ASSEMBLY THIRD READING
AB 71 (Luz Rivas, et al.)
As Amended May 24, 2021
2/3 vote. Urgency

SUMMARY

Conforms state law to the federal Global Intangible Low-Taxed Income (GILTI) provisions and taxes repatriated income to finance the Bring California Home Fund.

Major Provisions

1) Conforms, beginning on or after January 1, 2022, under the Personal Income Tax (PIT) Law, state law to GILTI, except as provided.

2) Provides that if a taxpayer that is not a C corporation has income under GILTI, which is derived from a corporation that is part of a combined reporting group doing business in this state and has made a water's-edge election, 50% of that income shall be apportioned to this state using the same apportionment factor as is used for the combined reporting group.

3) Provides that GILTI shall not apply to either of the following situations:

   a) The taxpayer is not a C corporation and the income under GILTI is derived from a corporation that is part of a combined reporting group doing business in this state that does not make a water's-edge election; or,

   b) The taxpayer is not a C corporation and the income under GILTI is derived from a corporation that is not part of a combined reporting group doing business in this state.

4) Requires, beginning January 1, 2022, a taxpayer that makes a water's-edge election to take into account 50% of GILTI, but not the apportionment factors, of its affiliated corporations.

5) Requires, beginning January 1, 2022, a taxpayer that makes a water's-edge election to take into account 40% of the repatriation income, but not the apportionment factors, of its affiliated corporations.

6) Provides a taxpayer that has made a water's–edge election with an opportunity to revoke the election for the 2022 calendar year.

7) Provides that it is the intent of the Legislature that the revenue, if any, resulting from the application of this bill in any taxable year beginning on or after January 1, 2022, be used for purposes of the Bring California Home Act.

8) Makes a number of changes to the Homeless Coordinating and Financing Council, and require the council to, among other things, identify state programs that provide housing or housing-based services and report this information to specified committees by July 31, 2022. The council would also administer allocations from the fund to counties and continuums of care that apply jointly and to large cities, as provided.

9) Requires the council to set aside $200 million for bonus awards to recipients, and allocate 60% of the remaining amount in the fund to counties and continuums of care applying jointly

and 40% to large cities, in accordance with a specified formula and subject to certain requirements.

10) Takes effect immediately as an urgency statute.

COMMENTS

1) *Background*: According to the author's office, "corporations are taking advantage of a tax loophole to evade paying taxes by claiming they make most of their profits overseas in low- or no-tax countries." This transfer of income is known as "profit shifting" whereby multinational corporations exploit mismatches or loopholes in the international tax rules by artificially shifting profits to low- or no-tax jurisdictions to lower the amount of tax they pay. According to the Organization for Economic Co-operation and Development (OECD), governments, citizens, and businesses all lose when profits are shifted to low- or no-tax jurisdictions. First, governments lose much needed revenue, citizens either have to pay for existing services or go without those services, and purely domestic businesses have a hard time competing with multinational enterprises[1]. Although the magnitude of profit shifting is uncertain, there appears to be ample evidence of its existence and its increase in recent years[2].

2) *Water's-edge election vs worldwide combined reporting*: By way of background, the "unitary business principle" recognizes that the value of a business is found in the combination of all its activities even if the value or income of that business is earned in several jurisdictions. Thus, corporations engaged in interstate commerce, and situated in the several states through which their business extends, may be valued as a unit for the purposes of taxation[3]. States are allowed to combine multiple businesses under a combined report so long as the overall business is a unitary business[4]. The unitary business principle also applies to multinational corporations where a domestic United States (US) corporation has foreign subsidiaries or where a foreign corporation has US subsidiaries[5]. Once the value is determined, the income may then be apportioned to the various jurisdictions based on a reasonable formula[6]. The ability to tax multiple, multinational corporations as a unitary business is known as worldwide combined reporting.

   However, in the early 1980s, foreign countries began pressuring the federal government to preempt a state's use of worldwide combined reporting[7]. In response, many states, including California, began offering a water's edge election[8]. In general, a "water's-edge election" permits a corporation to exclude its foreign income from the combined report, which generally excludes that income from the total unit value that is then apportioned to the various jurisdictions. As explained by Professor Shanske, "[i]t is important to be clear that the states were never trying to tax the foreign income as such; rather, as the income of a

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[1] OECD, *Ending Offshore Profit Shifting*
[2] Jane G. Gravelle, *Policy Options to Address Corporate Profit Shifting: Carrots or Sticks?*, April 2016
[3] *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194 (1897)
[4] Darien Shanske, *White Paper on Eliminating the Water's Edge Election and Moving to Mandatory Worldwide Combined Reporting*, Tax Notes, September 17, 2018.
[5] *Id*.
[6] *Id*.
[7] *Id*.
[8] *Id*.

unitary business the states successfully argued that this income should be subject to apportionment so that the [multinational corporation's] in-state income can be more accurately determined"[9].

3) *GILTI*: Before the enactment of the TCJA, the US generally taxed its firms and residents on their worldwide income. US firms were allowed to defer tax on foreign subsidiaries' active business earnings until those earnings were repatriated to the US, generally as dividends. The prior system generally discouraged repatriating foreign profits since corporations only faced additional taxes once profits were brought back to the US[10]. In order to address this distortion, the TCJA generally exempts earnings from active businesses of US firms' foreign subsidiaries, even if the earnings are repatriated.

   Although the change may have partially addressed the distortion, eliminating the repatriation tax may also exacerbate profit shifting to low-tax or no-tax jurisdictions. According to former Multistate Tax Commission Executive Director, Dan Bucks, "congress recognized that the switch to the territorial system exposed the federal corporate tax to increased profit shifting, and that's why it included GILTI and [the base erosion and antiabuse tax (BEAT), and other measures like a lowering of the corporate tax rate to try to counteract [profit shifting].[11]" Therefore, Congress added a new minimum tax on GILTI of 10.5%.

   In general, GILTI is income earned from intangible assets by foreign subsidiaries of US-based multinational corporations. Intangible assets include intellectual property such as patents, copyrights, and trademarks. Individuals or entities subject to GILTI are US shareholders or CFCs. GILTI operates, in part, as a way of finding shifted income by identifying suspiciously high returns[12]. GILTI is calculated as the total active income earned by a US firm's foreign affiliates that exceeds 10% of the firm's depreciable tangible property. A corporation can generally deduct 50% of the GILTI and claim a foreign tax credit for 80% of foreign taxes paid or accrued on GILTI. If a foreign tax rate is zero, the effective US tax rate on GILTI will be 10.5%, which is half of the regular 21% corporate tax rate. In general, if the foreign tax rate is 13.125% or higher, there will be no US tax after the 80% credit for foreign taxes[13].

4) *What does this bill do*? This bill conforms state law to the federal GILTI provisions, and requires a taxpayer that has made a water's-edge election and a taxpayer that is not a corporation but derives GILTI income from a combined reporting group to include 50% of GILTI for state purposes. As noted earlier, GILTI identifies shifted income by formula. If GILTI identifies $10 billion in a CFC in Ireland that was not really earned there, part of the $10 billion may have been shifted from the US and part of the $10 billion may have been shifted from another country like Germany. The 50% is used as a reasonable estimate of how much of the shifted income came from the US[14]. If the taxpayer believes that the 50%

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[9] *Id*.
[10] Kyle Pomerleau, *A Hybrid Approach: The Treatment of Foreign Profits under the Tax Cuts and Jobs Act*, Tax Foundation, May 13, 2018.
[11] Salt in the Public Interest, *Taxing GILTI Is Good, Bur Worldwide Combination Is Great*, Tax Notes State, June 17, 2019.
[12] Darien Shanske and David Gamage, *States Should Conform to GILTI, Part 3: Elevator Pitch and Q&A*, Tax Notes, Oct. 14, 2019.
[13] What is global intangible low-taxed income and how is it taxed under the TCJA, Tax Policy Center.
[14] Darien Shanske and David Gamage, *Why States Can Tax the GILTI*, Tax Notes, March 18, 2019.

amount is inappropriate, this bill allows a taxpayer, for taxable year 2022 only, to revoke the water's-election and use worldwide combined reporting. This bill also limits a taxpayer's ability to offset the additional tax liability created by these provisions with existing tax credits by more than $5 million.

5) *Why should states tax GILTI*? First, there is good evidence that the earnings are partially domestic insofar as profits have been shifted[15]; and, as noted earlier, there appears to be evidence that profit shifting is increasing. As such, those earnings should have always been included as part of the water's edge election. And second, as noted earlier, the federal government's change to a more territorial system, and the elimination of the repatriation tax, may inadvertently be encouraging multinational corporations to shift profits oversees despite additional safety measures like GILTI, BEAT, and a reduction in the federal corporate tax rate. To the extent the federal corporate tax incentivizes erosion of the corporate tax base, the TCJA may in turn lead to a narrowing of the state's own corporate tax base under a water's edge election. According to Dan Bucks, "All of the states that are water's-edge or separate-entity states are exposed to substantial risk from the federal switch to its version of a territorial tax system. That switch, without some effective state action – be it global combined reporting, tax haven reporting, or inclusion of GILTI in its tax base – exposes the states to a substantial risk of increased profit shifting.[16]" GILTI might actually be a necessary measure to address a further narrowing of the state's corporate tax base.

6) *Deemed repatriation*: As noted above, prior to the TCJA, the US generally taxed its corporations and residents on their worldwide income. However, a US corporation could defer foreign income by retaining earnings indefinitely through a foreign subsidiary. A US corporation would pay US tax on the foreign earnings only when they were repatriated, and the earnings would be taxed, when repatriated, at a rate of 35%. After the enactment of the TCJA, the US generally exempts earnings from active businesses of US firms' foreign subsidiaries, even if the earnings are repatriated. However, as part of the transition, the TCJA taxes these earnings as if they were repatriated but at preferred lower rates: foreign earnings held in cash and cash equivalents were taxed at 15.5% and those not held in cash or cash equivalents at only 8%. Corporations are allowed to pay the tax on the deemed repatriations in installments over eight years.

7) *What does this bill do*? This bill requires a taxpayer that has made a water's-edge election to include 40% of any repatriation income. As noted earlier with respect to GILTI, this bill attempts to make a reasonable determination as to how much has been shifted out of the US. The 40% for repatriation is lower than the 50% used for GILTI, in part, because some of that income might have been earned abroad and just left abroad. A taxpayer is then required to either apportion 14% of the repatriation to California or use the apportionment factor otherwise calculated for the combined group.

8) *Why should states tax deemed repatriation*? According to Professors Shanske and Gamage, there are several reasons why states should tax deemed repatriated funds, but the primary reason for taxing these funds is that these earnings are, at least partially, domestic[17]. There

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[15] Darien Shanske and David Gamage, *Why (and How) States Should Tax the Repatriation*, Tax Notes, April 23, 2018.
[16] *Id*., *Taxing GILTI Is Good, Bur Worldwide Combination Is Great*
[17] Id., *Why (and How) States Should Tax the Repatriation*

appears to be significant evidence that at least a substantial portion of the earnings parked abroad were, in fact, earned in the US and should have always been part of the state's corporate tax base[18]. Therefore, taxing repatriated income is a way of recapturing General Fund revenue that has been put away for a rainy day, ready to be used for large state projects.

9) *Housing provisions*: This bill would enact the Bring California Home Act, which would establish the Bring California Home Fund in the State Treasury, and modify the Homeless Coordinating and Financing Council to focus on preventing and ending homelessness in California. This bill would require the Controller to annually transfer specified amounts, based on the increased GF revenue from GILTI and deemed repatriated income, to the Bring California Home Fund.

   The council would be charged with collecting data and identifying state programs that provide housing or housing-based services and report this information to specified committees by July 31, 2022. The council would also administer allocations from the fund to counties and continuums of care that apply jointly and to large cities, as provided. The council would have to set aside $200 million for bonus awards to recipients, and would have to allocate 60% of the remaining amount in the fund to counties and continuums of care applying jointly and 40% to large cities, in accordance with a specified formula and subject to certain requirements.

   The council would allocate available funding in two-year cycles, with the first round allocated no later than March 31, 2023, and develop a simple application that an eligible entity may use to apply for funding, as well as common standards for recipients to monitor, report, and ensure accountability, provide services, and subsidize housing. The council and each recipient would establish performance outcomes for the initial cycle and outcome goals before each subsequent grant cycle, as provided, and the council would award bonus funding to a recipient, if the recipient has achieved those performance outcomes, or reduce or deny that bonus funding if the recipient has not achieved those performance outcomes. Failure of the recipient to use money allocated to it for an authorized purpose would require the council to either select an alternative entity to administer the recipient's allocation in accordance with specified requirements or solely establish performance outcomes and program priorities for that recipient jurisdiction and work with local, regional, or statewide entities to administer the allocation on behalf of the recipient. For a full discussion of the housing provisions of this bill, please see the Housing and Economic Development Committee's analysis of this bill.

According to the Author

Our state is facing an unprecedented homelessness crisis that has the potential of becoming a full-blown catastrophe due to the economic impacts of COVID-19 on low wage earners. Despite being the fifth largest economy in the world, one in four Americans experiencing homelessness reside in California. AB 71 delivers a comprehensive plan to address homelessness by investing, for the first time ever, dedicated annual state funding to our local governments; and, implements accountability and transparency measures to ensure every dollar is used effectively

[18] Id.

Arguments in Support
Supporters state that this bill "would establish a permanent source of funding and a collaborative statewide strategy for solving homelessness. The bill would help fill the currently shortcomings in California's response while implementing evidence-based solutions that allow for long-term planning and will help move people into permanent housing as soon as possible. Additionally, the bill would ensure those who are often move vulnerable; people of color, youth, and survivors of domestic violence have enhanced coordination and collaboration with local and state agencies what will help ensure equitable access to services and housing. The bill would not only hold the local agencies accountable for results through performance measures such as annual reporting and data collection, but also would support the agencies with funding and rewards for hitting goals. AB 71 would create a transparent program that includes the funding support that is vital to its success."

Arguments in Opposition
Opponents state that "California's homelessness issue is chronic, daunting, and requires a strong humanitarian effort. According to a 2020 poll conducted by the California Chamber of Commerce, homelessness remains an issue of great concern to voters. Fully, two-thirds believe homelessness in California has gotten worse since the start of the COVID-19 pandemic, with voters in Los Angeles, the Inland Empire and Central Valley reporting severe worsening in their regions. While the problem worsens, *it's important to remember that California state and local agencies have been addressing this issue for many, many years*." Additionally, opponents state that "[t]he State's financial commitment to reducing homelessness is substantial, but pales compared with how local residents throughout California have voted to tax themselves to address this issue." Furthermore, opponents state that making changes to the water's edge election, as proposed by AB 71, would "create international tension over the taxation of income that was not derived from sources within the United States."

FISCAL COMMENTS

According to the Assembly Appropriations Committee:

1) The Franchise Tax Board (FTB) estimates General Fund (GF) revenue gain of $310 million in fiscal year (FY) 2021-22, $950 million in FY 2022-23 and $950 million in FY 2023-24. GF revenue gain drops to $600 million in FY 2024-25, coinciding with the conclusion of deemed repatriation installment payments. The FTB also estimates implementation costs of an unknown, but potentially significant, amount to reprogram systems, update forms and provide needed taxpayer outreach to ensure compliance.

2) GF costs of approximately $6 million to HCFC in the first year to complete a statewide needs and gaps analysis. Additionally, costs of approximately $4.5 million in the first year and $4.3 million ongoing to HCFC to convene the funding workgroup and administer funding allocations to counties, continuums of care and cities.

3) GF costs of approximately $802,000 in the first and second years to the Department of Housing and Community Development to collaborate with HCFC on the needs and gaps analysis and development of a universal application for all programs related to homelessness.

4) Costs of an unknown amount to DHCS to seek a federal Medi-Cal waiver and convene the FMAP stakeholder advisory group.

VOTES

ASM REVENUE AND TAXATION: 7-4-0
YES: Burke, Grayson, Levine, Carrillo, Mullin, Quirk, Luz Rivas
NO: Nguyen, Gray, Petrie-Norris, Seyarto

ASM HOUSING AND COMMUNITY DEVELOPMENT: 5-2-1
YES: Chiu, Gabriel, Kalra, Ward, Wicks
NO: Seyarto, Kiley
ABS, ABST OR NV: Quirk-Silva

ASM APPROPRIATIONS: 12-4-0
YES: Lorena Gonzalez, Calderon, Carrillo, Chau, Gabriel, Eduardo Garcia, Levine, Quirk, Robert Rivas, Akilah Weber, Holden, Luz Rivas
NO: Bigelow, Megan Dahle, Davies, Fong

UPDATED

VERSION: May 24, 2021

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