Senate Budget and Fiscal Review—Mark Leno, Chair

SUBCOMMITTEE NO. 4 Agenda

Senator Michael J. Rubio, Chair
Senator Doug La Malfa
Senator Noreen Evans

Tuesday, February 1, 2011
9:00 a.m. Room 112

Consultant: Keely Martin Bosler

State Administration and General Government

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0860 State Board of Equalization

Background. The Board of Equalization (BOE) is one of California's two major tax collection and administration agencies. In terms of its responsibilities, BOE: (1) collects state and local sales and use taxes (SUT) and a variety of business and excise taxes and fees, including those levied on gasoline, diesel fuel, cigarettes, and hazardous waste; (2) is responsible for allocating certain tax proceeds to local jurisdictions; (3) oversees the administration of the property tax by county assessors; and (4) assesses certain utilities and railroad property. The board is also the final administrative appellate body for personal income and corporation taxes, which the Franchise Tax Board (FTB) administers. The BOE is governed by a constitutionally established board—consisting of four members elected by geographic district and the State Controller.

Governor's Budget. The *2011-12 Governor's Budget* proposes **$496 million** in support of BOE operations, of which **$283 million is General Fund**. The remaining budget consists mainly of reimbursements from local governments and support from various special funds. The proposed level of support represents a net increase of $13 million General Fund mainly from a budget proposal to continue a Statewide Compliance and Outreach Program that has been generating approximately $40 million annually from increased taxpayer education, outreach, and audit activities.

The number of personnel-years (PYs) for BOE is budgeted to increase slightly from 4,470 to 4,485.

Tax Gap Reduction Measures

Background. The BOE estimates that the total tax gap for all its programs is about **$1.5 billion**. The tax gap is defined as the total tax receipts due to the state less the tax receipts collected by BOE. The tax gap for the sales and use tax, the board's largest tax program, represents the majority of the tax gap.

The department has undertaken several initiatives to reduce this tax gap. However, a reduction to the Board's budget in 2009 and subsequent hard hiring freezes to manage this reduction has resulted in many vacancies at the board and has slowed the board's efforts to reduce the tax gap. The BOE estimates that it has an additional 180 vacancies they are trying to fill. Furthermore, the majority of the BOE's workforce is SEIU 1000 – whose contract signed last fall continued a personal leave program of one-day a month for a year. This has also temporarily reduced the personnel hours available to close the tax gap and the board has estimated it will cost the state $45 million General Fund in lost revenue collections in the current and budget years.

Question.

- **BOE.** Please explain what actions you have taken to reduce the revenue loss from the current hiring freeze and the PLP contract provisions?

1. Statewide Compliance and Outreach Program

Background. The BOE was approved to implement a three year pilot called the Statewide Compliance and Outreach Program (SCOP) in 2008. This program supported 148 new positions to focus on identifying and registering entities actively engaged in business in California whom were selling tangible personal property without a seller's permit. Seven teams were created across the state to perform permit checks. As of June 30, 2010, the SCOP had visited over 146,000 retail businesses and identified over 3,300 businesses operating without a valid seller's permit. Nearly 95 percent of businesses visited that did not have a seller's permit, voluntarily obtained the permit after the SCOP's visit. Noncompliant businesses were referred internally to the BOE's Legal Department, Investigations Division and then ultimately to local District Attorney's for prosecution.

The BOE estimates that the education and outreach activities of the SCOP have significantly increased voluntary compliance and has resulted in reducing the tax gap by approximately $68 million, annually. The BOE estimates that the benefit to cost ratio of this program is 4.8:1. Furthermore, the SCOP has also worked cooperatively with local governments to provide referrals concerning businesses operating without valid city/county business licenses.

Governor's Budget. The Governor's budget proposes to continue the SCOP program for an additional two years. The Governor's budget would extend the 147 positions for an additional two years at a cost of **$14.2 million** ($10.2 million General Fund).

Additional Businesses Required to Register…Means More Compliance Work to Do. A law change in 2009 (ABx4 18, Budget) required non-retail businesses with receipts of more than

$100,000 to register with the BOE and file annual use tax returns by April 15 each year. The annual use tax return and payment applies to purchases on which sales tax was not collected (generally from out-of-state sellers). This has resulted in BOE registering approximately 300,000 additional businesses (in addition to 197,000 retail businesses that already had seller's permits).

Given the recent law change described above to increase use tax compliance, there is likely significant education and outreach that is needed to ensure compliance with the new law.

Question.

- **BOE:** What are you doing to ensure that the new non-retail businesses are in compliance with use tax filing rules?

Staff Recommendation. Staff recommends that the Subcommittee approve this budget proposal on a permanent basis, but require annual reporting to ensure efficacy of the program over time.

2. Use Tax Collection - Voluntary Disclosure Program

Background. One component of the tax gap are the sales and use tax liabilities of businesses and individual consumers on products purchased from out-of-state vendors not required to collect the use tax. The use tax voluntary disclosure program was initiated in 2003 and extended permanently in 2010 (SB 858, Budget). This program places a line item on the income tax form for taxpayers to self report use tax that was not paid on items purchased from out-of-state vendors.

The BOE has indicated that this policy has resulted in an estimated **$10 million** in state and local revenue annually. The cost of this program is approximately $100,000.

Legislation, AB 469 (Eng), vetoed by the Governor in 2009, also contained other provisions that other states have used to improve voluntary use tax collections. These provisions include providing a "look-up" table to assist taxpayers in calculating their tax liability, and a mandatory reporting requirement if the tax was not reported to BOE. The BOE estimates that a look-up table could generate approximately $10.6 million ($6.5 million General Fund) in additional revenues by increasing use tax collections.

Staff Comments. Staff finds that the existing voluntary reporting mechanism for use tax that has not been paid has helped to close the tax gap at relatively little cost to the state. Additional progress could be made on closing the tax gap by providing a "look-up" table to assist taxpayers in complying with current law related to the use tax.

Staff Recommendation. Staff recommends that the Subcommittee adopt trailer bill language to do the following:

- Direct BOE to develop a "look-up" table to assist taxpayers in compliance with current law.

3. Sales Tax Nexus

Background. Under current law, purchases of tangible personal property are subject to use tax when purchased from any retailer even when purchased on the Internet. Current law also specifies that retailers that are considered to be engaged in business in California are required to collect use tax at the point of purchase by California consumers. However, a growing tax gap has emerged with Internet retailers that do not claim to be engaged in California technically and do not collect use tax on purchases made by California consumers. This has disadvantaged small business and corporations that do maintain brick and mortar presence in California.

The BOE has estimated that this law change would generate approximately **$100 million** right away, but there is significant potential for this number to grow.

Other States Have Acted to Close this Tax Gap. New York has closed this tax gap by redefining a "retailer engaged in business in this state" to include any retailer with an agreement with a resident that directly or indirectly refers business to the Internet retailer. This is commonly referred to as the "affiliate nexus" approach to closing the tax gap. In the case of New York state, Amazon.com challenged this law in court, but the Internet retailers started collecting the tax on purchases made by New York consumers immediately and continue to do so. The first court ruled in favor of New York state and the case is currently on appeal.

It is also important to note that Amazon.com did not pull the contracts with its affiliates, which has been a common concern when discussing this approach to closing the tax gap. Many other states have been considering a similar approach and in 2010 the Senate passed ABx8 8 (Budget) that was ultimately not passed by the Assembly. This "affiliate nexus" approach to closing the tax gap is being pursued in AB 153 (Skinner) in the current legislative session.

Corporations Benefit from Income Tax Cuts, but Do Not Claim Nexus. In 2008 the Legislature passed a new corporate tax cut that allows corporations that accumulate business tax credits to assign all or a portion of the unused credit to an affiliated corporation that is the member of the same combined reporting group. However, while these corporations may claim nexus for corporation tax purposes they may not claim nexus for sales tax purposes. Therefore, the recent credit sharing law that was passed in 2008 can benefit companies that do not claim nexus for sales tax purposes.

One example of a corporate structure described above includes Lab 126 located in Cupertino, California, which developed the Kindle e-reader. The Lab's parent company Amazon.com does not claim nexus in California for the purposes of collecting sales tax.

Legislation has been introduced in the Assembly (AB 155, Calderon) this year that would provide that a retailer whose parent has corporation tax nexus and whose subsidiaries in the state perform activities related to its retail efforts also have sales tax nexus.

Staff Comments. Current law has set up a comparative disadvantage for firms with brick and mortar invested here in California. Given the rise of Internet shopping, this is likely one of the areas where the tax gap has continued to widen. Furthermore, the development of Internet shopping tools such as Google Shopping allows consumers to identify which websites do not collect tax. This contributes to further confusing consumers in to thinking that use tax is not owed on purchases made on the Internet.

Staff Recommendation. Staff recommends that the Subcommittee hold this issue open, but consider adopting trailer bill to close the tax gap related to Internet purchases by:

(1) requiring Internet retailers with affiliate nexus to collect sales tax on behalf of California consumers; and

(2) requiring that certain Internet retailers that have corporation tax nexus also have sales tax nexus.

Other Issues

1. Headquarters Building

Background. The BOE Headquarters Building has a long and expensive history of problems. Construction was completed in 1993. The building has been fraught with construction defects causing water leakage, mold, and falling glass. The building has also experienced major system failures, including plumbing and the elevators. A major project was completed in 2006 to help remedy the problems. However, other problems continue and numerous employee complaints and lawsuits have ensued. The BOE estimates that this loss in productivity has resulted in annual revenue loss of approximately $22 million.

Furthermore, the BOE Headquarters building does not adequately meet BOE's space needs. Presently, the BOE staff is spread out over five different locations and the BOE has approximately 700 more positions than capacity at the main headquarters building.

The State started the process of purchasing the building from CalPERS several years ago. The State Pooled Money Investment Board (PMIB) advanced BOE around $91 million from the PMIB to purchase the building from CalPERS. The PMIB then would be repaid with the proceeds of a lease revenue bond sale. On November 15, 2010, the State Public Works Board authorized the sale of lease revenue bonds to repay the PMIB loan. The BOE estimates that the annual rent on the headquarters building will increase to nearly $13 million annually. This is an increase of approximately $2 million ($1.1 million General Fund) annually starting in 2011-12 to cover the full debt service costs of the bonds.

Governor's Budget. The Governor's budget includes an augmentation of **$2.1 million** ($1.1 million General Fund) to cover projected rent increases to cover the full debt service costs as projected by BOE.

Staff Recommendation. Staff recommends that the Subcommittee reject this budget proposal without prejudice. This issue can be considered later this session if additional information is presented.

2. Dell Computer Settlement

Background. The BOE has been named as the cross defendant in the class action case of *Diane Mohan v. Dell*. This case is currently pending in San Francisco County Superior Court. The case involves the collection of use tax by Dell Computers on the extended warranty service contracts during the years 2000 to 2008. The extended warranty service contract is an intangible and the court found that the use tax was collected erroneously. The class action attorneys have estimated as many as 10 million transactions over this time period. The BOE's experience is that about 20 percent actually completed refund claims and submitted them for payment, but this could still mean hundreds of thousands of claims that need to be processed.

The BOE has indicated that it does not have the staff to process these additional transactions. However, to date no final determinations or orders have been issued by the court about who will pay for these transactions.

Governor's Budget. The Governor's budget includes a "placeholder" request of **$4.2 million** ($2.8 million General Fund) in the budget year and $1.6 million ($1.1 million General Fund) in 2012-13 and 2013-14 to support 8 three-year limited term positions to address the additional workload associated with processing the Dell refunds.

Staff Recommendation. Staff recommends that the Subcommittee reject this budget proposal without prejudice. This issue can be considered later this session if additional information is presented.

1730 Franchise Tax Board

Background. The Franchise Tax Board (FTB) is one of the state's two major tax collection agencies. The FTB's primary responsibility is to administer corporation tax programs and California's personal income tax (PIT). In addition, FTB administers several non–tax–related programs, including the collection of child support payments and other court–ordered payments. The FTB is governed by a three–member board, consisting of the Director of Finance, the Chair of the Board of Equalization (BOE), and the State Controller. An executive officer, appointed by the board, administers the daily operations and functions of FTB.

The *2011-12 Governor's Budget* proposes **$586.5 million** in support of FTB's operations, of which **$551 million is General Fund**. The remaining budget consists mainly of other special funds related to FTB's court collection and Department of Motor Vehicles collection programs. The proposed level of support represents a net increase of almost $9 million General Fund mainly from budget proposals to augment the FTB's audit program and provide upgrades to FTB's mainframe computer system.

The number of personnel-years (PYs) for FTB is budgeted to decline slightly from 5,434 to 5,260.

Tax Gap Reduction Measures

Summary. The FTB estimates that its total tax gap is about **$6.5 billion**. The tax gap is defined as the total tax receipts due to the state less the tax receipts collected by FTB. The department has undertaken several initiatives over the last six years to reduce this tax gap using an enterprise approach. An enterprise approach means that staffs from all different divisions at FTB are involved in reducing the tax gap, including filing, audit, legal, and collections divisions.

The FTB has reported that it is on track to raise the additional revenues ($114 million) related to recent tax gap enforcement efforts, including the augmentations made last year to continue the board's ability to mine the DMV luxury auto registrations and IRS Information Return Master File for tax noncompliance leads and fund a vendor contract to identify good mailing addresses.

Recent efforts to reduce the tax gap have been negatively impacted by furloughs, hiring freezes, and the Personal Leave Policy (PLP) negotiated as part of the SEIU 1000 contract. The FTB has indicated that it did try and minimize the impacts of the furloughs by reducing non-revenue generating activities and low-return activities. However, regardless, the FTB estimated that 1.5 million hours were lost due to the furloughs and the more recent hiring freeze and PLP have further reduced revenues.

Question.

- **FTB.** Please explain what steps you have taken to minimize the revenue losses associated with the current hiring freeze and PLP contract provisions?

1. Audit Workload

Background. The FTB's audit program is responsible for conducting examinations of taxpayer income tax returns and claims for refunds in order to determine whether the self-assessed tax liabilities were calculated correctly. Historically, the audit program has prioritized audit models and processes have been evaluated based on the workload benefits (revenue) to costs and has pursued audits that return at least $4 of benefit to every $1 of cost invested in the audit.

The FTB recently assessed its audit workload and identified that there was additional capacity for audit staff that would generate at least a 4:1 cost benefit ratio.

Governor's Budget. The Governor's budget includes a proposal to add 34 positions at a cost of **$3.2 million** General Fund to augment the FTB's audit program. The FTB estimates that these additional auditors would generate **$13 million in additional revenues** in 2012-13 and $6.5 million in the budget year due to the time it takes to staff and train new auditors.

Staff Recommendation. Staff recommends that the Subcommittee approve this budget proposal.

2. Financial Institutions Records Match (FIRM)

Background. In recent years the FTB has pursued the implementation of a Financial Institutions Records Match (FIRM) system to help reduce the tax gap. The FIRM is an information technology project that would require financial institutions doing business in California to match FTB information on delinquent tax and non-tax debtors against their customer records on a quarterly basis. The FIRM is patterned after the FTB's Financial Institution Data Match system, which is a project implemented as a result of federal legislation to identify the assets of delinquent child support debtors.

The Senate passed legislation (ABx8 8, Budget) in 2010 to authorize FTB to implement a FIRM system. However, ultimately this legislation was not passed by the Assembly. The FTB would use the new data collection aid in the collection of debts under the authority of the existing Order to Withhold statutes. The proposal would not impact existing law that provides the applicable constitutional due process protections and appeal rights available in either the audit or collection processes. In addition, ABx8 8 required FTB to reimburse a financial institution for its actual costs incurred to implement FIRM, up to $2,500 for startup costs and no more than $250 per calendar quarter thereafter. This amendment removed bank opposition to this measure. A Feasibility Study Report (FSR) has been completed on this project.

Governor's Budget. The Governor's budget includes **$1.3 million** General Fund to support 3 positions in the budget year to start implementation of the FIRM system. The budget for this system when fully implemented would be $5.1 million to support 42 positions. The initial positions would be related to getting the technical aspects of the system functional and the additional positions in 2012-13 would support additional accounts receivable staff needed to collect funds identified by the bank record matches.

Approximately $540,000 in the budget year and $2.3 million in 2012-13 would be to reimburse the banks each quarter for their costs associated with implementing the FIRM system.

The Governor is proposing trailer bill language to implement this program – the trailer bill language is substantively the same as the language passed by the Senate in 2010.

The board has estimated that this proposal will generate **$43 million in additional revenues** in the current and budget years.

Staff Comments. Staff finds that the tax gap continues to be a burden on taxpayers that comply with all the state's tax laws. Staff finds that the FIRM system would help to reduce the tax gap by using a methodology that has been proven in the child support system.

Staff Recommendation. Staff recommends that the Subcommittee adopt the Governor's budget proposal and trailer bill language to implement the FIRM system.

3. Voluntary Compliance Initiative 2011

Background. Current federal and state law place reporting requirements and restrictions on abusive tax shelters and related transactions designed to avoid taxes. The use of and failure to report such transactions is subject to assessment, substantial penalties, and interest by the FTB up to eight years after the tax return is filed by the taxpayers.

The FTB, over the past decade, has implemented two amnesty-type efforts to recover past-due state tax revenues, a Voluntary Compliance Initiative in 2003 and a general tax amnesty program in 2005. In total these programs resulted in the collection of $4.5 billion in additional tax revenues (some of these revenues would have been collected in future years but due to the amnesty and Voluntary Compliance Initiative collection was accelerated). Under these programs, taxpayers that were already under audit or anticipating audit had an opportunity to pay the tax, pay reduced penalties, and avoid criminal prosecution associated with their tax avoidance strategies.

Governor's Budget. The Governor's budget includes a proposal to implement another Voluntary Compliance Initiative. The proposal includes **$513,000** to support 5.5 positions to backfill other revenue generating positions that would have to be redirected to implement this program. The FTB estimates that the 2011 Voluntary Compliance Initiative described in more detail below will generate approximately **$270 million in additional revenues** in the current fiscal year.

This new 2011 Voluntary Compliance Initiative would begin on August 1, 2011 and end on October 31, 2011. It would apply to taxable years before January 1, 2011. Specifically the proposal would create a narrow amnesty for certain taxpayers that have abusive tax avoidance transactions that are currently under audit, in protest, or are currently unknown to the FTB. This proposal would also apply to taxpayers with other unreported income from the use of an offshore financial arrangement.

The 2011 Voluntary Compliance Initiative would include the following incentives for businesses and individuals to participate:

- Waiver of all penalties, except the Large Corporate Understatement Penalty and Amnesty Penalty for qualified participants.
- No criminal action (amnesty) would be brought against any participant, unless they are currently the subject of a criminal complaint or under criminal investigation in connection with an abusive tax avoidance transaction.

The 2011 Voluntary compliance initiative would also make the following changes to further reduce the use of abusive tax avoidance transactions prospectively:

- Increase the statute of limitations for the FTB related to abusive tax avoidance transaction cases from eight to twelve years.
- Enact a uniform definition of abusive tax avoidance transactions.
- The abusive tax avoidance transaction use penalty would be modified to prevent taxpayers from avoiding the penalty by filing an amended return after being contacted by FTB, but prior to the FTB issuing a deficiency notice. Instead 50 percent of the penalty

would be imposed on any amended return filed after the Voluntary Compliance Initiative period.

- Amend the noneconomic substance transaction (NEST) penalty so that it is imposed on any California understatement resulting from a transaction the IRS examines and determines to lack economic substance.

In addition, participants in the 2011 Voluntary Compliance Initiative would be required to file amended returns and pay all unpaid tax and interest resulting from the abusive tax avoidance transaction. Furthermore, all tax years settled in the 2011 Voluntary Compliance Initiative would be closed to appeal rights.

Staff Comments. Given the FTB's past experiences with tax amnesty and the first Voluntary Compliance Initiative there is clearly short-term financial benefits that can be gained from implementing this sort of effort. Staff finds that the proposal also includes several ongoing law changes that would further discourage the future use of these tax avoidance strategies. This should have long-term impacts on the FTB's ability to close the tax gap that last beyond the 2011 Voluntary Compliance Initiative period.

The state's tax gap is unfair and places additional burden on compliant taxpayers. Good tax collection practices aim to reduce the tax gap and collect taxes that are due to the state.

Staff Recommendation. Staff recommends that the Subcommittee approve the budget proposal and trailer bill language to implement the 2011 Voluntary Compliance Initiative.

Other Issues

1. Mainframe Replacement

Background. Data security and reliability is critical for FTB given the volume of confidential taxpayer data it maintains. The FTB's data reliability is being threatened by outdated equipment and software that is out-of-support. The FTB is working towards implementing a major new information technology project called Enterprise to Data Revenue (EDR). Once this new system is implemented, FTB has estimated that it will generate $1 billion in additional tax collections annually. This new system will require upgrades to FTB's existing mainframe hardware. Furthermore, the current mainframe hardware is running very close to capacity making failure of the system more of a concern.

Governor's Budget. The Governor's budget includes **$4.7 million** General Fund on a one-time basis to replace the existing mainframe, storage device, and supporting software licenses.

Financing System Saves Upfront Cash. Staff finds that replacing the mainframe hardware is justified given the current lack of capacity on the existing system and the upcoming implementation of the new EDR system. However, given the State's current fiscal condition the staff recommends that FTB finance the replacement of the system over a three-year period. The FTB estimates that financing the system over three years would cost approximately $250,000 more than paying up front, but would save the state $3 million in the budget year. The FTB has offered this as the second best alternative in its budget change proposal.

Staff Recommendation. Staff recommends that the Subcommittee approve the mainframe replacement, but finance the replacement over a three year period.

Revenues

1. Maintain Existing Taxes: Realignment

Background. The 2009-10 budget passed in February 2009 included a 1 percent increase in the sales tax and a 0.5 percent increase in the vehicle license fee (VLF). These tax increases were passed for a two-year period. The increased sales tax and VLF rates would have been maintained for an additional one year and two years, respectively, if the voters had passed Proposition 1A in May 2009. However, the voters rejected Proposition 1A.

It was anticipated in 2009 that economic growth and reduced government expenditures would allow for the temporary revenues to expire without major budget implications. However, the economic recovery has been slow and the unemployment rate remains high. Furthermore, while some permanent spending reductions have been made including the elimination of adult dental care and the reduction of pension benefits for state employees, many solutions have been temporary and have resulted in a projected $25.4 billion budget deficit in 2011-12. Without corrective action a deficit of over $17 billion is projected in each of the next four fiscal years.

Governor's Budget. The Governor's budget has proposed a constitutional amendment to maintain the current sales tax and VLF rates for a five year period dedicated to local governments to support **$5.9 billion** in public safety programs that would be realigned from the state to the counties.

- **Maintain 1 percent Increase to State Sales and Use Tax.** The State Sales and Use Tax rate was increased from 5 percent to 6 percent effective April 1, 2009. The increase is set to sunset on June 30, 2011. The Governor's budget would extend the 1 percent State Sales and Use Tax for five additional years to support local public safety programs. This proposal is expected to generate $4.5 billion in the budget year.
- **Maintain 0.5 percent Increase to VLF.** The rate of the vehicle license fee (VLF) was increased from 0.65 to 1.15 percent of a vehicle's value, effective May 19, 2009 and will sunset on June 30, 2011. The increase from 0.65 to 1 percent went to benefit the General Fund and 0.15 of the increase was transferred to the Local Safety and Protection Account to fund local law enforcement programs. The Governor's budget would maintain this increase for five additional years to support local public safety programs, including the local public safety programs supported by the 0.15 raised in 2009. This proposal is expected to generate $1.4 billion in the budget year.

The Governor proposes to place the constitutional amendment on the ballot in June 2011.

VLF Historically at 2 Percent. The VLF is currently 1.15 percent and the Governor's proposal would maintain this rate for an additional five years to support local public safety programs. The VLF has historically been 2 percent of the market price of the vehicle. The LAO has found that a VLF rate of about 1 percent is appropriate and is consistent with the tax rate for other property (land). Furthermore, the VLF adjusts annually based on the depreciated value of the vehicle and is deductible on federal income tax returns.

The State Constitution already dedicates 0.65 of the VLF to local governments. The Governor's proposal would dedicate the remaining 0.5 for local public safety purposes.

Portions of Sales Tax Historically Dedicated to Local Government. The Sales and Use Tax is currently approximately 8.25 percent and can be up to 2 percent higher depending on the local jurisdiction since locals can generally levy an additional 2 percent through the transactions and use tax. Currently, the Sales and Use Tax is made up of the following components:

- 6 percent to the General Fund;
- 0.5 percent dedicated to local governments;
- 0.5 percent dedicated to local public safety services;
- 1 percent Bradley-Burns Uniform Local Sales and Use Tax with 0.25 percent dedicated to county transportation funds and 0.75 percent for city and county operations; and
- 0.25 percent dedicated to paying costs associated with the Economic Recovery Bond Act.

The Governor's budget proposal would maintain the Sales and Use Tax rate described above, but dedicate 1 percent currently going to the General Fund to local government to support realigned public safety programs. The LAO has indicated that maintaining this higher tax rate merits serious consideration given the magnitude of the State's budget deficit.

Staff Recommendation. Staff recommends that the Subcommittee hold this issue open.

2. Maintain Existing Taxes: Education

Background. The 2009-10 budget passed in February 2009 included a 0.25 percent surcharge on each personal income tax (PIT) bracket and a reduction in the dependent exemption credit from $309 to $99 for a two-year period. The surcharge and reduced dependent exemption credit would have been extended for an additional two years if the voters had passed Proposition 1A in May 2009. However the voters rejected Proposition 1A.

The LAO's fiscal forecast released in November 2010 projected that the Proposition 98 guarantee was expected to decline by $2 billion in the budget year. This decline is mainly the result of the expiration of the temporary taxes discussed above and in this issue. This decline would be on top of the significant loss of federal ARRA funds that are no longer available for school districts.

Governor's Budget. The Governor's budget has proposed a constitutional amendment maintaining the following tax rates for a five year period dedicated to education that will generate **$5.2 billion** annually.

- **Maintain 0.25 percent Surcharge.** A PIT surcharge of 0.25 percent was enacted effective in the 2009 and 2010 tax years. The Governor's budget estimates that maintaining this surcharge would generate $3.3 billion in the current and budget years.
- **Maintain Reduced Dependent Exemption Credit.** The dependent exemption credit was reduced from $309 to $99 effective in the 2009 and 2010 tax years. The Governor's budget estimates that maintaining this reduced credit will generate about $2 billion in the current and budget years.

The Governor proposes to place the constitutional amendment on the ballot in June 2011.

PIT Surcharge Regressive. The PIT rate ranges from 1.25 percent to 9.55 percent depending on income (this includes the temporary surcharge). Individuals with $46,766 or more in taxable income in 2010 pay the highest PIT rate on income earned above this amount. In addition, taxpayers with taxable income over $1 million pay an additional 1 percent surcharge, making their effective tax rate 10.55 percent in the 2009 and 2010 tax years.

Staff finds that the PIT surcharge is regressive in that it raises taxes the same amount at every income tax bracket. This means that proportionally an individual paying tax in the lowest bracket saw their rate increase by 25 percent, while an individual with $1 million in taxable income saw their rate increased less than 2.5 percent. The LAO has suggested that the Governor's proposal merits serious consideration given the State's fiscal situation.

LAO Supports Reduced Dependent Credit. The LAO has in the past recommended as a matter of policy reducing the dependent credit to make it consistent with the personal exemption credit, which is also $99.

Staff Recommendation. Staff recommends that the Subcommittee hold this issue open.

3. Corporate Tax Changes

Background. The 2008-09, 2009-10, and 2010-11 budget packages all included corporate tax changes. Generally these tax changes were a mix of short-term suspensions that provided temporary budget relief and permanent reductions that were made effective prospectively. These changes are outlined in further detail below.

Temporary Loss of Tax Benefit - $900 million per year for four years ($3.6 billion total)

- **Temporary Limit on Tax Credits.** The 2008-09 budget package temporarily limited to 50 percent the amount of business tax credits that could be used to reduce tax liability in the 2008 and 2009 tax years. This provided $1.3 billion in temporary revenue to the state. However, corporations were able to continue to carry these credits on their balance sheets.
- **Temporary Suspension of Net Operating Losses.** The 2008-09 budget package suspended net operating loss (NOL) deductions for the 2008 and 2009 tax years, except for taxpayers with net business income of less than $500,000 in either year. The 2010-11 budget package suspended NOLs for an additional two years, except for taxpayers with net business income of less than $300,000 in either year. Collectively these actions provided $2.3 billion over the four year period. However, corporations were able to continue to carry and accumulate these losses on their balance sheets.

Permanent Tax Cuts - $1.3 billion in permanent cuts ongoing starting in 2011.

- **Permanent Change Unitary Group Credit Sharing.** The 2008-09 budget package authorized corporations that accumulate business tax credits to assign all or a portion of any unused credit to an affiliated corporation that is a member of the same combined reporting group. With respect to credits earned in tax years beginning before July 1, 2008, the assignee corporation would have to have been a member of the group from at least June 30, 2008, through the year of assignment. For credits earned subsequently, the assignee corporation must be a member of the group in the year that the credit is earned through the year in which the assignment occurs. This tax policy change will result in a loss of General Fund revenues of approximately $315 million annually starting in the 2010-11 budget year.

- **Extend NOL Carry Forward Period and Allow for Carrybacks.** The 2008-09 budget package further expanded the NOL carry forward period from 10 years to 20 years for losses incurred after January 1, 2008. Furthermore, the budget package, amended in 2010, authorized NOL carry backs for losses incurred in 2013 or later tax years. The carry back provision will phase in, with 50 percent of any 2013 NOLs available for carry back, 75 percent of any 2014 NOLs, and full carry back for NOLs in subsequent years.

- **Elective Single Sales Factor.** The 2009-10 budget package created a permanent ***elective*** single sales factor for apportionment of business income across states. In contrast, prior law averaged a business's proportion of sales, property, and payroll in California (with the sales factor double-weighted) to apportion the California share of multi-state business income. Under this new tax policy, corporations can elect to allocate net income for California tax purposes under the old formula or 100 percent to sales. Businesses that proportionally have fewer sales in California relative to property and payroll will see their taxable income in California fall. This change will go into effect for the 2011 tax year. The annual losses projected from this policy change are in excess of $1 billion.

- **Cost of Performance.** The 2009-10 budget package replaced the "cost of performance" rule for corporate taxpayers with a market based rule when the elective single sales factor was enacted. Under the cost of performance rule sales of intangibles and services are assigned to California for tax purposes only if the greater cost of performance of the income producing activity occurs in California relative to other states. The market based rule would have required the sales of intangible goods and services to be used to apportion corporate income to California. The 2010-11 budget package repealed the market based rule returning the state to the old cost of performance rules for sourcing intangibles. The annual losses projected from returning to the cost of performance rule are approximately $100 million annually.

Governor's Budget. The Governor's budget modifies current law to make the single-sales factor multi-state corporate income apportionment method mandatory instead of elective. The Governor's budget also proposes to return back to the market based rule for sourcing intangibles. These two changes are expected to generate **$1.4 billion** in the current and budget years.

Elective Single Sales Factor Disadvantages California Based Companies. Allowing corporations to elect the formula they apportion income for tax purposes gives a comparative advantage to out-of-state corporations that have high sales, but low property and payroll invested in California. By allowing the corporation to elect the formula it uses to calculate tax owed, the corporation can then choose the calculation that is most advantageous to their situation. Furthermore, changing to mandatory single sales factor will bring California more in line with other states. Of the 23 states that have adopted single sales factor, only three allow an election. The FTB estimates that the increased tax liability under mandatory single sales factor will generally come from out-of-state businesses that will have higher tax liabilities.

Cost of Performance Rule Advantages Out of State Companies. The "Cost of Performance" rule specifically advantages corporations headquartered outside of California. Moving to a market-based rule reduces the ability of taxpayers to manipulate their sales factor and makes the treatment of intangibles consistent with tangible goods.

Carryback Provision Duplicative. While the carryback policy does conform to federal policy, there are unique circumstances in California that make this policy problematic. Specifically, the Proposition 98 guarantee that funds K-14 education depends on year-over-year growth in General Fund revenues. However, the premise of carrybacks is that corporations can go back and amend prior tax returns to lower tax liabilities and even trigger tax returns. However, the state has no ability to change the Proposition 98 guarantee retroactively to adjust for the amendments to revenues. Secondly, the carry forward policy allowed by current law essentially gets at the same policy goal, which is to average a corporation's tax liability over a period of time in order to encourage investments that may take multiple years to recover.

Staff Recommendation. Staff recommends that the Subcommittee hold this issue open, but consider the following tax policy changes:

- Adopt the Governor's proposal to implement mandatory single sales factor policy.
- Adopt the Governor's proposal to change to a market-based rule for sourcing intangibles and services.
- Repeal carryback provision.
- Suspend for two years the new credit sharing law.

4. Targeted Tax Expenditures: Enterprise Zones

Background. Existing law provides special tax incentives for four kinds of geographically targeted economic development areas. These areas include enterprise zones, local agency military base recovery areas (LAMBRAs), manufacturing enhancement areas (MEAs), and targeted tax areas (TTAs). The tax incentives enjoyed by businesses located in these areas include accelerated depreciation, 100 percent net operating loss carryover, wage credits, and credits for sales tax on equipment purchased for use in the zone. There are some differences among the tax incentives provided for each area, but taxpayers generally have access to each form of preferable tax treatment.

The law currently limits the number of enterprise zones (42), LAMBRAs (8), MEAs (2) and TTAs (1). The Department of Housing and Community Development has designated 42 enterprise zones and 7 LAMBRAs as of December 15, 2010.

Employers within enterprise zones are allowed to claim a tax credit of 50 percent of the wages paid to a qualified employee in the first year, 40 percent in the second year, 30 percent in the third year, 20 percent in the fourth year, and 10 percent in the fifth year, up to 150 percent of the minimum wage. Qualified employees include individuals: (1) eligible for job training programs; (1) eligible for most social welfare programs; (3) economically disadvantaged; (4) dislocated workers; (5) disabled and eligible or enrolled in a state rehabilitation plan; (6) veteran; (7) ex-offender; and (8) member of a federally recognized Indian Tribe. Furthermore, existing law also allows enterprise zones to designate targeted employment areas (TEAs) to contain census tracts where 51 percent or more of individuals are considered low or moderate income. Any hire made out of a TEA can qualify the taxpayer in the enterprise zone for the hiring tax credit and TEAs can be drawn outside the borders of the enterprise zones.

The tax expenditures related to these zones cost the state approximately **$300 million** annually.

Governor's Budget. The Governor's budget proposes to repeal the state tax benefits allowed in the four kinds of geographically targeted economic development areas described above. The proposal would eliminate all state tax benefits for both newly earned credits and deductions and for credits that had been earned in prior years, but have not been used. Local agencies would have the option of keeping their local incentives. This proposal will generate **$924 million** in the current and budget years.

Good Goal, But Not a Core State Responsibility. The enterprise zone program was formed in 1984 to help draw investment into depressed rural and urban areas. While this is a good goal, it is not a core responsibility of state government and given the state's chronic budget deficits it is important that all state spending, including tax expenditures be scrutinized.

Furthermore, the Governor has proposed a new option for local governments that want to continue to fund economic development activities. Specifically, the Governor has proposed a constitutional amendment to provide for 55 percent voter approval for limited tax increases and bonding against local revenues for economic development projects. Furthermore, the

Governor's proposal does not impact tax incentives that local governments may provide businesses in enterprise zones.

Program Not Proven Effective. In addition, the LAO and others have found that enterprise zone tax benefits have little to any impact on the creation of economic activity or employment in California. The LAO found that the program mainly seemed to shift economic activity from one zone to another within California without doing anything to grow economic activity. Furthermore, there is some evidence that benefits from the enterprise zone program go to taxpayers whose behavior has not been affected at all by the program, but instead by firms that specialize in finding businesses that could benefit from the program and offering to prepare the taxpayers tax return on a percent of benefit basis. In these cases it is clear that the taxpayer did not relocate their business because of the enterprise zone – since they had to be told of the tax benefit after they had already relocated.

Reform versus Elimination. Recently there have been significant efforts to make some reforms to the enterprise zone program. Specifically, SB 974 (Steinberg) from 2010 proposed to eliminate Targeted Employment Areas (TEAs) and stop the practice of retro-vouchering. As mentioned above, TEAs allow a taxpayer to qualify an employer for a tax credit not based on who they are, but based solely on residence within a zip code range listed on his or her employment records. Retro vouchering essentially allows taxpayers to gain tax credits for hiring decisions made in the past. Taxpayers often use the TEA criterion and the retro-vouchering to check payroll records and essentially "mine" the data for qualified employees and then file tax claims for refunds with the State.

In addition to the reforms listed above, there have been other reforms discussed that would limit the size of the enterprise zone program. However, the Governor's proposal to eliminate the enterprise zone program merits consideration given the state's fiscal situation and the lack of any evidence or performance data that the program provides any overall benefit to the state.

Staff Recommendation. Staff recommends that the Subcommittee hold this issue open.