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# Proposition 24: Repeal Corporate Tax Loopholes Act

SDCTA **opposes** this measure as it would repeal tax provisions set in place to promote current and future economic development in California. Removal of an optional single sales factor, which has been shown to promote economic activity and job creation, is counterproductive to California's economic recovery. Additionally, disallowing transfer of excess tax credits could reduce incentives for corporations to expand research and development operations in California.

- Prop 24 would repeal three corporate tax breaks and incentives enacted as part of State budget agreements in 2008 and 2009. These provisions are net operating loss carrybacks, transferable tax credits, and an optional single sales factor.
  - Net operating loss carrybacks allow corporations to apply operating losses in a current year to past or future years operating profit in order to reduce the corporation's tax liability.
  - A tax credit is a reduction in the amount of tax owed by an individual or business allowed by a government for the purpose of subsidizing particular activities or to recognize previous prepayments or overpayments. In September 2008, the State established a policy which allows corporations to transfer tax credits to affiliate corporations.
  - An optional single sales factor allows corporations to apportion their taxable profits based solely upon the amount of sales the corporation made in the State. Previously a corporation had to apportion taxable profits based upon a mixture of sales, property ownership, and payroll. A study in 2005 using the California Department of Finance's Dynamic Revenue Analysis Model suggested that a single sales factor would result in a net increase of 40,000 jobs in the State.
- The Franchise Tax Board estimates that this measure will result in a major increase in state revenue equal to $80 million in FY 2010, $600 million in FY 2011, $1.7 billion in FY 2012 and increasing each year after.
- Prop 24 would ease the State's budget crisis by increasing revenue and eliminating the potential of increased net operating loss carryback credits during an economic downturn.
- The primary proponent of Prop 24 is the California Teachers' Association. Opponents are organized into a group called "Stop the Jobs Tax". This group is comprised of hundreds of individual business (primarily technology based businesses), several taxpayers associations including the California Taxpayers Association, and several chambers of commerce including the California Chamber of Commerce.

***Prop 24 – "Repeal Corporate Tax Loopholes Act"***
**October 2010**

**Board Recommendation:** **OPPOSE**

**Rationale:**

This measure would repeal tax provisions set in place to promote current and future economic development in California. Removal of an optional single sales factor, which has been shown to promote economic activity and job creation, is counterproductive to California's economic recovery. Additionally, disallowing transfer of excess tax credits could reduce incentives for corporations to expand research and development operations in California.

**Title**: *"Repeal Corporate Tax Loopholes Act"*
**Election:** November 2010 General Election
**Description:** Repeals several corporate tax breaks enacted by the State in 2008 and 2009.
**Jurisdiction**: State
**Type**: Statutory
**Vote**: Simple Majority
**Fiscal Impact:** Likely major increase in State tax revenue, amounting to $1.7 billion in FY 2012 and increasing going forward.

**Background:**

As part of State budget agreements passed in September 2008 and February 2009 several tax breaks were enacted for California businesses and corporations, representing an overall decrease in tax liability of $1.7 billion annually.[1] The majority of these reforms are not set to take effect until FY 2011. The specific provisions of these tax breaks are described below.

***Net Operating Loss Carryovers***

Net operating income (NOI) is the profit (loss) of a business that remains after subtracting its operating expenses (all expenses excluding taxes and interest payments) from gross revenue. If a business incurs more operating expenses than they receive in revenue, the business experiences a net operating loss (NOL). Businesses and corporations commonly pay various federal, state, and local taxes based upon the value of their NOI, such as corporate and income taxes.

Businesses typically operate to maximize long-run profits, as opposed to profits in a single year. For this reason, requiring all businesses to comply with a single income reporting period for tax purposes may be disadvantageous for some businesses. To see why this is true, consider an example.

[1] Legislative Analyst's Office

**Example 1**

| Tax Year | Firm A | | Firm B | |
|---|---|---|---|---|
| | Net Operating Income | Tax* | Net Operating Income | Tax |
| 1 | $100,000 | $10,000 | $25,000 | $2,500 |
| 2 | -$50,000 | $0 | $25,000 | $2,500 |
| 3 | -$50,000 | $0 | $25,000 | $2,500 |
| 4 | $100,000 | $10,000 | $25,000 | $2,500 |
| **Total** | **$100,000** | **$20,000** | **$100,000** | **$10,000** |

*Assuming businesses pay 10% tax on NOI

In example 1, two firms with identical long-run profits have much different tax liability because the businesses are required to comply with the same income reporting period. As a remedy to this problem, the federal and state governments (including California) have devised a tax provision known as net operating loss carryovers. NOL carryovers allow a business to apply (or carryover) their NOL from the current year to NOI from past or future years and to receive a refund of taxes paid in those years. By doing so, governments are essentially taxing the long-run profits of the business, as opposed to the year-to-year profits. Reconsider the above example with NOL carryover.

**Example 2**

| Tax Year | Firm A | | | Firm B | |
|---|---|---|---|---|---|
| | Net Operating Income | Income after carryover | Tax | Net Operating Income | Tax |
| 1 | $100,000 | $100,000 + (-$50,000) = $50,000 | $5,000 | $25,000 | $2,500 |
| 2 | -$50,000 | -$50,000 – (-$50,000 = $0 | $0 | $25,000 | $2,500 |
| 3 | -$50,000 | -$50,000 – (-$50,000) = $0 | $0 | $25,000 | $2,500 |
| 4 | $100,000 | $100,000 + (-$50,000) = $50,000 | $5,000 | $25,000 | $2,500 |
| **Total** | **$100,000** | **$100,000** | **$10,000** | **$100,000** | **$10,000** |

Example 2 shows that the inequitable tax distribution demonstrated in example 1 can be corrected if NOL carryovers are allowed. NOL carryovers can take two forms, carryforwards and carrybacks. Carryforwards allow business to apply the current years NOL to future years NOI, while carrybacks allow business to apply NOL to past years NOI. Prior to the budget agreement of September 2008, the State of California Revenue and Taxation Code allowed only for carryforwards during the 10 consecutive years following a NOL. The budget agreement of September 2008 expanded NOL carryovers to allow for carrybacks, with an eligible carryover period of the 2 consecutive years prior to a NOL, and to extend the eligible period for carryforwards from 10 years to 20 years.[2] Under the new provisions, the State is now more in line with the provisions established by the federal government for the collection of federal income tax, which allow for a carryback period of 5 years and a carryforward period of 20 years.[3]

***Transferable Tax Credits***

A tax credit is a reduction in the amount of tax owed by an individual or business allowed by a government for the purpose of subsidizing particular activities or to recognize previous prepayments or overpayments. The State of California provides a variety of tax credits to businesses and corporations. The table below describes the current allowable tax credits for the year 2009.[4]

[2] California Revenue and Taxation Code Section 17276
[3] Internal Revenue Service, Revenue Procedure 2009-26
[4] California Franchise Tax Board, Form 100 Booklet 2009

| CREDIT NAME | CODE | DESCRIPTION |
|---|---|---|
| **Current Credits List** | | |
| Community Development Financial Institution Deposits – Obtain certification from: CALIFORNIA ORGANIZED INVESTMENT NETWORK (COIN) DEPARTMENT OF INSURANCE 300 CAPITOL MALL, SUITE 1600 SACRAMENTO CA 95814 Website: **insurance.ca.gov** | 209 | 20% of qualified investments made into a community development financial institution |
| Disabled Access for Eligible Small Businesses – FTB 3548 | 205 | Similar to the federal credit, but limited to $125 per eligible small business, and based on 50% of qualified expenditures that do not exceed $250 |
| Donated Agricultural Products Transportation – FTB 3547 | 204 | 50% of the costs paid or incurred for the transportation of agricultural products donated to nonprofit charitable organizations |
| Employer Child Care Contribution – FTB 3501 | 190 | Employer: 30% of contributions to a qualified plan |
| Employer Child Care Program – FTB 3501 | 189 | Employer: 30% of the cost of establishing a child care program or constructing a child care facility |
| Enhanced Oil Recovery – FTB 3546 | 203 | 1/3 of the similar federal credit but limited to qualified enhanced oil recovery projects located within California |
| Enterprise Zone Hiring & Sales or Use Tax – FTB 3805Z | 176 | Business incentives for trade or business activities conducted within an enterprise zone |
| Environmental Tax – FTB 3511 | 218 | Five cents ($0.05) for each gallon of ultra low sulfur diesel fuel produced during the taxable year by a small refiner at any facility located in this state |
| Local Agency Military Base Recovery Area Hiring & Sales or Use Tax – FTB 3807 | 198 | Business incentives for trade or business activities conducted within a local agency military base recovery area |
| Low-Income Housing – FTB 3521 | 172 | Similar to the federal credit but limited to low-income housing in California |
| Manufacturing Enhancement Area – FTB 3808 | 211 | Hiring Credit for Manufacturing Enhancement Area |
| Natural Heritage Preservation – FTB 3503 | 213 | 55% of the fair market value of the qualified contribution of property donated to the state, any local government, or any nonprofit organization designated by a local government |
| New Jobs Credit – FTB 3527 | 220 | $3,000 allowed for a qualified employer for each increase in qualified full-time employee hired in the current taxable year |
| Prior Year Alternative Minimum Tax | 188 | Must have paid alternative minimum tax in a prior year and have no alternative minimum tax liability in the current year |
| Prison Inmate Labor – FTB 3507 | 162 | 10% of wages paid to prison inmates |
| Research – FTB 3523 | 183 | Similar to the federal credit but limited to costs for research activities in California |
| Targeted Tax Area Hiring & Sales or Use Tax – FTB 3809 | 210 | Business incentives for trade or business activities conducted within a targeted tax area |

As part of the September 2008 budget agreement, the State of California enacted a provision which allows corporations to transfer tax credits to an affiliate corporation. An affiliate corporation, as defined in California Revenue and Taxation Code 25105, is any corporation in which the assigning corporation owns 50% of issued stock, either directly or through majority ownership of another corporation which also holds the receiving corporation's stock. In the absence of transferable tax credits a corporation's tax credits beyond what they can use in a given year would be wasted. This is especially important when considering tax credits designed to encourage particular business activities. For example, suppose of a corporation would like to create a new full-time position in order to receive the $3,000 New Jobs Credit, however it may elect not to create the new position because it has no more taxable income on which to apply to the tax credit.

### *Optional Single Sales Factor*

Many businesses that operate in California also have operations in other states. However, these multi-state businesses only record profits at a national level, requiring California to devise a method for determining which portion of a multi-state business' profits it can tax. The method used by California, and by all other states, is known as three-factor apportionment. Under three-factor apportionment, the portion of a business' profit taxable in a given state is based upon the proportion of its property located, payroll paid, and sales made in that state. The weight attached to each of the three factors vary by state, but the most common weighting methods include equal weighting and double weighted sales factor (50% sales, 25% property, 25% payroll). Another weighting method is known as the single sales factor, in which all of the

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weight is given to sales, while no consideration is given for property or payroll. Example 3 demonstrates how the taxable portion of a business' profits can change based on the weighting method.

**Example 3**

| | Proportion of business activity in state | Equal Weights | Double Weighted Sales Factor | Single Sales Factor |
|---|---|---|---|---|
| **Sales** | 20% | 20% x 1/3 = 6.67% | 20% x ½ = 10% | 20% x 1 = 20% |
| **Property** | 30% | 30% x 1/3 = 10% | 30% x ¼ = 7.5% | 30% x 0 = 0% |
| **Payroll** | 20% | 20% x 1/3 = 6.67% | 20% x ¼ = 5% | 20% x 0 = 0% |
| **Taxable Profit** | | **23.3%** | **22.5%** | **20.0%** |

In 1966, California adopted an equal weights apportionment method; however in 1993 California switched from equal weights to a double weighted sales factor.[5] As part of the budget agreement of February 2009, California adopted an additional provision which allows businesses to choose whether they would like to apportion their profits using a double weighted sales factor or a single sales factor.

**Example 4**

| | Proportion of business activity in state | | Double Weighted Sales Factor | | Single Sales Factor | |
|---|---|---|---|---|---|---|
| | **Firm A** | **Firm B** | **Firm A** | **Firm B** | **Firm A** | **Firm B** |
| **Sales** | 50% | 10% | 50% x ½ = 25% | 10% x ½ = 5% | 50% x 1 = 50% | 10% x 1 = 10% |
| **Property** | 10% | 40% | 10% x ¼ = 2.5% | 40% x ¼ = 10% | 10% x 0 = 0% | 40% x 0 = 0% |
| **Payroll** | 10% | 40% | 10% x ¼ = 2.5% | 40% x ¼ = 10% | 10% x 0 = 0% | 40% x 0 = 0% |
| **Taxable Profit** | | | **30%** | **25%** | **50%** | **10%** |

Example 4 details the portion of profits taxable for two hypothetical firms under both double weight sales factor and single sales factor apportionment. As can be seen in the example, firms with a higher concentration of sales relative to property and payroll will prefer a double weighted sales factor, while firms with a lower concentration of sales will prefer the single sales factor. The example demonstrates how providing businesses with the choice between the two apportionment techniques can lead to decreased tax revenues. Under the procedure prior to February 2009, the state would collect tax on 30% of firm A's profit and 25% of firm B's profit; however under the newly adopted procedure the state collects tax on 30% of firm A's profit and only 10% of firm B's profit.

**Proposal:**

Proposition 24, the "Repeal Corporate Tax Loopholes Act", is a voter generated initiative statute that would repeal the previously described corporate tax breaks provided by the September 2008 and February 2009 budget bills. Specifically the proposition would: (1) scale back NOL carryovers to ban carrybacks and decrease the carryforward eligibility period to 10 years, (2) repeal any provisions allowing for transfer of tax credits between affiliate corporations and (3) return to the use of only the double weighted sales factor for apportioning the profits of multi-state businesses.

[5] Legislative Analyst's Office, Report: Corporate Loopholes Act, 5/26/2010

**Policy Implications:**

***Fiscal Impact***

The Franchise Tax Board estimates that this measure will result in a major increase in state revenue equal to $80 million in FY 2010, $600 million in FY 2011, $1.7 billion in FY 2012 and increasing each year after.

***Economic Development***

Proponents of single sales factor apportionment argue that this method promotes economic development and employment growth in comparison to double weighted sales factor apportionment. This is because a business' portion of a taxable profits in a given state under double weighted sales factor apportionment increases with the number of employees, offices, and factories they have in that state, essentially taxing the creation of jobs and expansion of operations. As single sales factor apportionment does not consider a business' payroll or property, a business is not directly taxed for increasing employment or expanding operations. In 2005, a simulation using the California Department of Finance Dynamic Revenue Analysis Model indicated that use of single sales factor apportionment would result in a net increase of 40,000 jobs, accounting for the necessary cuts in state spending that would be required to institute such a policy.

If the State of California's current option to allow businesses to apportion profits using the single sales factor method provides incentive for businesses to expand operations in California, then this measure would lead to a decrease in economic development and employment in California.

***State Budget***

A primary difference between NOL carryforwards and carrybacks is the timing of the tax refund payment. If a business incurs a loss in the current period and elects to carryback the loss to a previous period, the government will make the payment of the refund during the current year; however if the business elects to carryforward the loss, then the payment is made sometime in the future. In addition, businesses are more likely to experience losses during an economic downturn, a time in which governments are likely to be facing budgetary shortfalls and may find it difficult to meet the increased demand for carryback refund payments. For this reason, carryback policies can add to budgetary problems experienced by governments during economic downturns. This measure would eliminate this problem by mandating that businesses that wish to carryover losses may only do so into future years.

***San Diego Region***

While all three provisions of Prop 24 could impact corporations in San Diego County by increasing their future tax liabilities, disallowing transfer of excess tax credits and removing the option single sales factor could have identifiable impacts. Disallowing transferable tax credits reduces incentive for technology and science firms to pursue expanded research and development operations. In San Diego County, this could apply to several industries which are major employers including biotechnology, electronics, and defense. In addition, several international corporations with large scale operations in San Diego, such as Callaway, TaylorMade, and Sony Electronics, could potentially benefit from an option single sales factor and could see a large increase in future tax liability if this incentive is repealed.

**Proponent Arguments:**

The California Teachers' Association is the primary sponsor of Prop 24. Primary arguments of the proponents include:

- The tax breaks benefit the biggest corporations in California, with 80% of benefits going to only 0.1% of all corporations.
- California's citizens have already been asked to pay higher income tax, sales tax, and vehicle license fees as a result of the State's budget problems; however corporations are not paying their fair share.
- California cannot afford to cut vital public programs during an economic downturn. Over the last two years $17 billion has been cut from K-12 education.

**Opponent Arguments:**

Opponents of Prop 24 are organized into a group called "Stop the Jobs Tax". This group is comprised of hundreds of individual business (primarily technology based businesses), several taxpayers associations including the California Taxpayers Association, and several chambers of commerce including the California Chamber of Commerce. Primary arguments of the opponents include:

- Prop 24 would tax the creation of new jobs in California when the state has record unemployment.
- The measure would remove incentives for businesses to move to or expand in California, and could lead to businesses leaving California to go to other states.
- Reduces long-term tax revenues used to fund public programs, such as education, by decreasing future economic development and the revenue base from which the state draws tax revenue.