STANDARDIZED REGULATORY IMPACT ASSESSMENT

Economic Impact Analysis of Regulation 23663 – the assignment of credits among affiliated members of the same combined reporting group

Franchise Tax Board

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STANDARDIZED REGULATORY IMPACT ANALYSIS

1. Need for the Proposed Regulations

The proposed regulations provide administrative procedures for resolving errors in the assignment of credits between members of a corporate group. Assembly Bill 1452 (Stats. 2008, ch. 763) added Revenue and Taxation code (RTC) section 23663, which permits members of a combined corporate tax reporting group to assign tax credits to affiliated members of the same combined reporting group. Many corporate taxpayers are part of a unitary group that file a combined report for California. Prior to AB 1452, tax credits could be used only by the specific corporation that generated the credits to reduce that corporation’s portion of the combined reporting group’s total tax bill. The intent of AB 1452 was to view combined reporting groups as a unified entity for the purpose of using tax credits, allowing such credits to be used anywhere within the combined reporting group to reduce the unitary group's total tax.

AB 1452 allowed the assignment of credits to members of a combined reporting group for taxable years beginning on or after July 1, 2008. Assigned credits may be used by the assignee in taxable years beginning on or after January 1, 2010. The election is irrevocable, and must be made on the assigning taxpayer’s original return for the year of the credit assignment.

There are a number of ways in which a taxpayer may make a defective election to assign credits. For example, an audit may result in the finding that the amount of credit generated by a taxpayer was less than the amount that the taxpayer assigned. Another possibility is that an audit may determine that either the assignor or the assignee was not a member of the combined group on all of the dates required in the statute. RTC Section 23663(e)(4) authorizes the Franchise Tax Board (FTB) to specify the treatment of any credit assignment that does not comply with section 23663.

The proposed regulations provide guidance for the treatment of defective elections to assign credits to affiliated members of a combined group. The proposed regulations allow taxpayers who make eligible mistakes in filing their tax returns to correct their elections, and provide guidance on the disposition of tax credits whose assignment cannot be corrected.

The proposed regulations will benefit taxpayers, tax practitioners, and the state of California by providing clarity that does not currently exist in connection with the treatment of a defective election to assign credits pursuant to RTC section 23663. The proposed regulations would give taxpayers certainty as to how credits are allocated when a defective election occurs. The proposed regulations also give effect to the statute’s intent of allowing a combined reporting group to benefit from a group member’s credits by giving taxpayers flexibility in determining how credits are allocated when there is agreement between the parties involved in the defective election. Similarly, the proposed regulations give taxpayers one year to correct certain errors in defective elections. The clarity from the proposed regulations will eliminate uncertainty for taxpayers and tax practitioners. The proposed regulations will improve administrative efficiency for both taxpayers and the FTB, and will facilitate tax administration for the State of California by providing definitions, guidelines,
flexibility and examples relating to defective elections to assign credits. The proposed regulations will also give effect to the statute's intent by allowing taxpayers in many cases to use the credits in the tax year they were originally claimed, rather than have taxpayers pay assessments in the original tax year and then reassign and use the credits in future tax years. The proposed regulations will also, in some cases where there are no future liabilities for the credits to offset or where credits expire, enable taxpayers to utilize tax credits that would have been denied absent these regulations. These benefits are the result of goals developed by the FTB with input from interested parties and based on broad statutory authority.

2. Major Regulation Determination

Senate Bill 617 (Stats. 2011, ch. 496) established new regulatory impact assessment standards for major regulations. State agencies must conduct a Standardized Regulatory Impact Assessment (SRIA) when it estimates that a proposed regulation has an economic impact exceeding $50 million.

Because the revenue impact of AB 1452 is greater than $50 million, the Department of Finance has instructed FTB that it is proper to treat this implementing regulation as a major regulation.

3. Public Input

FTB’s process for drafting the proposed regulations included the following three interested party meetings and one 60-day notice to solicit additional input from taxpayers.

- October 1, 2012 — Held an interested parties meeting to elicit public input on proposed regulations which would authorize and establish specific procedures under which taxpayers may request that FTB staff permit the correction of defective elections, and identify general standards under which FTB staff review requests for the correction of a defective election, including examples of situations where such requests may or may not likely be granted following staff review.
- December 5, 2013 — Held an interested parties meeting to elicit public input on a proposed structural framework for the regulations.
- June 12, 2014 — Held an interested parties meeting to elicit public input on draft language for new regulations that address defective assignments, and to clarify when an assignee is considered an eligible assignee in the same combined reporting group.
- August 29, 2014 — Released minor modifications to the draft regulatory language based on comments received at the June 12, 2014 interested parties meeting. The public was given 60 days to review and provide comments on these revisions.

Taxpayers and the public had opportunities to discuss the proposed regulations and voice their concerns. No reasonable alternatives to these proposed regulations were identified which would have a lesser adverse impact to the state, enhance the state’s business climate any further, or which could carry out the purpose of these regulations more effectively.
4. Definitions

This section defines several terms used in this analysis:

Combined Report: A tax return submitted by a unitary group of corporations. The combined report will include the total income earned and the amount of tax liability for both the group as a whole and for each corporate member of the group.

Affiliated Corporation: Another corporation that is a member of the same combined reporting group.

Assignor: A corporation that gives some of its tax credits to an affiliated corporation.

Assignee: A corporation that receives tax credits from an affiliated corporation.

Assignment: An election to transfer tax credits from a corporation to an affiliated corporation. Valid assignments are irrevocable, i.e., assigned credits may only be used by the assignee.

Defective Assignment: An assignment that does not comply with the requirements of RTC section 23663.

5. Mechanics of Combined Reports

Under California law, when a corporation is part of a unitary business it is required to use a combined report to determine its California tax liability. On a combined report, the amount of the unitary group's business income is aggregated and then apportioned to California based on the unitary group's California apportionment factors. Each member of the group calculates its California taxes separately using the group’s apportionment ratio. This is done by multiplying each member's net income for California tax purposes by the unitary group's California apportionment percentage. For example, suppose taxpayers A and B are part of a combined reporting group and have the income and sales amounts described in below (table 1). To calculate the apportionment factor for this group, the California sales for all three taxpayers are added together and divided by the sum of all sales for all three taxpayers. The resulting factor (25 percent in this example) is used by each of the three taxpayers to determine how much of their income is taxable in California.
Table 1

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>Combined</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Sales</td>
<td>$10,000,000</td>
<td>$20,000,000</td>
<td>$30,000,000</td>
</tr>
<tr>
<td>California Sales</td>
<td>$4,500,000</td>
<td>$3,000,000</td>
<td>$7,500,000</td>
</tr>
<tr>
<td>CA Apportionment Factor</td>
<td></td>
<td></td>
<td>25.0%</td>
</tr>
<tr>
<td>Income Subject to</td>
<td>$1,000,000</td>
<td>$3,000,000</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>Apportionment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CA Apportionment Factor</td>
<td></td>
<td></td>
<td>25.0%</td>
</tr>
<tr>
<td>Income Apportioned to CA</td>
<td>$250,000</td>
<td>$750,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>8.84%</td>
<td>8.84%</td>
<td></td>
</tr>
<tr>
<td>Tax before Credits</td>
<td>$22,100</td>
<td>$66,300</td>
<td>$88,400</td>
</tr>
</tbody>
</table>

Prior to AB 1452, tax credits could be used only by the specific corporation that generated the credits to reduce that corporation’s portion of the combined group’s tax bill. Thus, in the example below (table 2), if Corporation A generated $80,000 in tax credits, it could use those credits to reduce its tax to the $800 Minimum Tax for a California corporation, but Corporation B could not reduce its taxes.

Table 2

<table>
<thead>
<tr>
<th></th>
<th>Before AB 1452</th>
<th>A</th>
<th>B</th>
<th>Combined</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax before Credits</td>
<td>$22,100</td>
<td>$66,300</td>
<td>$88,400</td>
<td></td>
</tr>
<tr>
<td>Available Credits</td>
<td>$80,000</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>Credits Used</td>
<td>$21,300</td>
<td>0</td>
<td>$21,300</td>
<td></td>
</tr>
<tr>
<td>Tax After Credits</td>
<td>$800</td>
<td>$66,300</td>
<td>$67,100</td>
<td></td>
</tr>
<tr>
<td>Unused Credits</td>
<td>$58,700</td>
<td>0</td>
<td>$58,700</td>
<td></td>
</tr>
</tbody>
</table>

Under AB 1452, members of a combined group may assign tax credits to other members of the group (table 3). In the example below, A could assign credits to B. Since B can now use the credits, the tax liability of the combined group is lower.

Table 3

<table>
<thead>
<tr>
<th></th>
<th>After AB 1452</th>
<th>A</th>
<th>B</th>
<th>Combined</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax before Credits</td>
<td>$22,100</td>
<td>$66,300</td>
<td>$88,400</td>
<td></td>
</tr>
<tr>
<td>Available Credits</td>
<td>$80,000</td>
<td>0</td>
<td>$80,000</td>
<td></td>
</tr>
<tr>
<td>Transferred Credits</td>
<td>$58,700</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Received Credits</td>
<td></td>
<td>$58,700</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit Used</td>
<td>$21,300</td>
<td>$58,700</td>
<td>$80,000</td>
<td></td>
</tr>
<tr>
<td>Tax After Credits</td>
<td>$800</td>
<td>$7,600</td>
<td>$8,400</td>
<td></td>
</tr>
<tr>
<td>Unused Credits</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
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</table>

6. Tax Credits Assigned and Used

Taxpayers were allowed to assign credits to an affiliated corporation for tax years beginning on or after July 1, 2008, but could not use the assigned credits to reduce liability until tax years beginning on or after January 1, 2010. For tax years 2008 – 2013, taxpayers assigned approximately $3.4 billion of credits to affiliates (table 4). Of that total, approximately $1.2 billion in assigned credits were used to reduce tax liability for tax years
2010 – 2013. Usage of assigned credits was highest in 2010, the first year that they could be used, then dropped as some taxpayers depleted their stock of unused credits. Assigned tax credits are used on about 200 combined reports annually. Table 1 shows the number of combined reporting groups that have used credits that have been assigned from one member of the group to another.

<table>
<thead>
<tr>
<th>Table 4. Usage of Assigned Credits ($s, Millions)</th>
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<tbody>
<tr>
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<tr>
<td>Number of Returns Using Transferred Credits</td>
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<tr>
<td>2008-09   2010   2011   2012   2013   Total</td>
</tr>
<tr>
<td>Credits Assigned $1,576   $617   $360   $432   $374   $3,359</td>
</tr>
<tr>
<td>Assigned Credits Used $483   $271   $223   $201   $1,178</td>
</tr>
</tbody>
</table>

7. **Defective Assignments**

The assignor can make an election to assign a credit, using Form 3544, to an assignee that is a member of the same combined reporting group. The assignee uses Form 3544A to specify how much assigned credit will be used each year.

A defective assignment occurs when an assignment does not comply with the requirements of RTC section 23663 and includes any assignment which:

- Assigns an amount of credit (or the aggregated amount of the same credit) in excess of the amount of the assignor's eligible credits for the tax year;
- Fails to clearly identify the amount of the credit to be assigned;
- Fails to clearly identify the type of the credit intended to be assigned;
- Assigns a credit which is not an eligible credit; or
- Assigns a credit to an assignee that is not clearly identified or is not an eligible assignee.

A defective assignment may be discovered by the taxpayer or during audit. A taxpayer who discovers an assignment error may submit a request in writing to the FTB asking to correct the defective assignment. If granted permission, the correction would be effective as of the year of the defective assignment. If the defective assignment is discovered during an audit, it would likely be three to four years at a minimum after the tax return was filed. The taxpayer’s defectively assigned credits would be allocated based on the regulations and the taxpayer will be notified and billed for any taxes due. Audit will adjust the credit carryover to accurately reflect the credits available. Any defectively assigned credits which are allocated to the assignor may be reassigned on an original tax return in a future tax year. Upon the approval of the proposed regulations the taxpayer will have one year to correct any past assignment errors made in years for which the statute of limitations has not expired.
There are several common types of defective assignments. This section compares the administrative procedures and timing of cash flows for the most common types before and after the promulgation of the proposed regulations.

7.1. More Credit Assigned than Generated

Suppose that Corporation A files a 2010 tax return on which it states that it generated $75 of credit and assigned all of that credit to Corporation B. Corporation B uses the $75 credit to reduce its 2010 tax liability. In 2015, FTB audit determines that Corporation A had only generated a $50 tax credit in 2010.

Without the Proposed Regulations:

The election would be invalid. The credit would revert back to Corporation A and be reduced to $50. The $50 credit could either be used by A in a future tax year, or be reassigned correctly in a future tax year. An assessment would be issued for the entire $75 on the group’s 2010 return. Corporation A could reassign the $50 credit to Corporation B on a 2015 or later tax return.

If any member of the combined group has sufficient tax liability in 2015 to use the $50 credit, the group will reduce its payments for the 2015 tax year at approximately the same time that it pays the assessment due on the 2010 tax year. The net payment will be $25, the same as it would be with the regulations.

If no member of the group has tax liability in 2015 against which to use the $50 credit, the payment to the state will be $75, $50 greater than it would have be with the regulations. Future payments by the group would be reduced by $50 if the group is able to use the credit in a future tax year.

Under the Proposed Regulations:

The credit used in 2010 by Corporation B would be adjusted down from $75 to $50, and an assessment issued for the remaining $25.

The effect of the regulations is, therefore, nothing if the group has current liabilities against which to use the credit, a temporary increase of $50 in payments to the state if the group has future but not current liabilities against which to use the credit, or a permanent $50 increase in payments to the state if the group will never again owe tax greater than Minimum or Alternative Minimum Tax.

A slightly more complicated case arises if Corporation A had transferred $50 of credit to Corporation B and $25 to Corporation C before being determined to have only generated $50.
Without the Proposed Regulations:

As in the case above, no credit could be used against 2010 taxes, but the reverted $50 could be used in a later year. Depending on the taxpayer’s ability to use the credit in the year the assessment is finalized, the assessment may or may not have a real effect on cash flow.

Under the Proposed Regulations:

The $50 of credit would be allocated to Corporations B and C pro rata based on the ratio of credit assigned to them in the defective assignment, but Corporations B and C would still be allowed to use $50 of credit on their 2010 tax return. The effect of the regulations would still be nothing, a temporary increase in payments, or a permanent increase in payments, depending on the group’s ability to use the credits in a future year.

7.2 Clerical Errors in the Assignment

This category covers a number of possible errors. For example, a taxpayer may fail to specify the type of credit being assigned or the year in which the credit was generated.

Without the Proposed Regulations:

Credits assigned with these types of errors would be returned to the assignor and could then be reassigned at the next available opportunity.

For example: Corporation D assigned a $100 credit to Corporation E in 2012. In 2016, it is discovered that the assignment contained an error. The credit would revert to Corporation D. Corporation D may either use the credit itself or reassign the credit to Corporation E or any other qualified assignee in 2016 or another future tax year. As in the case described above, the taxpayer would be assessed $100 of additional tax for tax year 2012. If the taxpayer is able to use the credit in 2016, it would likely reduce the tax payments made to the state in 2016 by $100. If the taxpayer does not have sufficient liability against which to apply the credit, any increase in payments to the state will be reversed in a future year in which the taxpayer can benefit from the credits.

Under the Proposed Regulations:

Taxpayers would be allowed to fix many types of clerical errors, so the identification of the error would not result in any assessments to the taxpayer. As above, the regulations may result in no net change in payments to the state, a temporary increase, or a permanent increase in payments to the state, depending on the group’s ability to use the defectively assigned credits in future years.

7.3 Assignor or Assignee is Ineligible

If either the assignor or the assignee is ineligible, the credit goes back to the assignor. This section of the proposed regulations provides the taxpayer with certainty as to the allocation
of defectively assigned credits, but does not allow the credits to be used in the year of the original return.

*With or Without the Proposed Regulations:*

The assignor would need to wait until a current or future year to reassign a credit. For example: Corporation G assigns $100 credit to Corporation H in tax year 2011. In 2016, Audit determines that H was an ineligible assignee. The credit would go back to Corporation G, who may keep the credit or reassign the credit to Corporation I in 2016. As in the above cases, there would be little impact if Corporation G, I or another eligible member of their group can use the credit in 2016. If the credit cannot be used in 2016 there would be either a temporary or permanent transfer from the taxpayer to the state. Unlike the case of clerical errors in the assignment, there would be no change in the pattern of payments with or without the regulations in the case of ineligible assignments.

8. **Timing Issues in Net Tax Payments.**

If the proposed regulations are adopted, the FTB will issue fewer assessments for taxes owed because of defective assignments. The next two sections will explore the expected amount of these foregone assessments. To model the economic impact of these changes, FTB considered three groups of taxpayers, assuming that the proposed regulations are not adopted.

8.1 No Impact

The first group of taxpayers has current tax liability against which to use their tax credits. The proposed regulations will have very little effect on these taxpayers.

For example, in 2016 it is determined that the assignment of a $10,000 credit in 2012 from Corporation A to Corporation B was defective. The credit was defective because the taxpayer did not specify the year in which the credit was generated. Corporation B has $30,000 in tax before credits for 2016. After the determination that the 2010 assignment was defective, the credit will revert to Corporation A and may be reassigned in the future. Corporation A subsequently specifies the year the credit was generated and reassigns the credit to Corporation B in tax year 2016, reducing Corporation B’s 2016 tax to $20,000. The taxpayer may reduce its payments toward its 2016 tax by $10,000 at approximately the same time that it pays the $10,000 it owes for 2012 taxes. These two changes effectively cancel each other out, so there should be no economic impact.

8.2 Temporary Impact

The second group of taxpayers cannot use all of the reassigned credits immediately, but can use them within a few years.

Again assume that in 2016 it is determined that the assignment of a $10,000 credit in 2012 from Corporation A to Corporation B was defective. The credits from the defective
assignment in 2012 revert to Corporation A. Assume this time that neither A nor B has a 2016 tax liability, but that A can use the $10,000 to reduce tax in 2017. In this case Corporation A may make a payment to the state in 2016, and reduce payments to the state by a like amount in 2017. There could be short run economic impacts from the increased tax payments in 2016 and from the decrease in tax payments in 2017. Since this transfer of funds to the state is temporary, it is expected to have little long run economic impact.

8.3 Long Term Impact

Assume instead that the taxpayer A generates enough tax credits each year to reduce each member of the combined reporting group’s taxes to the Minimum Tax (or in some cases the Alternative Minimum Tax) and that credits from the defective 2012 election have reverted back to Corporation A.

Absent the proposed regulations, the taxpayer will be assessed tax for the defective 2012 assignment but will not have current or future tax liability to offset these assessments. This results in a permanent increase in tax payments.

These increased tax payments are all associated with past tax years for which the taxpayer’s economic decisions are irreversible. Since this group of taxpayers is already able to reduce their tax to the Minimum Tax for the foreseeable future, the presence or absence of the regulations will have no effect on their future tax payments. For this group of taxpayers, therefore assessments for prior tax years are “sunk costs” that should have no impact on economic behavior. It follows that the economic impact of the proposed regulations arises primarily from the change in revenue available to the state from assessments on this group of taxpayers.

8.4 Payments, Refunds, and Interest

The discussion above has described taxpayers making payments to the state when their use of tax credits is disallowed. In fact, most corporate taxpayers leave extra money on account with FTB to cover audit related payments. Many audit assessments, therefore, result in the taxpayer requesting a smaller refund at the conclusion of the audit rather than the taxpayer making an actual payment to the state. The economic impact of an assessment should not depend on whether it results in a larger payment from or a smaller refund to the taxpayer. The remainder of this analysis will continue to use the term payments to describe either an increase in payments or a reduction in refunds.

This discussion has not yet considered differences that may arise in the amount of interest paid by taxpayers on the assessments described above with or without the regulations. The amount of interest will be small for two reasons. First, most large corporate taxpayers leave extra money on account with FTB. If the amount of money on account is greater than the assessment, these taxpayers will not have underpaid their tax, so they will not owe any interest. Second, for those taxpayers that do not have sufficient funds on account to cover their assessments, interest rates are currently low.
9. Likely Cash Flows

9.1 Gross Amount of Defective Assignments

Taxpayers used $1.2 billion in assigned credits in tax years 2010-2013. As of January 2016, FTB Audit has identified about $200 million of credits with defective assignments that may be correctable if the proposed regulations are adopted. About $57 million of these credits were actually used by taxpayers to reduce their liability for tax years 2010-2012, and will, therefore, generate assessments if the regulations are not adopted. The amount of credit claimed in cases where the taxpayer did not have enough credit available to assign was about $1 million. To the extent that these credits were never available, they would generate assessments even if the regulations are adopted, so the net difference in assessments with and without the regulations are about $56 million. This $56 million represents about 3 years of Audit activity for tax years in which credit assignments were allowed, or about $19 million per year of Audit activity. The use of assigned credits was much larger in tax years 2009 and 2010 than in subsequent tax years. Taxpayers appear to be learning to avoid defective assignments. FTB estimates, therefore, that going forward the identification of credits with defective assignments will drop to about $10 million per year (Please refer to Section 10 for further detail).

9.2. Ability of Taxpayers to Use Credits Returned to the Assignor.

An examination of more recent tax returns from taxpayers that used credits with defective assignments that could be fixed under the proposed regulations indicates the following:

About $12 million in these credits were used by taxpayers whose tax liability in their most recent filing was greater than the defective tax credits that they previously used. Thus, if their tax liability for the next year that they file is at least as great as for their most recent filing, they will be able to reassign and use any defective credits returned to the assignor immediately. The proposed regulations should have little or no impact on these taxpayers.

About $11 million in credits with defective assignments was used by taxpayers whose most recent filing reported tax liability greater than zero, but less than the amount of credit in question. If this group of taxpayers reports the same amount of liability in future tax years, it will take them a few years to reassign and use any credits returned to the assignor. The portion of the $11 million that can be used immediately will have little economic impact, the remainder will, if the regulations are not adopted, result in a short term transfer of money from these taxpayers to the state as described in 7B, above. For this group also there is unlikely to be a long run economic impact.

The remaining $33 million in credits with defective assignments was used by taxpayers who consistently generate more credits than they can use. Without the proposed regulations this $33 million will be transferred to the state for the long term. Adoption of the regulations would reverse this result.
If the relative size of these 3 groups stays the same in the future, and future audits revert about $10 million annually in credits with defective assignments, the ongoing transfer from the state to taxpayers of adopting these regulations would be about $7 million per year.

In sum, the adoption of the proposed regulations would result in a revenue loss to the state of about $39 million in the first year ($33 million to taxpayers that can’t reuse the reverted credits plus $6 million from taxpayers that can reuse some but not all of the reverted credits) and about $5 million per year thereafter ($7 million in new unusable reversions minus $2 million in reuse of reverted credits from earlier years).

<table>
<thead>
<tr>
<th>Table 5</th>
<th>Flow Of Credits With Defective Assignments</th>
<th>State Fiscal Year</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td>2016/17</td>
</tr>
<tr>
<td>Defectively Assigned Credits Identified and Claimed for Earlier Tax Years</td>
<td>56</td>
<td>10</td>
</tr>
<tr>
<td>Credits Reusable in Year of Audit Adjustment</td>
<td>17</td>
<td>3</td>
</tr>
<tr>
<td>Credits From Earlier Audit Adjustments Reused</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Net Cash Flow From State to Taxpayers if Regulation is Adopted</td>
<td>39</td>
<td>5</td>
</tr>
</tbody>
</table>

10. Baseline Information

The latest defective assignment data (table 6) reviewed for this report consisted of information on 40 taxpayers and the research and development (R&D) credit, which makes up over 90 percent of the credits assigned. These taxpayers may make large credit assignments to several members of the same combined reporting group. If some of these assignments are defective it is likely that one or a few, not all, of these assignments would be at risk. An accurate determination would require Audit to review each return to determine the defective portions.

<table>
<thead>
<tr>
<th>Table 6.</th>
<th>Defective Assignments ($ in millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Year Assigned</td>
<td>2008</td>
</tr>
<tr>
<td>Credits Assignment Involved</td>
<td>$14</td>
</tr>
<tr>
<td>Less Outliers</td>
<td>$11</td>
</tr>
<tr>
<td>Adjusted Credits Assignment Involved</td>
<td>$3</td>
</tr>
</tbody>
</table>

The baseline would be the revenue impact in a world without these regulations. The defective assignments summarized in table 6 above reflect assignments by tax year. This data is presented with and without outliers since one or two taxpayers with extraordinarily high credit assignments could distort the revenue impact. The amount without outliers is more representative of defective assignments and likely a better indicator of the additional revenue that would be generated without the proposed regulations. The actual impact of the defective assignments is determined upon completion of the audit. Although a
corporation may assign $200 million in credits, the final impact of a particular assignment error is likely to be a small fraction of the defective amount. Based upon updated defective assignment data in table 6, there was on average approximately $33 million in defective assignments for tax years 2008 through 2014. Because FTB expects taxpayers to continue to learn to avoid defective assignments and adoption of this regulation would permit taxpayers who make eligible mistakes to correct their elections, FTB estimates the additional revenue from defective assignments would drop to approximately $10 million per year upon implementation of these regulations.

Without these regulations the defective assignments would be returned to the assignor and the assignee would be billed for that amount. These multistate corporations are audited regularly and often leave substantial sums of money on account with FTB to cover potential audit assessments. The issuance of assessments related to the defective assignment of credits, therefore, should be easily absorbed by the affected taxpayers. Fluctuations in cash balances are managed to maintain certain levels and do not impact economic activity, the company’s operations or profitability.

The assignor would have the option of reducing future tax liability or reassigning the credit correctly at a future date. Therefore, any revenue gain attributed to defective assignments would likely be due to timing differences. Revenue collected in the year of assessment would be offset by the revenue loss when the credit is used in future tax years. Additionally, as is frequently the case, the proposed assessment may be challenged in court and the final payment could be a fraction of the assessed amount.

To determine a baseline — the actual impact of defective assignments — the frequency and dollar amount of these erroneous assignments must be known. Due to fluctuations in the frequency and magnitude of defective tax credit assignments, the revenue impact could vary widely, and the baseline may be unreliable.

11. Economic Impact

To assess the economic impact of the proposed regulations FTB considered the effect of the cash flows described in Section 8 on both the taxpayer and the government.

11.1 Impact to Taxpayers

11.1.1 Proposal Will Improve Taxpayers’ Cash Balances, Unlikely to Affect Real Economic Activity

FTB expects reduction in payments to the state that would occur if the proposed regulations are adopted to have a minimal effect on the real economic activity of affected corporations. Most of the taxpayers affected by these proposed regulations are very large corporations for whom California taxes are a very small part of their business expenses. The total usage of defective assigned credits is less than one tenth of one percent of the cash balance on these corporations’ balance sheets. This suggests that most of these taxpayers could easily transfer additional cash to FTB without disrupting ongoing operations.
The taxpayers who will make payments to the state if these regulations are not adopted are those who do not have current tax liabilities against which to use additional credits. Since the amount of tax they owe in the current tax year will not change if the regulations are adopted, the regulations will have little, if any, effect on their expected rate of return for current economic activities. The proposed regulations should not, therefore, have a significant effect on any real economic decisions – such as investment or production – made by taxpayers.

11.1.2 Dynamic Impact of Improved Taxpayer Cash Balances Will Be Mostly Out-Of-State

The primary impact of the proposed regulations on taxpayers is an increase in cash balances concentrated in the largest corporations. These corporations can and will deploy that cash anywhere in the world that they believe will generate the greatest return on their investments. If they choose to hold onto the cash in liquid form, the cash will be dispersed throughout the global financial market. There is no reason to believe that a significant portion of this cash will be reinvested in California, and for this analysis FTB assumes the impacts are limited to a change in balances left on account with FTB.

11.2 Impact to State

If the proposed regulations are adopted, cash flow to the state will be reduced by the amount described above. Since the state operates under a balanced budget requirement, the reduced payments should induce a similar decrease in state government expenditures. These regulations would not impose any additional costs or result in additional savings to the FTB, or any other state agency.

11.3 Dynamic Impact on the State’s Economy

As described above, the initial impact of the proposed regulations would be a reduction in state revenues and an equivalent increase in cash balances for affected corporations. The reduction in state revenues would be about $39 million initially and about $5 million per year ongoing. As described above, FTB believes that the general economic effect of an increase in corporate cash of this magnitude would be imperceptibly small. The economic literature on the dynamic impact of changes in state spending provides a range of results that are summarized in Table 2 of Ramey (2011). Many of the papers cited in this table find multipliers in the range of 1.5 – 2. This suggests that a reduction in state spending of $39 million in the first year after the adoption of the proposed regulations would result in a decrease of $60-80 million in statewide economic activity, and the ongoing loss of $5 million in state revenue per year would result in an ongoing loss of $7-10 million per year.

11.4 Impact on Incentives for Innovation in Products

By providing a remedy for the correction of credit assignment errors these regulations are complementary to existing law which allow the assignment of credits. These regulations do

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not mandate, require, or provide incentives for additional investment in the state by individuals or businesses, and as such, will not impact any incentives for innovation in products, materials, or processes in this state.

11.5 Additional Benefits

Adoption of the proposed regulations would also likely improve California's "business climate" as they provide certainty as to what happens to defectively assigned credits and improve the administrative efficiency for the taxpayer and the FTB. However, these effects cannot be quantified.

11.6 Summary Conclusions

By providing needed clarity in the area of defective elections and the assignments of credits the proposed regulations would enhance rather than hinder or adversely impact the ability of California businesses to compete with businesses from other states. They address the assignment of credits by all businesses that earn credits in California, both California and foreign businesses, and do not create a competitive advantage or disadvantage to California businesses. Although, the clarification provided would enhance the business climate by providing certainty in the area of credit assignments.

Jobs would neither be created nor eliminated due to these regulations. Issues addressed in these regulations effect corporations which are part of a combined reporting group in which more than one corporation may generate more tax credits than they can use. The impact of tax compliance is minor. These regulations would not alter the manner in which credits are assigned under current law. The clarification they provide with respect to what happens when credits are defectively assigned would neither result in new business creation or elimination of existing businesses because economic decisions and business investment would not be effected.

Since these regulations only address the assignment of credits within combined reporting groups comprised of multiple affiliated corporations it will not have an impact on private individuals, non-corporate businesses, small businesses, and most corporations.

12. Alternative Regulations

No alternative regulations were proposed at the three stakeholder meetings, therefore, FTB has evaluated two less stringent versions of the proposed regulations as possible alternatives.

12.1 Alternative 1

Proposed Regulation section 23663-4 gives taxpayers one year to correct a defective assignment error. Currently, assignment errors discovered by the taxpayer within one year could be self-corrected under the Proposed Regulation section 23663-4. The majority of defective assignments are discovered in the audit process, and the process of correction and reallocation can take a number of years due to the length of time between the
assignment on taxpayers’ original tax return and resolution of the audit process, as well as a heavy audit workload.

Alternative 1 would be to remove Proposed Regulation section 23663-4. Removing the proposed regulation would not be very efficient or an improvement on the proposed regulations under section 23663 since it would require taxpayers to go through a much more time-consuming and burdensome process to correct a defective assignment. The one-year window is especially useful since it ties to the timing of taxpayers’ next year’s tax returns and incentivizes taxpayers to review their prior year tax returns’ assignments when preparing the next year’s tax returns.

The intent of the credit sharing legislation—the use of tax credits by assigning them to group members who have sufficient tax liability against which the credits could be allowed would be hampered by requiring taxpayers to wait years in order for defective assignments to be corrected. Without Proposed Regulation 23663-4, the curing would generally take place in the audit process.

12.1.1 Economic Impact

FTB does not have an estimate of how many taxpayers discover assignment errors and correct them. Although the number of such taxpayers is likely to be minor the dollar value of these adjustments could vary. Removal of the self-correction provision, leaving the error discovery and correction to the audit process would result in four to five years during which tax liability would be temporarily understated. During that time, state corporate tax revenue will be understated. Once the error is detected and corrected the assignor’s tax liability will be adjusted up to the appropriate level. It is unlikely that this temporary reduction in tax liability and tax revenue will have a significant effect on GDP, personal income, private investment, employment, or other economic indicators.

12.1.2 Cost-Effectiveness

Removing the one-year window will require FTB to detect this error as part of the audit, but would not increase the FTB workload or require additional staffing. A FTB audit is a complete review of all relevant components of the tax return and as such the credits assigned and assigned credits used will be verified in the course of the audit and the error would be discovered. Any additional workload or costs to the FTB would be minor. There would not be any additional compliance costs to the taxpayer, just a shift in the workload.

12.1.3 Reason for Rejecting Alternative 1

Allowing the taxpayer to self-correct and remedy an assignment error allows the taxpayer to correctly assign the credit and use it quickly rather than waiting for the lengthy audit process. It is a time saving remedy which promotes the purpose of the statute—to draw down existing credit balances by allowing the taxpayer to assign and apply these credits to outstanding tax liability.
12.2 Alternative 2

Existing law is unclear as to whether defectively assigned credits stay with the assignor or go to the assignee. When assignors assign more credits than they have available to assign (usually due to a reduction of credits during audit), Proposed Regulation 23663-2 allocates the credits that the assignor has to the assignee. For example, an assignor reports it has 100 credits available and assigns 100 credits, and upon audit it is determined that the assignor only has 80 credits, then the 80 credits will be assigned to the assignee. In every other instance, defectively assigned credits stay with the assignor pursuant to Proposed Regulation 23663-3 since it is unlikely the law would allow the credits to be allocated to assignees in such instances.

Alternative 2 would remove Proposed Regulation 23663-2 and, instead, in all instances defectively assigned credits would stay with the assignor pursuant to Proposed Regulation 23663-3. Therefore, in the example above, instead of FTB assigning the 80 credits to the assignee, those credits will stay with the assignor who would then correctly reassign them in the year following the completion of the audit—a lag of four to five years.

12.2.1 Economic Impact

In tax year 2010 approximately $8.5 million of $259 million credits assigned (table 6) were defective because the assignor assigned more credits than were available. As in alternative 1, the relatively minor and temporary change in revenue is unlikely to have an impact on GDP, personal income, private investment, employment, or other economic indicators.

12.2.2 Cost-Effectiveness

This change will not impact the FTB audit workload. From an FTB perspective the credit assignment will be corrected and left with the assignor instead of the assignee. The taxpayer (the assignor) will have to reassign the credit correctly in a subsequent tax return filing, 4 or 5 years after the original defective assignment, whereas previously the correction was made by FTB and left with the assignee. There will be an additional duty placed on the taxpayer but it will be unlikely to impact the operations of the company significantly or result in additional compliance costs.

12.2.3 Reason for Rejecting Alternative 2

This alternative is less desirable since it frustrates the purpose of RTC section 23663 which was to allow credits to be used against the tax liability of other group members. Without Proposed Regulation 23663-2, taxpayers would need to reassign credits on their next original tax return when an audit reduces taxpayers' credits below the amount assigned. However, under Proposed Regulation 23663-2, this scenario would allocate the reduced amount of credits to the assignee as of the original assignment date and give effect to the taxpayer's election to assign credits.