

TO HAVE AND HAVE NOT

In September 2008, the Legislature passed a spending plan that included \$11.4 billion in reductions to nearly all areas of the state budget. In February 2009, the Legislature made an additional \$6.8 billion in cuts to 2008-09 spending and passed a budget for 2009-10 that included \$8.6 billion in spending reductions. In light of the magnitude of California's fiscal problems, one might expect that there would be no "winners." In fact, both the September 2008 and February 2009 budget agreements created some very big winners – a very small number of corporations that will receive tens of millions of dollars per year in tax breaks as a result of changes made to California's corporate tax laws.

Three's Company

The two budget agreements made three changes to California's corporate income tax laws that mark a significant departure from longstanding policy, including:

- **Elective single sales factor apportionment.** Allowing corporations to choose between two methods for determining the share of their profits that would be taxed in California. Traditionally, California has used a three-factor formula that takes into account the share of a corporation's property, payroll, and sales that are located in California. Under the change made in February 2009, corporations could choose to be taxed solely on the share of their sales that occur in California.
- **Tax credit sharing.** Allowing corporations to transfer tax credits among a family – or combined reporting group – of related corporations. Traditionally, only the corporation earning a tax credit could claim that tax credit.
- **Net operating loss carrybacks.** Allowing corporations to claim refunds on taxes already paid by claiming tax deductions for net operating losses (NOLs). California previously allowed businesses to "carry forward" and deduct operating losses against future income. The recent change allows businesses to "carry back" operating loss deductions and claim refunds against prior years' taxes.

No public hearings were held, and no public testimony was provided, on either the September 2008 or the February 2009 changes that will, at full implementation, result in a loss of \$2.0 billion per year, and potentially as much as \$2.5 billion, in corporate tax revenues, an amount equal to nearly one-quarter of the income tax dollars currently paid by California corporations (Figure 1).¹

The Color of Money

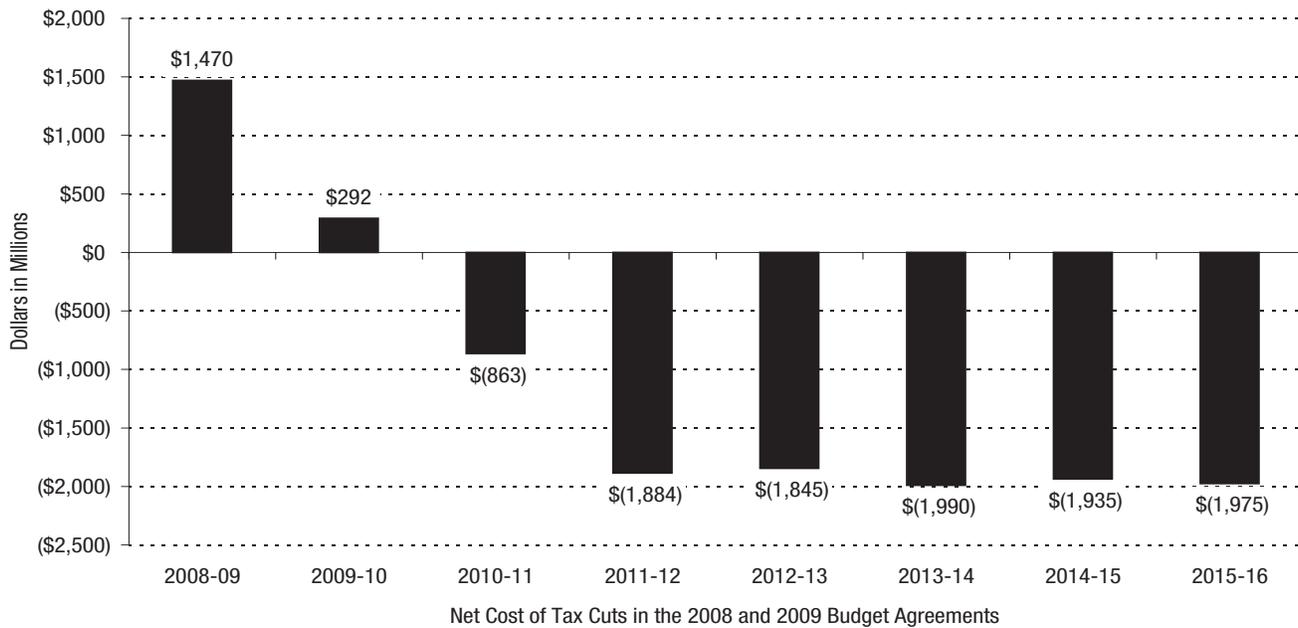
The three proposals will result in very large tax cuts for relatively few California businesses:

- Nine corporations will receive tax cuts averaging \$33.1 million each in 2013-14 due to the adoption of elective single sales factor apportionment.²
- Eighty percent of the benefits of single sales factor apportionment will go to the 0.1 percent of California corporations with gross incomes over \$1 billion.
- Six corporations will receive tax cuts averaging \$23.5 million each in 2013-14 from the adoption of credit sharing.
- Eighty-seven percent of the benefits from credit sharing will go to the 0.03 percent of California corporations with gross incomes over \$1 billion.

Moreover, some firms will likely benefit from more than one of these provisions. For example, a firm could benefit from both single sales factor apportionment and credit sharing. In addition

Figure 1: 2008 and 2009 Tax Deals Will Lose \$8.7 Billion Over Eight Years

Losses Will Continue Permanently



Note: Includes temporary business tax cuts enacted in February 2009.
Source: Franchise Tax Board

to these major permanent changes, the February 2009 budget agreement included two temporary tax cuts for businesses that take effect immediately: a tax credit for motion picture production activities and a tax credit for businesses that increase employment. A total of \$400 million worth of hiring credits are available and \$500 million in motion picture tax credits are available over five years.

As You Like It

California's corporate income tax applies to the income generated by business activities that are attributable to California. For corporations that only do business within the state, determining the income that is subject to state tax is straightforward. For multi-state and multi-national corporations, determining the income that is attributable to California is more complex. Traditionally, states have used a formula based on three equally weighted factors to apportion income among states for tax purposes. The traditional formula apportioned income based on the percentage of a corporation's total property, payroll, and sales within a given state. California used this approach prior to 1993. In 1993, California shifted to a formula that gave twice as much weight to the fraction of sales that occur within the state. This approach is called "double weighting" the sales factor.

AB 15xxx (Krekorian), enacted in February 2009, allows corporations to base their corporate income tax payments solely

on the share of their sales that occur within California. This change would take effect beginning January 1, 2011. AB 15xxx allows corporations to choose, or elect, to use the new method or to continue to use the existing formula. This policy, known as elective single sales factor apportionment, allows firms to calculate their taxes both ways and choose the method that offers the lowest tax bill. The shift to elective single sales factor apportionment will cost the state an estimated \$260 million in 2010-11, with the cost quickly rising to \$1 billion per year in 2014-15. Some forecasts suggest that when fully implemented, single sales factor apportionment will cost the state \$1.5 billion per year in lost revenues.³

State law prohibits disclosure of the names of the firms that would benefit from the state's adoption of single sales factor apportionment. Since there were no public hearings on AB 15xxx, there is no public record of the measure's supporters. In the past, supporters of proposals to more heavily weight the sales factor have included Apple, Inc.; Genentech, Inc.; Intel; Paramount Pictures; The Walt Disney Corporation; and Warner Brothers Entertainment, Inc., among others.⁴

Estimates prepared by the Franchise Tax Board show that the benefits of single sales factor apportionment would be concentrated among a very few, very large corporations:

- Nine corporations – 0.001 percent of all California corporations – would receive tax cuts of more than \$20

million – nearly one-third of the total cost of single sales factor apportionment (Figure 2). Tax cuts for the “lucky nine” would average \$33.1 million per firm in 2013-14. An additional 13 corporations’ tax bills would be reduced by \$10 million to \$20 million in 2013-14.

- Single sales factor apportionment will overwhelmingly benefit California’s largest corporations; 80 percent of the benefits will go to companies with gross receipts in excess of \$1 billion. These beneficiaries account for just 0.1 percent of all California corporations (Figure 3). Ninety-five percent of the benefits will go to 0.3 percent of the state’s corporations.
- Elective single sales factor apportionment will result in 2013-14 tax cuts of \$1 million or more for 152 corporations – 0.02 percent of all California corporations – at a \$768 million cost to the state.
- Twenty-eight utility corporations will receive 2013-14 tax cuts averaging \$1.7 million per firm (Figure 4). This is significant since these firms are tied to California by virtue of the service they produce and the customers they serve.

All in the Family

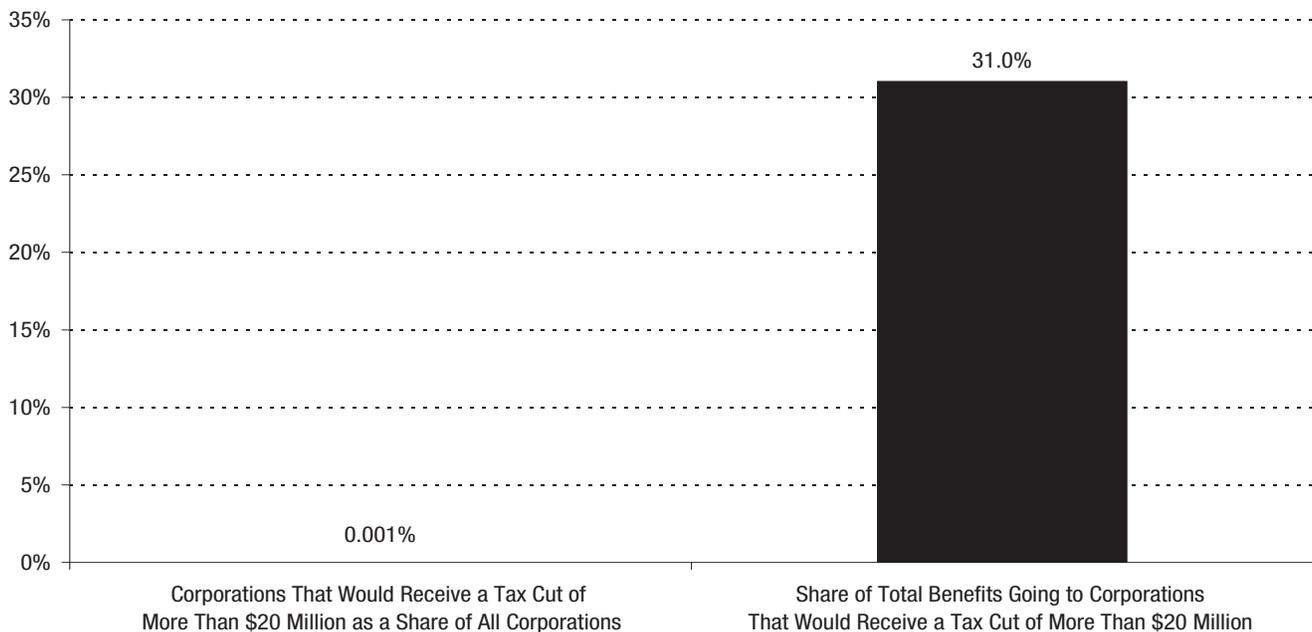
California traditionally restricted the use of tax credits to the taxpayer that actually engaged in the activity that generated the credit. AB 1452 (Committee on Budget), enacted as part of the September 2008 budget agreement, allows taxpayers to share

credits with other corporations that are related – members of the same combined reporting group in tax terminology.⁵ This change would apply to credits earned on or after July 1, 2008 or credits earned in prior years that are eligible to be carried forward into years beginning on or after July 1, 2008, but shared credits could not be used to reduce a corporation’s taxes until 2010. This provision will cost the state \$80 million in lost revenues in 2009-10, and \$270 million in 2010-11, and the cost would increase to an estimated \$385 million in 2015-16.

Similar to the benefits from single sales factor apportionment, the benefits of credit sharing would largely go to a very few, very large corporations:

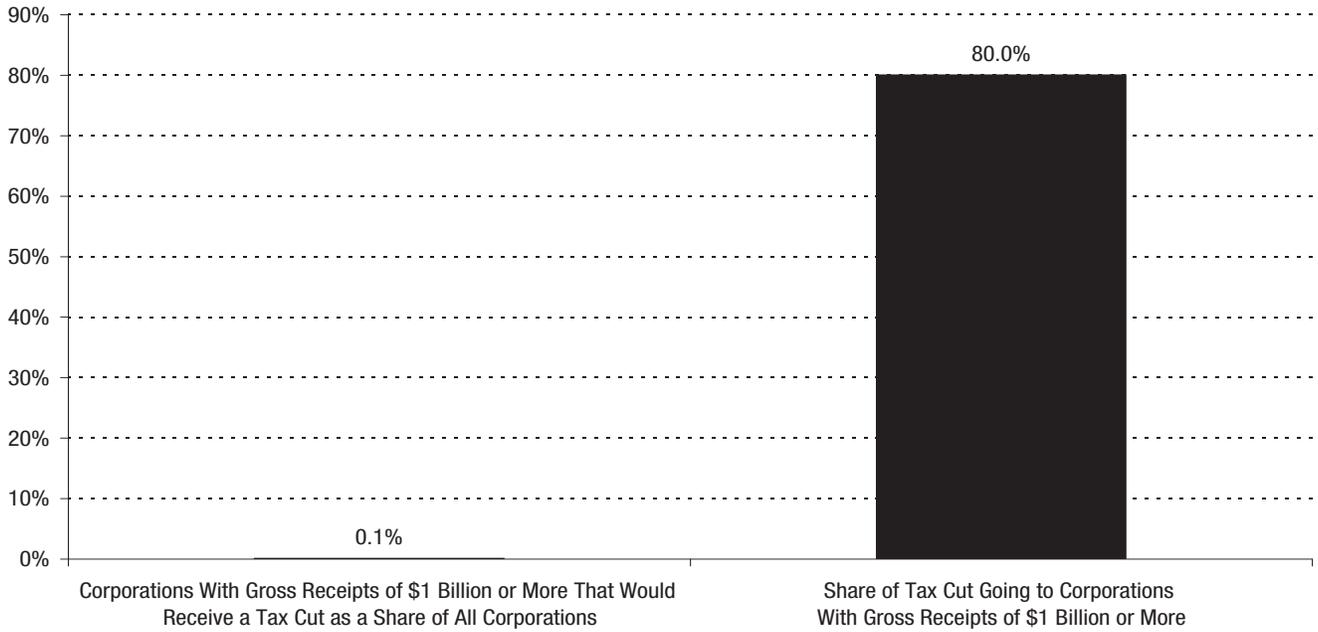
- Six corporations – 0.001 percent of all California corporations – would receive tax breaks of more than \$10 million from credit sharing in 2013-14. These tax breaks, which would average \$23.5 million per firm, will cost the state a total of \$141 million. An additional eight corporations would receive tax breaks of \$5 million to \$10 million per firm at a cost of \$54 million in 2013-14 (Figure 5).
- Credit sharing will also benefit California’s largest corporations. Nearly nine out of every 10 dollars (87 percent) of revenues lost due to this provision will go to 229 firms – 0.03 percent of California corporations – that have gross receipts in excess of \$1 billion (Figure 6).

Figure 2: Nine Corporations Would Receive Tax Cuts of More Than \$20 Million Each — Nearly One-Third of the Benefits From Single Sales Factor Apportionment



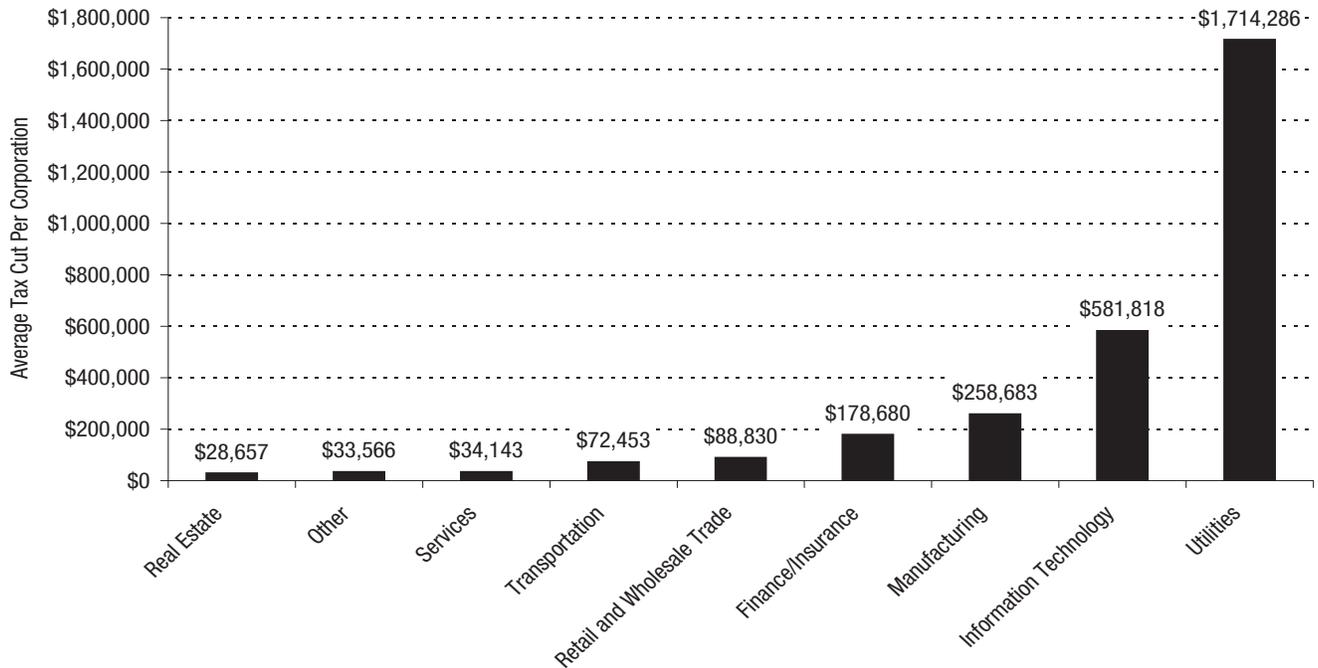
Source: Franchise Tax Board

Figure 3: 80 Percent of the Benefits From Single Sales Factor Apportionment Would Go to 0.1 Percent of Corporations



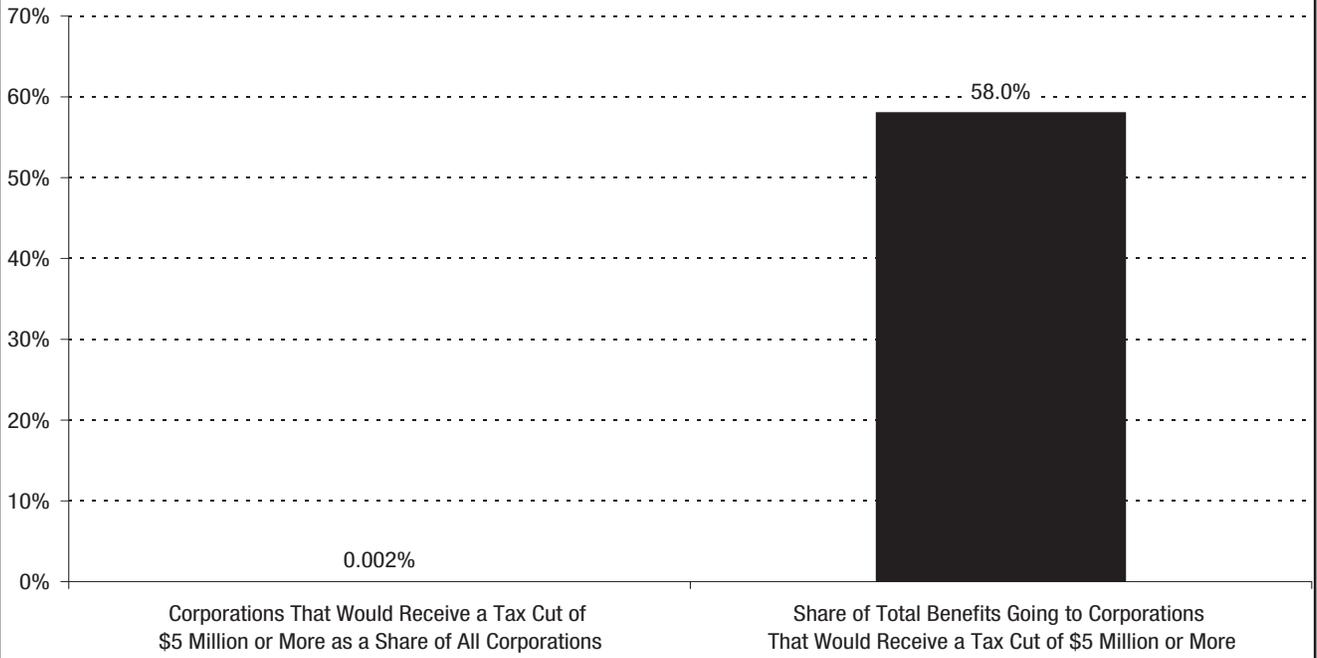
Source: Franchise Tax Board

Figure 4: The Utility Sector Would Receive the Largest Benefit Per Corporation From Single Sales Factor Apportionment



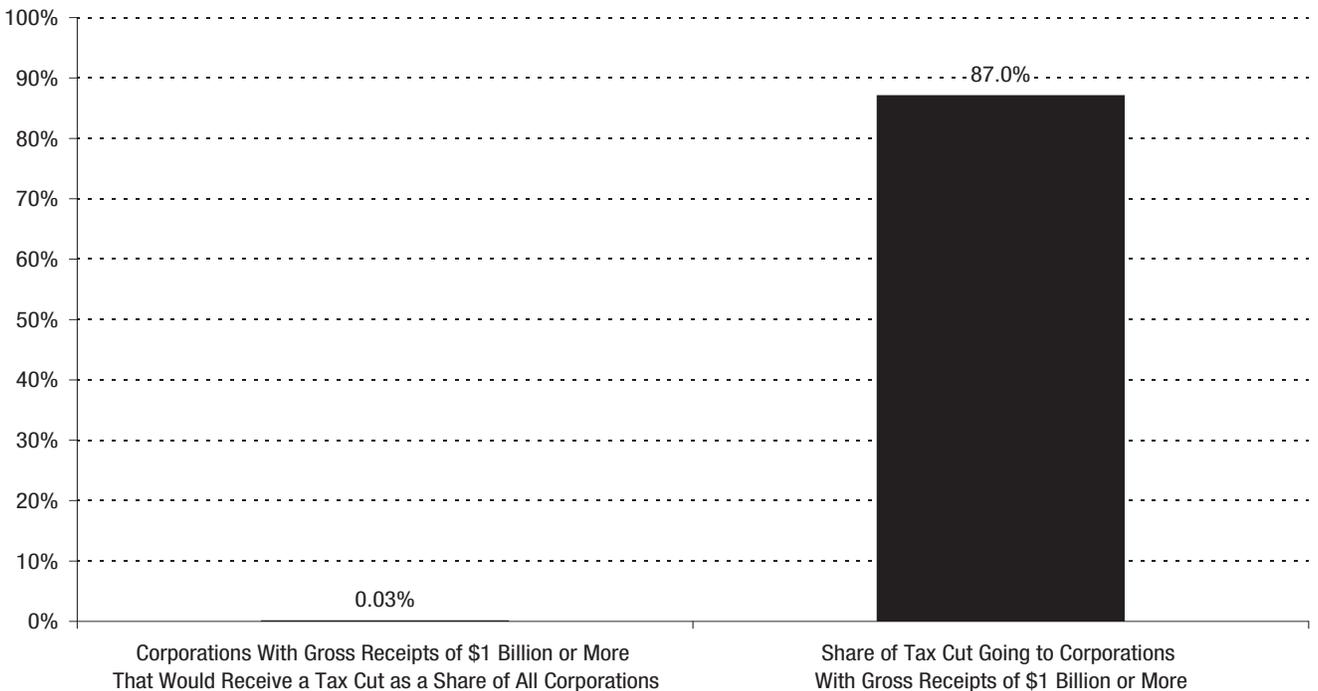
Source: Franchise Tax Board

**Figure 5: Fourteen Corporations Would Receive Tax Cuts of \$5 Million or More Each —
 Totaling More Than Half of the Benefits From Credit Sharing**



Source: Franchise Tax Board

Figure 6: 87 Percent of the Benefits From Credit Sharing Would Go To 0.03 Percent of Corporations



Source: Franchise Tax Board

Take It Back

Tax laws allow businesses that lose money to “carry forward” their losses and claim them as a tax deduction in a future year when the business becomes profitable. The September 2008 budget agreement suspended large businesses’ ability to claim deductions for operating losses in 2008 and 2009 and then extended the period that losses incurred in 2008 or prior years could be carried forward for use in future years; lengthened the period that losses earned in 2008 or later could be carried forward; and allowed losses to be carried back and used as a deduction in a prior year beginning in 2011.⁶ While federal law previously allowed businesses to “carry back” their losses, the September change marks a major and very costly shift in California’s tax policy.

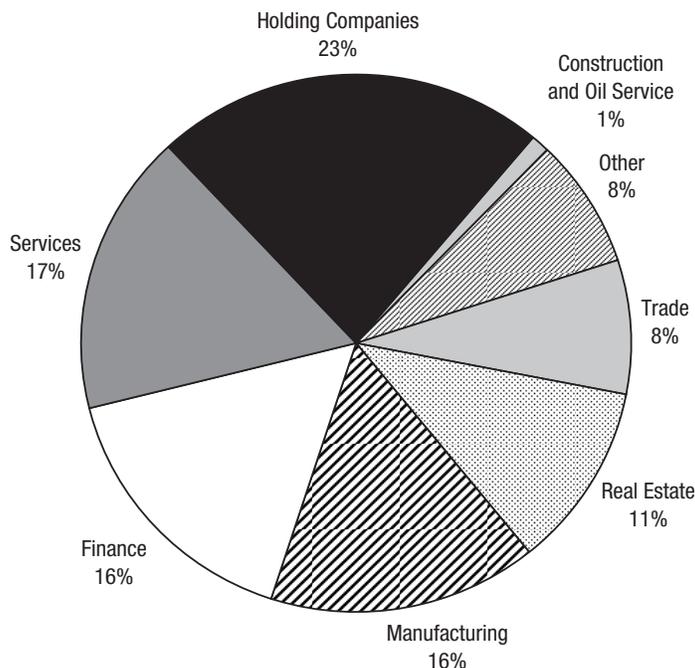
Loss carryback deductions are particularly noteworthy in the context of California’s persistent budget problems. When businesses carry back a net operating loss deduction, they file an amended tax return and claim a refund of taxes paid in a prior year – taxes that were already collected and taxes that were spent in the year that they were owed. The magnitude of the revenue loss attributable to loss carrybacks – over \$500 million at full implementation – is significant. The impact of loss carrybacks is particularly troublesome because businesses are likely to claim them in bad budget years based on profits

earned and taxes in during previous good economic times. Thus, allowing businesses to claim tax deductions for prior years will likely exacerbate California’s persistent budget problems. Loss carryback deductions will cost the state an estimated \$30 million in 2010-11, with the cost rising to \$505 million in 2011-12 and similar amounts thereafter.

While the benefits of net operating loss carrybacks will be more broadly distributed than those for single sales factor apportionment or credit sharing, this provision will still disproportionately benefit very large corporate taxpayers:

- More than one-quarter (28 percent) of the benefits of loss carrybacks will go to firms that claim deductions in excess of \$100 million. At the state’s 8.84 percent corporate tax rate, a deduction of \$100 million would offset the tax on \$1.1 billion of profits.
- Corporations with gross receipts in excess of \$1 billion will claim four out of every 10 dollars of loss carryback deductions.
- Almost one-quarter (23 percent) of the benefits of net operating loss carrybacks will go to holding companies (Figure 7). Real estate firms will claim 11 percent of the benefits and banks, savings and loans, and other financial corporations will receive an estimated 16 percent of the benefits.

Figure 7: Holding Companies Would Claim Nearly One-Quarter of Net Operating Loss Carryback Deductions



Note: "Other" includes agriculture, mining, and transportation and utilities.
Source: Franchise Tax Board

Bringing It All Back Home

The business tax cuts enacted as part of the September 2008 and February 2009 budget agreements will cost the state \$8.7 billion in lost revenues between 2008-09 and 2015-16 *after* taking into account the revenue gain from the suspension of net operating loss deductions and limits on tax credit usage imposed in the September agreement. This figure includes \$9.6 billion in lost revenues from the three measures discussed in this paper; \$1.1 billion of net revenue gain from the suspension of net operating loss deductions and limits on tax credit usage included in the September 2008 agreement; and the \$775 million loss

attributable to the temporary motion picture production and hiring tax credits enacted in February.⁷ Annual revenue losses of close to \$2 billion per year and potentially as much as \$2.5 billion per year would continue in 2016-17 and beyond. The large revenue losses in 2010-11 and beyond are significant in light of multi-year budget forecasts that project that the state will face shortfalls in excess of \$25 billion per year in 2011-12 and beyond.⁸ The massive, permanent tax cuts enacted as part of recent budget agreements will exacerbate California's persistent budget troubles, requiring deeper cuts in public services or potentially larger tax increases for California's families to make up for lost revenues.

Jean Ross prepared this Budget Brief with assistance from Alissa Anderson. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, individual donations, and subscriptions. Please visit the CBP's website at www.cbp.org.

ENDNOTES

- ¹ The February 2009 changes were contained in AB 15xxx (Krekorian). The September changes were made in AB 1452 (Committee on Budget). AB 15xxx also included several large temporary tax reductions benefitting business, including a tax credit for motion picture production activities and a tax credit for businesses that expand employment. AB 1452 suspended businesses' ability to claim net operating loss deductions in 2008 and 2009, but allows businesses to carry losses incurred in these two years forward for an additional two years, extended the carryforward period for all loss deductions, and exempted small corporations.
- ² The estimates of the distribution of the impact of credit sharing and single sales factor by size, firm, sector, and corporation discussed assume that the law had been in effect in 2006. The estimates of the distribution of the impact of net operating loss carrybacks assume that the policy had been in effect in 2007. The CBP estimated per firm and sector impacts in 2013-14 when all three of these provisions would be fully phased in.
- ³ Senate Floor Analysis of AB 15xxx as amended February 14, 2009, downloaded from http://info.sen.ca.gov/pub/09-10/bill/asm/ab_0001-0050/abx3_15_cfa_20090214_174915_sen_floor.html on May 28, 2009.
- ⁴ See, for example, Senate Revenues and Taxation Committee, *Analysis of AB 1037 (Frommer) as Amended August 7, 2006* downloaded from http://www.leginfo.ca.gov/pub/05-06/bill/asm/ab_1001-1050/ab_1037_cfa_20060807_131151_sen_comm.html on May 29, 2009 or Assembly Committee on Revenue and Taxation, *Analysis of AB 1591 (Ma) as Amended June 7, 2007* downloaded from http://www.leginfo.ca.gov/pub/07-08/bill/asm/ab_1551-1600/ab_1591_cfa_20070608_135615_asm_comm.html on May 29, 2009.
- ⁵ The budget agreement also limited the use of business tax credits to no more than 50 percent of the tax owed. Prior to this change, which applies to the 2008 and 2009 tax years, businesses could offset as much as all of their tax liability with credits. To offset the impact of this limit, the length of time businesses can carry tax credits forward was extended by two years. The limitation does not apply to businesses with taxable incomes of less than \$500,000.
- ⁶ Businesses could carryback 50 percent of losses attributable to 2011, 75 percent of losses attributable to 2012, and 100 percent of losses attributable to 2013 and thereafter. Losses could be carried back and applied to the two prior years. Losses attributable to 2008 and future years could be carried forward for 20 years. California previously allowed losses to be carried forward for 10 years. The loss carryforward suspension did not apply to taxpayers with net business incomes less than \$500,000.
- ⁷ The net gain from the suspension of NOL deductions and limits on tax credit usage in 2008 and 2009 is relatively small, since businesses can carry forward credits and deductions that might have been used in those years to reduce future years' taxes.
- ⁸ Legislative Analyst's Office, *The State Budget Situation* (May 27, 2009) downloaded from http://lao.ca.gov/handouts/FO/2009/052709_CSAC.pdf on May 28, 2008.