ASSEMBLY BUDGET COMMITTEE

Budgets Options: Tax Structure and Tax Expenditures

Tuesday, May 11, 2010, 10:30 AM
State Capitol Room 4202

Purpose

The purpose of this hearing is three-fold.

- Examine and discuss California's current debt and credit circumstances in view of the state's budget situation and ongoing changes in the credit markets;
- Analyze recent changes to taxing business activities in California, specifically the method of apportioning income of multistate corporations, the treatment of companies' net operating losses, and the ability of related businesses to share tax credits; and,
- Identify various special tax programs and tax expenditures and examine how these programs affect the state's budget situation.

Background

<u>California and the Credit Markets</u>

The State Treasurer's Office, in cooperation with various other state offices, coordinates California's borrowing program and structures the financings that are offered in the credit markets. California's borrowing program is fundamental for both the short-term and long-term financing needs of the state. Economic developments in the last two years have roiled credit markets with impacts on both the availability and cost of credit for California. More recent developments in European and worldwide credit markets as well as volatility and speculation involving derivative instruments relating to municipal offerings can have an impact on state borrowing costs.

<u>Tax Structure: Recent Changes</u>

As components of the 2008-09 and 2009-10 budget packages, important changes were made to the tax laws affecting corporations and other companies doing business in California. Three of these changes are discussed below:

Income Apportionment
Under California's corporation tax law, multistate businesses must apportion their income among the jurisdictions in which they do business. Currently, for most corporations, California uses a three-factor formula to determine how much income is subject to tax in California. The three factors are payroll, property and sales, with the

sales factor double-weighted. Certain agricultural, extractive and financial establishments use a simple three-factor formula, without double-weighting sales. Each factor represents the ratio of the California share of each measure to the total amount. The average of the ratios is applied to a corporation's total net income to calculate California income.

A component of the 2009-10 budget package gives multistate corporations an additional option for determining the share of income that is taxed in California. The legislation allows companies the option to use only the sales factor to determine the amount of California income. This so-called "single sales factor" option becomes effective for the 2011 tax year. When it becomes effective, the change is expected to reduce revenues by approximately $200 million in 2011-12, reaching approximately $900 million in the long term.

Many states have changed their apportionment method to reflect a single sales factor formulation. Although there is a range of opinion as to the effect of such a change, the argument for adopting this method is that it encourages businesses to locate or expand property and payroll in the state, since these activities are not factors in the ultimate taxation of any income. Other states that allow for a single sales factor apportionment make it mandatory. California's only other filing election for corporations is an option to include either worldwide or water's-edge income in the reporting group. Unlike the annual option for single sales factor, water's-edge/worldwide election is for a seven-year period.

Allowing an "option" of using single sales factor would appear to work against the goal of encouraging location and expansion of business in California. Under mandatory single sales factor, an out-of-state company would be taxed on income relating to California sales, and an in-state company would not have its property and payroll included in determining California income. By adding the option of the three factor formula, the out-of-state company could reduce its level of taxation to the extent that it expanded its property and payroll outside the state. Thus, for these companies, the optional component removes any incentive to locate or expand in California.

Tax planning activities are inherent in an optional single sales factor apportionment. A notable example is when a company has losses one year and income the next. During a loss year, it would choose to maximize the loss apportioned to California by using whichever method resulted in the greatest loss. In the subsequent year, if it had positive income, it would use the method that minimized its taxable income in California. The corporation could then use the losses from the prior year to offset any or all of its income in the positive income year.

Net Operating Losses

A business experiences an operating loss when various deductions and expenses exceed its gross income for the year. Under federal and state laws, the business may use this loss—called a net operating loss (NOL)—in subsequent years to offset its income. Under federal law, the business can carry forward any NOL for a 20-year period, and carry it back for up to two prior years. Under current state law, a business may generally carry forward any losses for 10 years with no carryback allowed. The principal rationale for allowing the temporal portability of losses is recognition of the arbitrary nature of a taxable year for purposes of measuring income.

Under a component of the 2008-09 budget package, the use of NOLs was suspended for tax years 2008 and 2009. In addition, after the suspension is lifted, the agreement liberalized the carryforward period for NOLs and established a carryback provision as well. NOLs earned in 2008 and after will be allowed a carryforward period of 20 years. In addition, NOLs earned in 2011 and after will be allowed a two-year carryback period. That is, companies can also carry their losses back to offset profits from previous years and receive a refund on taxes already remitted

The ability of businesses to carryback losses creates some uncertainty with respect to the state budget, and may exacerbate the budget stresses to which the state is already subject. Opponents of the carryback provision argue that the policy exposes the state budget to more volatility than experienced in the business cycle itself. For example, a business could file a refund claim during an economic downturn, when the state budget is already under stress. From a policy perspective, limits on carrybacks and carryforward are important because they ensure that periods of income and loss are reasonably proximate to each other—that is, they derive from a common periods of business activity. Opponents of expanding carryovers argue that 20 years is well-beyond a recognizable business cycle period.

Credit Sharing

Businesses can earn various tax credits based on different types of activity or investment. For example, expenditures on research and development above a certain base amount are generally eligible for a tax credit of 15% under the corporate tax or personal income tax. Prior law limited the use of these credits to the entity that directly earned them. Because these entities did not necessarily incur a tax liability, some credits have gone unused.

As a result of the 2008-09 budget package, for tax years beginning on or after July 1, 2008, a member of a combined reporting group may assign these credits to another member of the combined reporting group. This assignment or "credit-sharing" is irrevocable and may be used to reduce tax liabilities for tax years beginning on and after January 1, 2010. FTB indicates that this provision will result in revenue reductions of $300 million annually beginning in 2010-11.

Opponents of this measure argue that the in addition to the revenue losses, the extended application of the credits will result in sheltering income derived from business activities that are unrelated to the credit. Supporters of the change argue that without this type of sharing, some earned credits would never be used and the incentive would lose its impact.

Tax Expenditures and Revenue Options

There is no universally accepted definition of "tax expenditure," but there is enough agreement on the term to allow a discussion of goals and merits of various tax programs that fall into this category. Broadly stated, a tax expenditure is a tax provision—such as an exemption, exclusion, credit, deduction, deferral, or preferential tax rate—which deviates from the "basic tax structure' and results in a reduction in government revenues that would otherwise be raised. California has various tax expenditure programs operating through its personal income tax, corporate tax, sales and use tax, property tax, as well as its other taxes.

Tax expenditures have been adopted by the Legislature for four principal reasons: conform to federal tax provisions; address perceived inequities; ease tax administration; and, provide incentives or tax relief. Unlike budgetary provisions, tax expenditures are generally not subject to an annual review process to assess their effectiveness or benefits. As a result, unless "sunset" provisions or performance measures are explicitly incorporated in the authorizing legislation, tax expenditure programs generally continue regardless of their policy merits or effectiveness.

The Legislative Analyst's Office (LAO) periodically reviews tax expenditure programs and, based on various evaluation criteria, makes recommendations as to whether such programs should continue unchanged, altered in a manner that would make them more efficient, or eliminated entirely. Recently, the LAO recommended certain changes in state tax expenditure programs, including:

Personal/Corporate Income Tax

- Eliminate enterprise zone and similar subsidies
- Eliminate favorable treatment of like-kind exchanges
- Conform senior exemption to personal exemption
- Eliminate exemption for employer-provided health insurance
- Tax one-half of social security income
- Eliminate exemption for employer-provided parking
- Eliminate small-business stock exclusion

Sales and Use Tax

- Apply sales tax to mark-up for doctor and veterinarian sales

LAO has also proposed tax changes that would equalize treatment of real and certain personal property (property taxes and vehicle license fee) and align alcohol tax rates with social costs. Finally, LAO has proposed alternatives to the Governor's "trigger" proposals which are dependent on receiving federal aid. LAO's alternatives include: extend moratorium on the use of NOLs; reduce dependent credit exemption on a permanent basis; delay credit-sharing among related companies; delay implementation of and make mandatory the single sales apportionment factor; and, decelerate the phase-in of NOL carrybacks.