed annually.

Amounts deferred under 401(k) plans become taxable income when ultimately withdrawn during retirement. Interest earned on balances in 401(k) plans is tax-deferred, and becomes taxable income when withdrawn. Taxpayers face penalties for withdrawing 401(k) plan proceeds before age 59-1/2. Contributions to 401(k) plans may be invested in a broad range of investment vehicles and may be moved between investments without penalty.

Similar rules apply to public sector employees with regard to deferred compensation plans. Maximum deferral is $7,500 per year, and is not indexed.

Averaging of Lump Sum Pension Distributions

Both state and federal law allow a taxpayer to elect 5-year averaging of lump sum withdrawals from pension and profit-sharing plans. This helps to avoid a very large tax liability in the year a taxpayer withdraws a large amount of retirement savings.

Unearned Income of Dependent Children ("Kiddie Tax")

Children under age 14 who have net unearned income (i.e., investment income such as dividends, interest, or royalties) of over $1,000 are subject to special rules. The purpose is to prevent shifting of income from parents to children to avoid tax. The child's unearned income in excess of $1,000 is subject to tax at the parents', rather than the child's, highest tax rate. However, if the child's income is less than the threshold for the 100% Low Income Tax Credit ($6,110 in 1988), there generally will be no tax liability under the "kiddie tax" due to interaction with the Low Income Tax Credit (see Section 13).

"Passive Investments"

California has adopted special rules enacted in federal law which limit the ability of taxpayers to use passive investment losses to offset or shelter unrelated income. Passive investments are trade or business activities in which the taxpayer does not actively participate. Examples include investments in limited partnerships and ownership in a business where the taxpayer is not regularly and continuously involved on a substantial basis. All rental activity is defined as passive.

These rules require the segregation of income and deductions into "active" and "passive" categories. Net losses from investments in the passive category cannot be used to offset wage, salary or portfolio income. Losses from rental activities of up to $25,000 per year may offset other income, but only if the taxpayer actively participates in the management of the rental activity and has at least a 10% interest in it. Passive activity losses which cannot be deducted pursuant to these rules may be deducted from future income, including capital gains, attributed to the passive investment.

Income Averaging

Through 1986, California permitted income averaging, which provided tax relief to taxpayers whose income fluctuated dramatically from year to year. However, following federal law, California repealed income averaging beginning in 1987.

Other Special Provisions Which Affect Businesses

There are other special provisions appearing in the personal income tax which primarily affect business taxpayers. Several of these are described in the Bank and Corporation Tax chapter of this report.

19. MINIMUM TAX

Corporations taxable by California are subject to a minimum franchise tax. This is a specified dollar amount which is the minimum amount due even if computed tax liability is less. The minimum tax is described in Section 4 of the Bank and Corporation Tax chapter of this report.

Generally, personal income taxpayers are not subject to a minimum tax. However, two classes of taxpayers who file under the personal income tax are subject to the minimum tax. These are limited partnerships and real estate mortgage investment conduits (REMICs). They are subject to the minimum tax because they generally are organized and operate similar to corporations. Refer to Section 4 of the Bank and Corporation Tax chapter of this report for a description of the minimum tax.

(Do not confuse the minimum tax with the alternative minimum tax, or AMT. Refer to Section 17 of this chapter and Section 13 of the Bank and Corporation Tax chapter for a description of the AMT.)

20. VOLUNTARY CONTRIBUTIONS

California allows taxpayers to make voluntary contributions on the tax return, for amounts in excess of their tax liability, to several nonprofit organizations or activities. These contributions designated on the tax form are often called "check-offs."

Voluntary contributions may be made to the following: the Alzheimer's Disease and Related Disorders Fund, the California Election Campaign Fund (to a designated political party), the California Fund for Senior Citizens, the Rare and Endangered Species Preservation Program, the State Children's Trust Fund for the Prevention of Child Abuse, the U.S. Olympic Committee Fund, and the Vietnam Veterans Memorial Fund.

Most voluntary contributions made on the tax return are deductible as charitable contributions on the following year's tax return for taxpayers who itemize deductions.

The voluntary contribution for the Vietnam Veterans Memorial will sunset at the end of 1990 and all others will sunset at the end of 1991.

Voluntary contributions cannot be made on the federal tax return. The federal form does contain a "check-off" allowing taxpayers to send $1 or $2 to the Presidential Election Campaign Fund. This differs from the voluntary contributions on the state form, because the federal check-off designates a portion of one's tax payment, while state law permits contributions of amounts in excess of tax liability.

Chapter II

THE BANK AND CORPORATION TAX

1. WHO PAYS THE BANK AND CORPORATION TAX

This tax applies to all corporations which earn income derived from or attributable to sources in California, except insurance companies. Professional corporations, associations, and certain trusts are included within the purview of this tax. It also applies to banks and to financial institutions such as savings and loan associations (thrifts) and credit unions.

Insurance companies are exempted from the bank and corporation tax (and most other state and local taxes) pursuant to the state Constitution. Instead, insurance companies are subject to a state gross premiums tax.

About 479,000 corporations are expected to file tax returns for the 1988 year. Additional discussion about which corporations are subject to the bank and corporation tax is provided in Section 3 below, entitled "Three Separate Taxes Compose the Bank and Corporation Tax."

Corporations which are not organized for profit are exempt from the bank and corporation tax, except for income they earn which is unrelated to their exempt purpose (see Section 14 of this chapter).

2. OVERVIEW OF HOW THE BANK AND CORPORATION TAX IS CALCULATED

Taxpayers must compute tax liability based on or measured by income earned during the year. The year may be either a calendar year, or a fiscal year commencing in any month specified by the taxpayer. This period is called the taxpayer's "income year."

A brief summary of how tax is computed is as follows: Taxpayers must add up all sources of nonexempt income and subtract deductions to which they are entitled, thereby arriving at "net income." They then apply the 9.3% corporate tax rate to net income to determine tax. Certain tax credits are allowed to reduce tax dollar for dollar. Many corporate taxpayers are also liable for the alternative minimum tax.

When corporations do business both within and outside of California, it is necessary to determine what portion of total corporate income is taxable by California. This is done by means of formula apportionment, which is described in Chapter III of this report, entitled "Determining the Income of Multistate and Multinational Corporations."

The California bank and corporation tax is similar, but not identical to, the federal income tax on corporations. Major differences are identified below.

Refer to the Personal Income Tax chapter of this report for taxes imposed on unincorporated businesses.

3. THREE SEPARATE TAXES COMPOSE THE BANK AND CORPORATION TAX

There are really three separate taxes levied under the umbrella of the state bank and corporation tax.

Bank and Corporation Franchise Tax. Every corporation doing business in California (whether organized in California or out-of-state) is subject to the bank and corporation franchise tax. "Doing business" means "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit."

The franchise tax is not a tax on income. Rather, it is a privilege tax measured by net income earned in California. Since it is not a tax on income, but rather is measured by income, the tax base includes tax-exempt interest from United States obligations, and taxpayers are subject to a minimum franchise tax.

The majority of corporations taxed by California are paying the franchise tax.

Corporation Income Tax. The corporation income tax was enacted in 1937 to remove an inequity in the taxation of interstate corporations which were not taxable under the franchise tax. It provides that corporations deriving income from California sources but not sufficiently present to be classified as "doing business" in California are subject to the corporation income tax.

This tax is nearly identical to the franchise tax. However, because it is an income tax, corporations subject to it are not required to include interest from tax-exempt United States obligations nor are they subject to the minimum tax.

The most common situations where the corporation income tax is applied rather than the franchise tax are those where a corporation operates in California through an agent or by using travelling sales persons, so it does not have an established presence in the state. Another major kind of group taxable under the corporation income tax is a "business trust," which is a trust established for the purpose of making a profit (rather than for mere conservation of assets).

Only a very few corporate taxpayers file under the corporation income tax.

Bank Tax. Banks and financial institutions doing business in California are subject to an additional tax (known as the bank tax), which is levied in conjunction with the regular bank and corporation tax. This tax in in lieu of personal property taxes and local business taxes, from which banks and financial institutions have been exempt since the enactment of the bank and corporation tax in the 1930's.

The bank tax rate is designed to be equivalent to the average amount general corporations pay each year in personal property taxes and local business taxes. The purpose is to make the total burden of corporate taxes plus personal property and local business taxes similar for general corporations and banks/financials. The bank tax rate is set annually by the Franchise Tax Board, based on a survey of the magnitude of those other taxes paid by general corporations.

Federal law has a net income tax which applies to all corporate taxpayers, and does not have an add-on bank tax rate.

4. TAX RATES AND MINIMUM FRANCHISE TAX

The bank and corporation franchise tax rate is 9.3% of net income, or the minimum tax, whichever is greater.

The minimum franchise tax is the following dollar amount in any income year when computed tax liability is less than this amount:

$300, for income years beginning in 1987 and 1988

$600, for income years beginning in 1989

$800, for income years beginning in 1990 and thereafter

The corporation income tax rate is also 9.3% of net income. However, the minimum tax does not apply.

The bank tax rate, which must be added to the franchise tax rate for banks and financial institutions, is not fixed. It is set annually by the Franchise Tax Board at between zero and 2.4%, depending on the taxes paid by other corporations (as described above in Section 3). For 1987, the additional bank tax rate was 1.344%. Banks are subject to the minimum tax if their computed tax from the combined corporate plus bank rates is less than the amounts shown above.

In federal law, the tax rate applying to most corporations is 34%. Graduated marginal rates are provided for small corporations, at the levels of 15%, 25%, and 34%. The benefit of the graduated rate phases out for corporations with net income over $335,000, so that those with incomes above that level in effect pay a flat 34% rate. There is no minimum tax in federal law comparable to the state's minimum franchise tax.

5. INCOME AND DEDUCTIONS

Corporations begin computing California tax by adding all sources income, including income from business activities, dividends, interest, rents, royalties, gains from the sale of property, income from the discharge of debt, and so on. Unlike federal law, the California franchise tax also requires corporations to include interest from federal, state, and municipal obligations. For corporations, there are virtually no exclusions from income, nor sources of exempt income, similar to those in the personal income tax.

The corporate tax is measured not by gross income, but by net income, which is what we commonly think of as business profit. In order to determine net income, corporations are allowed to deduct specified expenses from gross income.

The value of a deduction to a taxpayer, measured in terms of tax eliminated, generally may be estimated by multiplying the deduction by the tax rate. Therefore, the state tax savings to a corporation resulting from deducting a $1,000 expense is $93 [$1,000 expense times 9.3% state corporate tax rate].

The most important deductions are described below. Unless noted otherwise, these are generally similar to deductions allowed to corporations in federal law.

<u>Trade or Business Expenses</u>. Taxpayers are permitted to deduct the ordinary and necessary expenses of carrying on a trade or business. Typical deductible expenses include the amounts paid in compensation and fringe benefits to employees, the employer portions of unemployment insurance and social security taxes, rent, utilities, advertising, and other similar current costs. Capital expenditures (that is, those that add to the value or useful life of property) cannot be deducted. Rather, they must be depreciated. (See Section 6 below.)

<u>Taxes</u>. Corporations may deduct real and personal property taxes. Local, state, federal, and foreign income or profits taxes are not deductible. Sales taxes are also generally deductible; however, sales taxes incurred in the process of manufacturing or constructing property must be capitalized into the value of the property.

Meals, Travel, Entertainment, and Private Club Expenses. Meal, travel, and entertainment costs generally are 80% deductible. Certain convention and cruise ship expenses are subject to special limitations. Unlike federal law, California disallows expenses incurred at private clubs which discriminate on the basis of race, sex, age, or national origin.

Charitable Contributions. Corporations may deduct the value of contributions to charitable or nonprofit organizations. The maximum deduction is 5% of net income; excess contributions may not be carried over (the federal cap is 10% of net income and carryover is permitted). Deductions for contributions of appreciated property (property which has increased in value) generally are limited to the basis (cost) of the property. A larger deduction is allowed for the contribution of certain appreciated computer and research property to California colleges and universities.

Various other more specialized deductions are available to corporations. Some of these deductions are described in the following Sections 6 to 8.

When discussing business tax deductions, reference is often made to "expensing" certain costs. This refers to instances where tax law permits taxpayers to deduct in the year incurred certain capital costs which ordinarily must be depreciated. See Section 6 below for a discussion of depreciation and some examples of expensing permitted.

6. DEPRECIATION

Depreciation deductions allow taxpayers to recover their capital investments in assets over the useful lives of those assets, by deducting annually reasonable allowances for the exhaustion, wear, and tear of property.

Depreciation is allowed for property used in a trade and business or for the production of income (investment), including most kinds of tangible property and improvements to real property, farm buildings, machinery and other physical assets, and certain intangible assets (e.g., copyrights, licenses, franchises). Depreciation is not allowed for property used for personal purposes, inventory and stock in trade, land, depletable natural resources (see Section 7 on Depletion below), and goodwill.

In the bank and corporation tax, California generally does not use the federal depreciation system called the Modified Accelerated Cost Recovery System, or MACRS. Instead, California uses a depreciation system generally known as the Asset Depreciation Range (ADR) system, which is similar to that used in federal law for pre-1981 assets.

Under the ADR system, assets generally are depreciated over the remaining useful life of the asset or over a designated "class life." Under this system, assets are grouped into more than 100 classes, and a guideline "life" for each class is established. For purposes of the ADR system, taxpayers may use a straight-line depreciation or certain rapid depreciation methods (such as double declining-balance, 150% declining balance, sum of the years' digits, or other consistent methods). The amount which is to be depreciated is the property's basis, or its value when acquired.

The ADR system generally requires the use of longer useful lives and less accelerated depreciation methods than would be allowed under the federal MACRS system.

Only one narrow class of corporate taxpayers is permitted to use the more rapid federal MACRS depreciation system. These are Subchapter S corporations, which are described in Section 9 of this chapter.

(For filers under the personal income tax, use of the federal MACRS depreciation system is permitted. Refer to Section 15 of the Personal Income Tax chapter of this report for a description of depreciation used by state personal income tax filers.)

California does allow corporate taxpayers to use certain forms of rapid depreciation or amortization in special circumstances. A few of these include: 5-year amortization is allowed for pollution control facilities added to pre-1976 plants; 3-year depreciation is allowed for facilities constructed by employers to facilitate ridesharing; research and experimentation expenditures may be "expensed" (deducted in the year incurred) or amortized over 5 years; expenditures made to improve the circulation of a periodical may be expensed or amortized over 10 years; soil conservation and certain other expenses by farmers may be expensed rather than depreciated; a portion of mining exploration and development costs may be expensed; and a portion of intangible drilling costs incurred by a well operator may be expensed rather than depleted or depreciated.

The use of certain of these rapid write-offs may have to be taken into account in the computation of the alternative minimum tax (see Section 13).

7. DEPLETION

Depletion is to the owner of an oil or gas well or mineral or timber property what depreciation is to the owner of a capital asset. Depletion deductions allow owners of natural resources to recover the costs of the resource as it is extracted, harvested, or otherwise diminished.

Depletion deductions are allowed to any taxpayer with an economic interest in a property containing depletable resources. Two alternative depletion computations are provided in both state and federal law. The taxpayer must compute the depletion amount both ways and deduct the larger amount. The two methods are:

Cost Depletion. The adjusted basis (cost) of the depletable resource is partially deducted each year in proportion to the fraction of the total resources extracted during the year. Each year, the cost basis of the property is reduced by the amount of depletion deducted for that year, and the remaining basis is used to compute cost depletion for the next year, until the entire cost basis has been deducted. At that point, no additional cost depletion is allowed. This is the less commonly used depletion method.

Percentage Depletion. Most depletable property qualifies for this alternate computation method. However, it is not available for timber.

Under percentage depletion, a flat statutorily-set percentage of annual gross income from the natural resource property is taken as the depletion deduction each year. Thus, the deduction bears no relationship to the actual amount of the resource extracted during the year. However, the laws set an upper limit on the deduction of 50% of taxable income from the property. Percentage depletion is used only if it results in a higher deduction than computed under the cost depletion approach.

Percentage depletion can continue to be taken even after the cost basis has been fully deducted. Both state and federal law provide that depletion deductions in excess of cost basis are items of tax preference for purposes of the alternative minimum tax (see Section 13).

For over 100 different types of minerals, percentage depletion rates are specified in the tax law. The rates range from 5% to 22%.

Special State Rules For Gas, Oil, and Geothermal. Both federal and California law specify the percentage depletion rate for most gas, oil, and geothermal properties as 22% of gross income. However, unlike federal law, in cases where total accumulated depletion deductions exceed the adjusted cost of the property, and the depletion deduction for that tax year is large, California requires dollar reductions of the allowable depletion deduction, as follows:

Where the percentage depletion deduction for the tax year would exceed $1.5 million, the deduction must be reduced by 125% of the amount over $1.5 million. This has the effect of completely phasing out depletion deductions where computed depletion exceeds $7.5 million. Where the computed depletion deduction is less than $1.5 million, no reductions are required (however, the 50% of taxable income limit still applies).

8. CARRYOVER OF NET OPERATING LOSSES (NOLs)

Businesses incur "net operating losses" for tax purposes when allowable deductions exceed gross income. (When deductions are less than gross income, the business has "net income," i.e., a profit.) A business may show a net operating loss for tax purposes without incurring actual out-of-pocket losses, due to the allowance of tax deductions for items which may not be actual out-of-pocket expenses, such as depreciation.

In a year when a business shows a net operating loss for tax purposes, it is not required to pay any bank and corporation taxes, except the minimum franchise tax. In addition, California law allows the business to "carry over" a portion of the net operating loss and deduct it against income earned in future years. NOL carryover rules apply to trade or business losses only (not personal losses). Identical rules apply in both the bank and corporation tax law and the personal income tax law. Specific provisions are as follows:

All taxpayers may carry over 50% of any net operating loss incurred in tax years 1987 through 1991, and deduct them against net income in subsequent years. The NOLs may be carried forward for 15 years, and must be applied against earliest years first. Losses incurred in 1992 and thereafter are not eligible for carryover.

Special rules cover the deduction of NOLs incurred in tax years 1985 and 1986. Half of those losses may be carried over and deducted in tax years 1987, 1988, and 1989 only.

In addition, certain special classes of taxpayers may choose to deduct NOL carryovers using either the above rules or special rules allowing 100% carryover with dollar maximums. Those special classes of taxpayers are those engaged in new small businesses, in businesses in an enterprise zone or program area, or in farming.

California and federal law relating to NOLs are similar, with a few major exceptions:

- Federal law does not limit the deduction to 50% of the NOL.
- Federal law does not have special rules covering 1985 and 1986 losses.
- Federal law does not sunset in 1991.
- Federal law does not have different rules for special classes of taxpayers such as small businesses, etc.
- Federal law allows carryback of NOLs to tax years preceding the years in which the losses were incurred, as well as carryover to future years, while California allows carryforward only.

9. TREATMENT OF SUBCHAPTER S CORPORATIONS

"Subchapter S corporations" are named for a section of federal tax law which allows certain closely-held corporations (those with small numbers of shareholders) special treatment.

Under federal definitions, Subchapter S corporations are domestic corporations with 35 or fewer shareholders. They must have rather simple corporate form (i.e., have only one class of stock, have no nonindividual shareholders, and not be members of affiliated groups). In general, Subchapter S corporations must be involved in an active trade or business (there is a limit on the amount of passive investment income from royalties, dividends, interest, et cetera they may receive).

Corporations which meet these definitions may elect to be exempt from the federal corporate tax, and instead pass through the corporate tax liability to individual shareholders. California law is somewhat different, as described below:

California permits corporations which qualify as federal Subchapter S corporations to elect special treatment for state purposes as well. One additional qualification requirement is that out-of-state shareholders must consent to be taxed in California. Once the election is made, corporate income is taxed at the state rate of 2.5% instead of the normal 9.3% (recall that in federal law the S corporations pay a zero corporate rate).

In both federal and state law, the S corporation is treated as a conduit, through which its items of income, losses, deductions, and credits are passed through to the individual shareholders. These items are included in the computation of the tax liability of the individual shareholders on a pro rata basis, and taxed under the provisions of the state personal income tax law or the federal individual income tax law.

In California law, S corporations are permitted to use the MACRS depreciation system (described in Section 6 of this chapter) rather than the ADR system which other corporations must use. In addition, California S corporations are not subject to the Alternative Minimum Tax (see Section 13 of this chapter).

10. CAPITAL GAINS AND LOSSES

Capital gains are profits from the sale of property and other capital assets. They are classified as a different type of income from "ordinary income" of a corporation arising from its trade or business activities.

Capital assets are defined as all property except the following: inventories, property held for sale in the ordinary course of business, depreciable business property, and real property used in business. Capital assets include real property (land and buildings), personal property, and intangible assets (such as stock).

Capital gains are measured as the difference between what the asset was sold for and what it was originally purchased for. (For real property, any amounts invested in improvements are added to the purchase price; for all properties, costs of sale are deducted from the sales price.) The gain is recognized in the year the asset is sold or exchanged.

In both federal and California law, corporate capital gains are treated the same as ordinary income, that is, fully includible in income subject to tax. However, California differs from federal in the treatment of corporate capital losses.

Under California law, corporate losses from capital assets can be deducted from both capital gains income and from ordinary corporate income. By contrast, in federal law corporate capital losses may be fully deducted against capital gains, but excess capital losses cannot be deducted against ordinary income. They must be carried forward and deducted against capital gains in later years.

In addition, under new language in both state and federal law effective in 1987, when a corporation is liquidated and its appreciated property is distributed to shareholders, a capital gain is recognized both for the shareholders and the corporation (this resulted from repeal of the so-called "General Utilities" rule).

11. SPECIAL ACCOUNTING RULES

Accounting rules are important because they regulate the timing of reporting income and deductions for tax purposes. The tax law attempts to match properly the reporting of income and associated deductions, and to require the timely reporting of income. The purpose is to prevent tax avoidance by filers taking advantage of the time value of money.

A few special accounting rules which affect business taxpayers in both the personal income tax and the bank and corporation tax are described below. Although California was generally similar to federal law in these areas as of 1987, subsequent federal changes to some of these rules have not been adopted by California to date.

Installment Sales. Gain from the sale of property generally is recognized (and the tax is due) in the year in which the property is sold. However, gain from installment sales (where the seller receives deferred payments) is permitted to be reported incrementally over two or more years in proportion to the amount of the gross profits received. But such deferral in reporting income is restricted or unavailable for businesses using revolving credit plans for customer sales, for most sales of stock and securities, and for sales of personal property by dealers. The "proportionate disallowance rule," which limits deferral where the seller has outstanding debt, applies in California for corporations only.

Long-Term Contracts. A long-term contract (for constructing, installing, or manufacturing) is one which is not completed within the tax year. A taxpayer can choose to report long-term contract income under one of two methods. Under the "percentage-of-completion" method, income from the contract is reported based on the portion of the contract completed during the year and expenses are deducted when incurred. Under the "hybrid" method, 40% of the contract must be reported using the percentage-of-completion method and the balance reported using "completed contract" rules. (Under completed contract rules, income and expense from the contract are reported in the tax year in which the contract is completed.) Reporting of long-term contract income using the stricter federal hybrid method is accepted by California.

Uniform Capitalization Rules. Manufacturers are permitted to recover their costs of producing goods for sale by either expensing (deducting the costs in the year they are incurred) or by capitalizing the costs. Capitalizing means accumulating the costs in an inventory account, then deducting them at the time the corresponding inventory goods are sold. Similar rules regarding expensing and capitalizing costs apply to wholesalers and retailers who acquire goods for resale.

New provisions adopted in 1987 in both state and federal law specify uniform capitalization rules for manufacturers, wholesalers, and retailers. Several items which previously could be expensed must now be capitalized, such as storage costs, repackaging costs, wages of employees who purchase inventory, and others. Capitalizing prevents deduction of costs before the associated income is reported.

12. TAX CREDITS

Tax credits are amounts which are allowed to reduce tax liability dollar for dollar. Thus, they operate differently from deductions, whose value in reducing tax liability is the amount of the deduction times the tax rate (see Section 5 of this chapter).

Tax credits in the bank and corporation tax generally are intended to provide incentives to businesses to engage in certain activities that are socially or economically desirable. Most have counterpart credits available for businesses which file under the personal income tax law.

Tax reform legislation enacted in 1987 placed sunset dates (i.e., automatic repealers) on most tax credits in the bank and corporation tax law, to give the Legislature an opportunity to evaluate their impacts.

Some of the tax credits allowed in state law are similar to credits offered in federal law. However, in most cases the federal credit sizes are larger. This is because the federal tax burden is roughly three times greater than California's. This can be seen by comparing the rate structures: California's corporate rate is 9.3% while the federal corporate rate is 34%. As a result, many state income tax credits patterned after federal credits are roughly one-third the size of the federal credit.

Several of the major credits in California bank and corporation tax law are described below:

Solar Energy Systems

A tax credit is allowed on both personal income tax and bank and corporation tax returns for solar energy systems used for commercial purposes, that is, installed on premises other than single family dwellings. This includes solar air and water heating, electricity generation from solar voltaic facilities, and wind energy. The credit is 10% of the cost of the system, and expires at the end of 1988.

Federal law offers a 10% business energy investment credit for investment in specified solar energy property other than wind energy property. This credit sunsets at the end of 1989.

Employer-Provided Child Care

California allows credits in both the personal income tax and the bank and corporation tax to employers for providing child care services to their employees.

Specifically: (a) A 30% credit is allowed for the costs of start-up expenses related to establishing or expanding a child care program or constructing an on-site or near-site child care facility. (b) A 50% credit is allowed for employer costs to operate child care information and referral services, with a maximum dollar credit. (c) A 50% credit is allowed for employer contributions to child care arrangements for employees' children, such as on-site service, center-based service, home-provider care or in-home care; this credit cannot exceed $600 per year per child for full-time care or $300 per year per child for part-time care.

These credits sunset at the end of 1991. There are no comparable federal credits.

Employee Health Insurance

California will allow a tax credit to certain small business employers who provide health insurance coverage to employees and their dependents. The credit will be the greater of $25 per month per covered individual or 25% of the employer's cost of coverage. Eligible employers must have no more than 25 employees, must not have provided employee health insurance in 1986 and 1987, and must meet other requirements.

This credit will become available when the state Special Fund for Economic Uncertainties equals at least 3% of state General Fund expenditures and real growth in California personal income is at least 3%, but in any case no sooner than 1990. The credit will be available for five years, then will sunset.

There is no similar credit in federal law.

Targeted Jobs

A tax credit is allowed to employers who hire certain disadvantaged and disabled employees. The credit is 10% of the first $3,000 of annual wages, and it may be claimed for wages paid during the first 24 months of employment. Types of employees eligible for the credit include AFDC recipients, SSI/SSP recipients, work incentive program registrants, general assistance recipients, summer youth employees, specified refugees, and certain physically or mentally handicapped persons. The credit will not apply to wages of employees who begin work for the employer after 1989.

There is a similar Targeted Jobs Tax Credit in federal law. The credit size is 40% of the first $6,000 of first-year wages, and will not apply to those who begin work after 1989. The list of eligible employees is somewhat different from state law.

Low Income Housing Construction and Rehabilitation

California allows a tax credit in the personal income tax and the bank and corporation tax for construction or rehabilitation of low income housing in California. The credit is equal to 30% of amounts invested, claimable over four years (9%, 9%, 9%, and 3%). It is available in addition to the comparable credit offered in federal law (9% annually for 10 years for non-subsidized housing, 4% annually for 10 years for subsidized housing). To qualify for the state credit, the rents must be maintained at low income levels for 30 years (compared to 15 years for the federal credit). The credit sunsets at the end of 1989.

Research and Development Expenditures

California allows a tax credit in the personal income tax and the bank and corporation tax for incremental research and development expenditures made during the year. Incremental expenditures are those exceeding the average amount of such expenditures during the prior three years. The credit is 12% of expenditures for basic and applied research conducted by universities and certain nonprofit institutions, and 8% for qualified research conducted by others. The credit sunsets at the end of 1992.

A similar federal credit is permitted at the level of 20% of incremental research and development expenditures. It sunsets at the end of 1989.

Clinical Testing ("Orphan" Drugs)

California allows a tax credit in the personal income tax and the bank and corporation tax for 15% of clinical testing expenses incurred in California in connection with the development of drugs for rare diseases. The credit sunsets at the end of 1992.

A similar credit is available in federal law at the level of 50% of testing expenses. It sunsets at the end of 1990.

Enterprise Zone and Program Area Incentives

California provides an array of tax incentives to businesses and their employees located in designated enterprise zones and program areas, which are economically depressed areas of the state designated by the State Department of Commerce. Those special incentives include:

For enterprise zones: a tax credit for sales or use taxes paid on the purchase of certain machinery and equipment, a tax credit to employers for wages paid to certain disadvantaged individuals, a tax credit to certain disadvantaged employees, a tax deduction for interest income arising from investments in enterprise zones, first-year expensing of certain costs of depreciable property, and 15-year net operating loss carryover to offset zone income without limitation.

For program areas: a tax credit for sales or use taxes paid on the purchase of certain machinery and equipment, a tax credit to employers for hiring certain previously unemployed persons, a tax deduction for interest income from investments in program areas, first-year expensing of certain costs of depreciable property, and 15-year net operating loss carryover to offset program area income without limitation.

These tax advantages are available during the 15-year life of each designated enterprise zone or program area.

There are no comparable incentives in federal law.

13. ALTERNATIVE MINIMUM TAX (AMT)

Corporate taxpayers which take advantage of certain tax preferences (exemptions, deferrals, or deductions) must compute an alternative minimum tax

(AMT) at a 7% rate and pay this if it exceeds the amount of regular tax due. The purpose is to ensure that taxpayers who take advantage of special tax reduction provisions in the tax code pay at least some minimum amount of tax on the preferentially-treated income. These AMT rules conform generally to federal law, which imposes the AMT at a 20% rate. The AMT replaces the add-on preference tax which was a part of California bank and corporation tax law until 1988.

Computation of the AMT is rather complex. In simplified terms, the taxpayer is required first to compute the regular tax, using the rules described in this chapter and applying the regular corporate rate of 9.3%. Then the taxpayer must compute the "tentative minimum tax," which is calculated by including more income and by adding back certain tax preferences, subtracting an exemption amount ($40,000 for corporations) and applying the AMT tax rate of 7%. If the "tentative minimum tax" is higher than the computed regular tax, then the difference is the AMT due, which must be paid in addition to the regular tax.

A very simplified example of this procedure is shown in Table 3.

Tax preference items and required adjustments are generally similar to those in federal law. Specific rules for computing each of these are provided in the law. Generally the adjustments and preference items include:

- Excess accelerated depreciation and rapid amortization deductions.
- Excess depletion deductions.
- Excess intangible drilling cost deductions.
- Excess bad debt deductions.
- Excess incentive stock option value.
- Amounts deferred under the completed contract and installment payment methods of accounting.
- Excess expensing deductions (for such things as mining exploration and development costs, research and experimental costs, and magazine circulation costs).
- Net passive losses.
- The amount of untaxed appreciation of charitable contributions.
- Losses from passive farming activities.
- Recomputed net operating loss carryovers.

TABLE 3

EXAMPLE: COMPUTATION OF ALTERNATIVE MINIMUM TAX (AMT)
FOR A MYTHICAL CORPORATION

1) Regular Tax Computation:

Income of $500,000 less deductions of $300,000 =
Net Income of $200,000 times 9.3% rate =

Regular Tax of $18,600

2) Tentative Minimum Tax Computation:

Income of $500,000 less deductions of $300,000
plus income adjustments of $50,000 plus tax
preferences added back of $100,000 =
Alternative Minimum Taxable Income of $350,000
less exemption of $40,000 = $310,000
times 7.0% rate =

Tentative Minimum Tax of $21,700

3) **Difference** between Tentative Minimum Tax and Regular
Tax [$21,700 less $18,600] = **AMT** of . . . . $ 3,100

4) Total Tax Computation:

Regular Tax plus AMT [$18,600 plus $3,100] =

Total Tax Liability of $21,700

- 50% of the amount by which pre-tax "book" income of corporations exceeds alternative minimum taxable income (beginning in 1990, this item will be replaced by one which includes 75% of excess "adjusted current earnings").

These rules for corporations for the most part apply to personal income taxpayers as well.

14. TAX EXEMPT ORGANIZATIONS

Approximately 98,000 corporations are exempt from the bank and corporation tax. In general, these organizations can be described as nonprofit educational, religious, charitable, literary, scientific, civic, fraternal, and social organizations. State and federal rules for qualifying as a tax-exempt organization are nearly identical.

There are restrictions on the amount of lobbying in which such organizations may engage and retain their tax exempt status.

In addition, nonprofit business and labor organizations, chambers of commerce, real estate boards, cemeteries, certain political organizations, and various beneficiary and retirement organizations may qualify for tax exempt status.

Almost all nonprofit organizations which are exempt from the bank and corporation tax nonetheless are subject to tax on "unrelated business income" in excess of $1,000 per year. Unrelated business income (UBI) is income from a trade or business activity that is regularly carried on and is not related to the organization's exempt purpose. The tax rate on unrelated business income is the regular corporate rate of 9.3%.

Chapter III

DETERMINING THE INCOME OF MULTISTATE AND MULTINATIONAL CORPORATIONS
(The Unitary Method of Apportionment)

1. INTRODUCTION

When a corporation operates both within and outside of California, it is necessary to determine what portion of total corporate income is earned in California and which therefore is subject to tax in this state.

The method used by California and many other states is called the "unitary method of apportionment," often erroneously referred to as the "unitary tax." It applies both to corporations operating in several states within the United States only, and to corporations operating worldwide.

The unitary method of apportionment (UMA) was developed early in the history of state corporate taxation as an alternative to the so-called "source method," which attempts to identify the geographic source of each corporate income stream. The source method was believed to be inadequate, because a corporation's income is earned as the combined result of all its activities in all locations. Attempting to identify one geographic source of the earnings might not accurately reflect the contribution of all corporate activities to the ultimate profitability of the company. In addition, it was believed that the source method is inadequate because multistate and multinational firms have the ability to manipulate their internal accounts so as to shift profits earned in California or another high tax state into a state with low or no taxes on corporate income (or conversely, shift losses to high tax states).

The UMA, by contrast to the source method, combines total corporate income, then uses a formula to apportion total income to all the geographic units in which the corporation operates. This has the advantages of reflecting the contribution of all corporate activities to overall profit, and of making the assignment of income and expenses to divisions within the corporation, or particular geographic locations, irrelevant to the determination of tax liability.

The use of the unitary method of apportionment by states has been quite controversial over the years, and recent California reform legislation in this area is the culmination of over a decade of debate in this state. It should be stressed, however, that most of the controversy has centered around the application of the UMA to multinational corporations; its use for apportioning income of multistate corporations operating only in the United States has received relatively little challenge. Further discussion of the controversy surrounding worldwide combination and apportionment is provided in Section 6 of this chapter.

The UMA is a very complex area of tax law, and it has evolved over the years in statutory provisions, regulations of the Franchise Tax Board, decisions on taxpayer appeals by the quasi-judicial Board of Equalization, and judicial decisions in both state and federal courts. This area of law is still evolving.

2. UNITARY CORPORATIONS

The UMA applies to single corporations which operate both within and without California. It also applies to groups of affiliated corporations which, in effect, operate as one integrated business. When a group of corporations operates as a "unit" (i.e. is "unitary"), that group is treated as if it were one corporation and is subject to the UMA.

(A single corporation or a group of affiliated corporations may conduct more than one unitary business. In those circumstances, each unit is accounted for separately. A corporation may also have "investment" activities which are accounted for separately from the unitary business. See Section 8 below on Business vs. Nonbusiness income.)

The Franchise Tax Board determines whether a group of affiliated corporations is unitary by means of several criteria which have grown out of a body of judicial opinions. This is a complex factual determination which must be made individually for each corporate group. This is also an area where the law is still very much in evolution. However, it can be stated very generally that the most important of these criteria are:

1) Common ownership: The affiliated corporations must have more than 50% common ownership in order to be in the same unitary group.

2) Same line of business or vertically integrated: The affiliated corporations generally must be in similar businesses, where there is some evidence of operational relatedness, functional integration, or a flow of value between the businesses. Alternatively, they must be vertically integrated, where several stages of production process are controlled by the affiliated corporations.

3) Other cases of functional integration: In some instances, corporations which are neither in the same line of business nor vertically integrated are found to be unitary because centralized management gives rise to functional integration.

3. COMBINATION

Once it is determined that a single corporation or a unitary group of corporations does business both inside and outside of California, all its income and deductions from all its separate sites are combined. The group computes net income as if it were a single corporation.

Income and expenses from intercompany transactions are disregarded (the same way transactions between a husband and wife filing a joint return in the personal income tax are disregarded). Thus, for example, dividends paid from one affiliated corporation to another are not counted as income since this is an intercompany transaction.

The portion of this total nationwide or worldwide net income which is taxable by California is then determined by formula, as described below.

4. FORMULA APPORTIONMENT

The formula is based on three "factors": property, payroll, and sales. These three factors are thought generally to represent the most basic features of corporate activity which contribute most to profitability and which are easily measurable.

The formula works as follows for each tax year:

1) The corporation computes the ratio of its property in California (stated in dollars of value) to its property everywhere. It computes similar ratios for its California payroll and sales to payroll and sales everywhere.

2) The arithmetic average of the three ratios is computed. This represents the proportion of the corporation's total activity that it conducts in California.

3) The average ratio computed above is applied to combined total net income, to determine the share of the income of the unitary business which is apportioned to California.

4) The California tax rate of 9.3% is applied to this figure.

Table 4 illustrates the application of the three-factor formula to a mythical corporation.

Because formula apportionment is intended to identify only that portion of total income that is earned in California, it is assumed that double taxation of the same income by different jurisdictions does not occur. Therefore, no tax credit for taxes paid to other states is provided in the bank and corporation tax. Further, no tax credit for taxes paid to foreign countries is provided, since national level taxation is a different tier of taxation from state taxes, and the federal foreign tax credit is assumed to eliminate double taxation at the national level.

5. WORLDWIDE COMBINATION

Through 1987, all worldwide unitary corporations were required to combine their worldwide operations and use the UMA, as described above, computing worldwide factors and worldwide income. The apportionment percentage was expressed as California property, payroll, and sales as a percent of worldwide property, payroll, and sales.

However, as a result of 1986 legislation (SB 85, Alquist), worldwide corporations are now permitted to elect to use either worldwide combination or water's edge combination, which is described below.

6. CRITICISMS OF WORLDWIDE COMBINATION

Arguments made to the Legislature for repealing mandatory worldwide reporting for multinational corporations, as was ultimately accomplished in SB 85 of 1986, included the following:

- Property, payroll, and sales do not produce equal profits in all parts of the world. For example, labor may be cheaper (and thus relatively more profitable) overseas than in the United States. Thus, the formula is distorting, and results in instances of double taxation by California and foreign nations.

- Fluctuations in international exchange rates make it difficult to put economic activities around the world on a consistent and comparable basis for purposes of the formula apportionment.

- The worldwide combination and apportionment system places excessive record-keeping burdens on corporations.

TABLE 4

EXAMPLE: USE OF UNITARY APPORTIONMENT FORMULA FOR A MYTHICAL CORPORATION

1) Compute ratio of corporate assets in California to assets worldwide:

	In California	Total Everywhere	Ratio of California to Total
Sales	$1,000,000	$20,000,000	5%
Property	4,000,000	40,000,000	10%
Payroll	2,000,000	10,000,000	20%

2) Take average of 3 ratios to determine apportionment factor:

5% + 10% + 20% = 35% divided by 3 = 11.6666%

3) Apply apportionment factor to total corporate net income to determine income apportioned to California:

Worldwide Income of Corporation:	$ 5,000,000
times Unitary Apportionment Factor:	x 11.6666%
Income Apportioned to California:	$ 583,330

4) Apply California tax rate to determine tax:

Income Apportioned to California:	$ 583,330
times Bank and Corporation Tax Rate:	x 9.3%
Tax Due to California:	$ 54,250

- The worldwide system discourages corporations from making relatively less profitable investments in California, because investment in California property will increase the share of the corporation's income subject to California tax. For example, start-up of a plant is often initially less profitable.

- This system discourages investment in California by foreign firms, thereby robbing the state of the potential employment growth associated with such investment.

- Foreign governments have protested that the system is unfair to their businesses which operate worldwide, and have threatened retaliation on U.S. corporations operating in their countries.

- Third world countries might copy the system of worldwide combination, potentially increasing tax burdens of businesses from industrialized nations.

It is worth noting that not all of the worldwide corporate community expressed these criticisms of the UMA. Further, some corporations have lower tax liability using the UMA than using an alternative method.

SB 85 of 1986 responded to these concerns by designing a system under which multinational corporations could elect one of two methods of determining income subject to tax in California, beginning in 1988.

7. WATER'S EDGE COMBINATION UNDER SB 85

Under SB 85 of 1986, and its clean-up legislation, SB 85 of 1988, affiliated corporations which operate as a unitary business may <u>elect</u> to combine only the affiliates which are designated as being within the "water's edge." Affiliates outside the water's edge are disregarded and their income plays no direct role in the computation of income subject to tax in California. The concepts of unity and combination and the operation of the formula, as described above, continue to apply.

The major provisions applying to corporations which elect water's edge combination are as follows:

Definition of "Water's Edge"

The "water's edge" includes the 50 states of the United States and specified "tax havens." Thus in general, affiliates organized in the United States are considered <u>inside</u> the water's edge and are combined. Affiliates organized overseas are considered outside the water's edge and are not combined, except to the extent of their U.S. activities. However, affiliates organized overseas which have 20% or more of their activities in the United States are inside the water's edge.

So-called "80-20" corporations (U.S.-domiciled corporations with less than 20% of their activities in the U.S.) are within the water's edge.

Water's Edge Election Fee and Election Period

Corporations electing to use water's edge combination must elect annually for a 5-year period. In addition, they must pay an annual election fee of .03% of the sum of current sales and historic property and payroll in California. Proceeds from the election fee are deposited into a Special Fund, used to pay for infrastructure and economic development in California.

Offset of Election Fee for New Investment

The election fee base (current sales and historic property and payroll in California) may be reduced by the amount the corporation expended in 1987 and thereafter for investment in new plants, new equipment, and new employees in California. However, in no event may the election fee drop below .01% of current property, payroll, and sales in California.

Dividend Exclusion

Corporations electing water's edge combination may exclude from income a portion of the dividends they receive from certain affiliates. The excludable amount is equal to 75% of the highest amount of such dividends the corporation received in any one of the three taxable years ending before January 1, 1987 (this is called "base" dividends). Dividends received in excess of this base level are subject to a sliding deduction which may be either more or less than 75%, depending on whether the relative level of foreign to domestic payroll increases or decreases.

Domestic Disclosure Spreadsheets

Corporations electing water's edge combination must file domestic disclosure spreadsheets with the Franchise Tax Board every three years. Some smaller corporations are exempted from this requirement. Spreadsheets must provide information on income and apportionment factors reported to other states.

Audits

The Franchise Tax Board is required to conduct audits of corporations electing water's edge combination, to ensure that income is properly accounted for and to prevent tax avoidance.

8. BUSINESS VS. NONBUSINESS INCOME

Business and nonbusiness income of multistate and multinational corporations is treated differently when determining California tax liability.

Business income is all income which arises from the conduct of trade or business operations. Most corporate income is business income and is apportioned to California or elsewhere by formula, as described above.

Nonbusiness income is that which does not arise in the normal course of the taxpayer's business operations, i.e., it is investment income. It can include such things as dividends from other corporations, interest, royalties, gains from the sale of investment properties, and the like so long as they are not related to the normal business of the corporation. In general, nonbusiness income is allocated in full to the state where the taxpayer is commercially domiciled, or where the relevant property is located.

9. LITIGATION

The states' authority to employ the worldwide UMA has been subject to numerous legal challenges. The most significant case in this area was Container Corporation of America v. Franchise Tax Board. In 1983, the United States Supreme Court upheld the constitutionality of the states' use of the unitary method of apportionment in the case of worldwide corporations with domestic parents.

A constitutional challenge of the worldwide UMA brought by a foreign parent corporation is now in the state courts. It is Barclay's Bank of California v. Franchise Tax Board. A Superior Court in Sacramento, California ruled in 1987 that the worldwide unitary method of apportionment violates the foreign commerce, due process, and foreign affairs clauses of the U.S. constitution in the case of this foreign parent corporation. The case is pending on appeal before the Third District Court of Appeals, with arguments expected in 1989.

10. FEDERAL TREATMENT OF MULTINATIONAL CORPORATIONS

Federal law taxes corporations in a manner similar to California taxation of individuals. Corporations organized in the United States ("residents") are taxed on all their income and are allowed a credit for taxes asserted by foreign countries because they have income sources there. Corporations organized outside the United States ("nonresidents") are taxed on only their U.S. source income.

In making determinations of income source, the federal government uses the "separate accounting method." This method requires accounting separately for income streams and expenses attributable to each member of an affiliated group of corporations and to U.S. versus foreign operations. Transactions between affiliates are to be accounted for on an "arm's length" basis. That is, pricing is to be adjusted to reflect what the transactions would be if they were conducted at arm's length between competitor corporations rather than between affiliated corporations.

A key feature of the federal system is an aggressive audit program to ensure that arm's length pricing is used by affiliated corporations to reflect accurately the income and goods exchanged between related businesses. These are often referred to as "Section 482 audits."