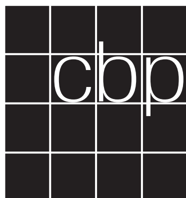

CALIFORNIA BUDGET PROJECT

budget brief

OCTOBER 2012

WHAT WOULD PROPOSITION 39 MEAN FOR CALIFORNIA?

Proposition 39, which will appear on the November 6, 2012 statewide ballot, would end the state's current practice of allowing multistate firms to minimize their California corporate income taxes by choosing the more favorable of two methods for determining their income subject to tax. This practice began in 2011, after the option was approved by the Legislature in the 2009-10 budget. Proposition 39 would change the law so that almost all multistate firms would be required to calculate the share of their income subject to the state's corporate income tax the same way: based on the percentage of their total sales that occur in the state. Proposition 39 would take effect in the 2013 tax year and would result in an estimated $1 billion annually in additional state revenues, growing over time. Approximately half of the revenues would be used from 2013-14 through 2017-18 to fund energy efficiency and clean energy initiatives. The bulk of the new revenues raised by Proposition 39's tax changes would come from a relatively small number of multistate firms that benefit from the current policy. The measure's supporters include Thomas Steyer, founder and co-senior managing member of Farallon Capital Management, and the California League of Conservation Voters. The California Budget Project neither supports nor opposes Proposition 39. This *Budget Brief* provides an overview of the measure and the policy issues it raises.

What Would Proposition 39 Do?

Corporations pay California tax on the share of their income attributable to business activity in the state. The majority of corporations in California – approximately 90 percent – do all of their business within the state and are taxed on all of their income.[1] For the remaining, multistate corporations, formulas are used to determine the share of income attributable to California and therefore subject to its corporate income tax.[2] Proposition 39, the "California Clean Energy Jobs Act," would require almost all multistate corporations doing business in California to calculate the share of their income that is subject to California's corporate income tax based on the percentage of their total sales that occur in the state, a method known as single sales factor apportionment. Currently, these firms can use either single sales factor apportionment or a different formula based on the shares of a firm's total property, payroll, and sales in the state.[3] California has used variations of the latter formula since at least 1966, and the most recent version, known as "double-weighted" sales factor, has been in effect since 1993.

Allowing multistate corporations to choose annually between the double-weighted and single sales factor formulas means that these firms will generally use the formula that is most advantageous to them. Proposition 39, by eliminating the choice between formulas, would increase the amount of tax paid by some corporations – those that currently choose the double-weighted sales factor formula – but would not affect the amount of tax paid by corporations that already choose single sales factor. Thus, the measure would result in a net increase in state revenues – an estimated $500 million in 2012-13 and $1 billion each year thereafter, growing over time, according to the Legislative Analyst's Office (LAO).[4] Half of the new revenues,

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up to $550 million, would be transferred each year from 2013-14 through 2017-18 to a "Clean Energy Job Creation Fund" for energy efficiency and clean energy projects throughout California.

Proposition 39 provides exceptions for several types of firms. The state would continue to use a separate, equally weighted, three-factor formula for determining the taxable income of multistate firms in agriculture, resource extraction, the savings and loan industry, and finance.[5] In addition, certain cable companies would be allowed to exclude some of their California sales when calculating their corporate income tax liability.

The Largest Firms Would Provide the Majority of Proposition 39's New Revenues

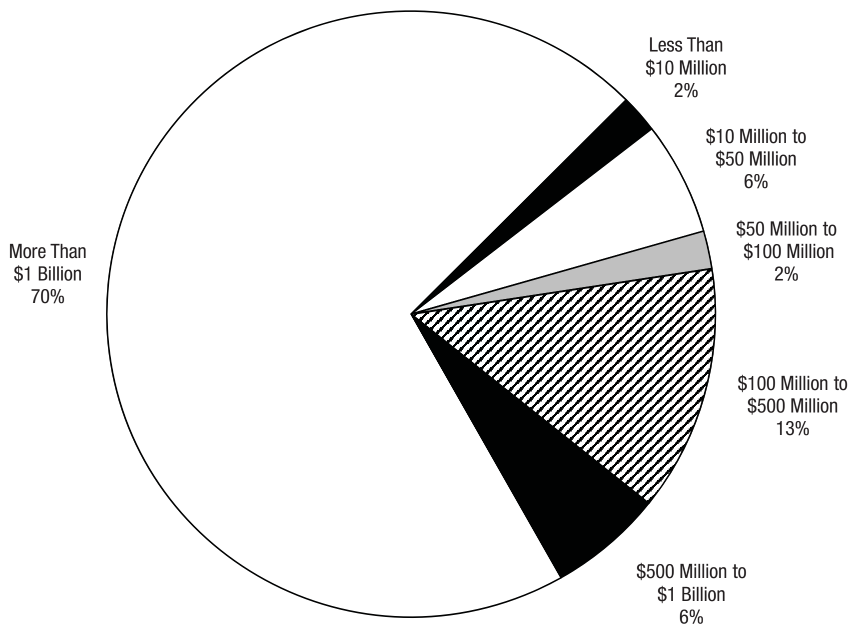
Proposition 39 would directly affect only multistate firms. Less than one-tenth of California's corporations are multistate, but these corporations account for nearly nine-tenths of the state's net business income.[6] Even among multistate firms, a small minority of corporations would be affected. In a given year, only about 2 percent of all corporations doing business in California would likely be affected by the switch to mandatory single sales factor. Finally, the greatest share of Proposition 39's revenues would be provided by large corporations. About 4 percent of the corporations that would be affected have gross receipts over $1 billion, but these firms would provide approximately 70 percent of the new revenues (Figure 1).[7]

Proposition 39 Would Benefit Firms That Locate Primarily in California and Sell Mostly to Other States

Currently, California and Missouri are the only two states that allow a choice between single sales factor and another formula each year (see box, "How Do States Tax Corporate Income?"). All other states that have adopted single sales factor have made the formula mandatory, either for all corporations or for certain categories of firms. States that have adopted the mandatory approach provide both a carrot and a stick: the carrot of lower taxes for firms that locate in-state and export out-of-state and the stick of higher taxes for firms that sell to the state's market without locating a proportionate share of property and payroll there. California's current apportionment system does not reward firms for making location and investment decisions that benefit the state, but rather provides a tax break for all multistate firms by allowing them to choose the most advantageous formula for calculating their tax bill (see box on p. 4, "Single Sales Factor and Double-Weighted Sales Factor Apportionment Formulas").

Figure 1: The Largest Firms Would Provide More Than Two-Thirds of the Revenues Raised by Proposition 39

Estimated Share of New Corporate Taxes, by Firms' Level of Gross Receipts



Note: Percentages do not sum to 100 due to rounding.
Source: Franchise Tax Board

How Do States Tax Corporate Income?

The US Constitution allows states to tax the portion of a corporation's income related to its activities within a state.[8] When a corporation does business in more than one state, it typically must pay corporate income taxes in multiple states. Ultimately, the total amount of a corporation's income should be subject to tax, but some corporations avoid state taxes on a portion of their income due to inconsistencies in apportionment methods among states. Over the years, this policy challenge has led to efforts to standardize apportionment methods.

Most states use formulas to determine the share of a multistate corporation's income that is subject to tax. Early formulas to apportion income for state taxes were based solely on the share of a corporation's property located in a given state. Some formulas also included a "payroll factor" that looked at the share of compensation within a state. The choice of these two factors reflected the services – public safety, highways, the judicial system, schools, and universities – that businesses benefited from by virtue of locating in a specific place. The use of property and payroll had the effect of allocating income to states where production activities took place. A "sales factor" was later added to the formula to reflect the market where income-generating sales took place. The prevalence of a three-factor formula – based on property, payroll, and sales, initially evenly weighted – dates to at least the 1940s.

The three-factor apportionment formula with equal weight on the percentages of a company's property, payroll, and sales in the state was included in the Uniform Division of Income for Tax Purposes Act (UDITPA), a set of recommendations introduced in 1957 to help resolve inconsistencies in state tax systems. Many states eventually adopted UDITPA's apportionment formula, and California began using it in 1966.[9]

However, many states have altered their apportionment formulas in recent years. States have added weight to the percentage of sales in their formulas – thus reducing taxes for firms that have disproportionately large shares of in-state property and payroll – in an attempt to attract capital investment and employment. Today, nearly half of all states have enacted or are phasing in single sales factor apportionment, and most of the remaining states that continue to include other factors in their apportionment formulas place greater weight on the sales factor. California shifted to a double-weighted sales factor formula in 1993. The single sales factor formula became available as an option in the 2011 tax year, making California one of only two states – the other is Missouri – that allow multistate firms to choose between single sales factor and another apportionment formula each year.

Proposition 39 Would Prevent Firms From Switching Formulas Annually To Minimize Taxes or Maximize Deductions

Proposition 39 would eliminate a potentially costly practice that the state currently permits without a clear policy rationale. Apportioning corporations can currently "switch from one formula to the other depending on whether they are having a good or a bad year."[10] In a high-profit year, a corporation with most of its property and payroll in California and a large share of its sales elsewhere can potentially minimize its income subject to California tax by choosing single sales factor apportionment. In contrast, in a bad year, a California-based corporation that incurs a loss can choose to allocate a *greater* share of its income to California using the double-weighted sales factor formula and maximize its ability to claim a net operating loss (NOL) deduction.[11] A firm with significant sales in California but with smaller shares of property and payroll in the state could use the opposite strategy: In good years, the corporation could potentially reduce its tax bill by using the double-weighted sales formula, while in bad years it could maximize losses by using single sales factor apportionment.

The LAO highlighted this problem in a 2010 report and recommended that the state require all firms to use single sales factor, stating that such an approach "would help the state's competitiveness while limiting the cost to the budget."[12] The LAO report also noted that allowing corporations to minimize tax obligations by switching between formulas "arbitrarily favors some firms over others."[13] Corporations that operate only in California do not benefit, as all of their income is taxed in California in good years and bad. In addition, companies that have a balanced proportion of their total property, payroll, and sales in California do not experience large shifts in tax liabilities from switching between formulas and therefore do not benefit either.

Single Sales Factor and Double-Weighted Sales Factor Apportionment Formulas

Under the double-weighted sales factor formula, the share of a corporation's income considered taxable in California is based on a weighted average of three factors: the percentages of the firm's total property, payroll, and sales in the state that tax year, with twice as much weight on the sales factor.[14] Under the single sales factor method, the percentage of a firm's income subject to California's corporate income tax is equal to the percentage of the firm's sales in California.

To illustrate how these formulas might affect the calculation of state tax liabilities, take, for example, a business with 75 percent of its sales in California, but only 20 percent of its property and 20 percent of its payroll in the state. Under double-weighted sales factor apportionment, 47.5 percent of the corporation's net income would be allocated to California. Under single sales factor apportionment, 75 percent of the corporation's net income would be taxed in California.

Calculating the Share of Profits Subject to California's Corporate Income Tax

Double-Weighted Sales Factor Formula:

$$\text{Net Income} \times \frac{(\text{Property Factor} + \text{Payroll Factor} + 2 \times \text{Sales Factor})}{4}$$

$$= \text{Net Income} \times \frac{(0.20 + 0.20 + 2 \times 0.75)}{4}$$

$$= \textit{Net Income} \times 0.475$$

Single Sales Factor Formula:

$$\text{Net Income} \times \text{Sales Factor}$$

$$= \textit{Net Income} \times 0.75$$

The single sales factor formula produces a higher tax liability than the double-weighted sales factor formula for this hypothetical firm that sells many of its goods in California but has a relatively small share of its property and payroll in the state. On the other hand, the single sales factor formula would generally result in a lower tax liability for a firm with a large share of property and payroll in California that sells most of its goods elsewhere. The precise impact, however, would depend on the exact proportions of a firm's property, payroll, and sales in the state.

How Would Proposition 39 Affect the State Budget?

Proposition 39 Would Increase Corporate Income Tax Revenues

The corporate income tax is an important source of revenue for California: it is the third-largest source of General Fund revenues behind the personal income tax and the sales tax. Proposition 39 would increase state corporate income tax revenues by an estimated $500 million in 2012-13 and $1 billion in 2013-14, an annual amount likely to rise over the following years. From 2013-14 through 2017-18, half of the new revenues – up to a maximum of $550 million – would be transferred from the General Fund into a new Clean Energy Job Creation Fund. The estimated net increase to the General Fund would be at least $500 million annually from 2013-14 through 2017-18, and at least $1 billion each year thereafter. These additional revenues would help the state reinvest in vital programs and systems. By making single sales factor mandatory, Proposition 39 would allow the state to regain more than half of the annual revenues it would otherwise lose in future years due to a set of corporate tax deals enacted in 2008 and 2009 (see box on p. 8, "Corporations Received Large Tax Breaks During the Recession").

Proposition 39 Would Establish a State Fund To Support Clean Energy Projects

The Clean Energy Job Creation Fund would provide funding for projects that both create jobs in California and improve energy efficiency and alternative energy generation, including:

- Energy efficiency retrofits and "clean energy installations" in public schools, colleges, and universities,
- Programs through local governments for providing financial and technical assistance for energy-saving retrofits, and
- Job training and workforce development related to energy efficiency and clean energy projects through the California Conservation Corps, the Certified Community Conservation Corps, YouthBuild, and other existing workforce development programs.

The Legislature would allocate monies from the fund. The measure states that these dollars must be used for "cost effective" projects that would be overseen by existing state and local government agencies with "expertise in managing energy projects and programs." Proposition 39 would establish a Citizens Oversight Board to annually review expenditures. The board would be composed of nine members: three appointed by the State Treasurer, three appointed by the State Controller, and three appointed by the Attorney General. All funded projects would have to be coordinated with the California Energy Commission and California Public Utilities Commission.

Proposition 39 Would Increase State Funding for Schools

Some – and eventually all – of the new revenues resulting from Proposition 39 would be deposited into the General Fund and thus would affect the calculation of the state's minimum funding guarantee for K-12 schools and community colleges.[15] Because significant growth in General Fund revenues tends to increase the amount of the minimum guarantee, the passage of Proposition 39 would likely lead to an increase in school funding.

The LAO estimates that if voters approve Proposition 39, the minimum guarantee for K-12 schools and community colleges would increase by approximately $200 million to $500 million per year from 2012-13 through 2017-18. In 2018-19 and beyond, when *all* new revenues from Proposition 39 would be deposited into the General Fund, the minimum guarantee is estimated to increase by an amount ranging from at least $500 million to potentially more than $1 billion per year.[16]

How Would Proposition 39 Affect California's Economy?

There Is No Conclusive Evidence That Mandatory Single Sales Factor Would Affect Firms' Hiring and Investment Decisions

Mandatory single sales factor apportionment could prompt a variety of responses from firms. Corporations that sell mostly to other states might expand their existing facilities and payrolls in California to maximize their tax advantage in the state. Corporations that sell a high percentage of their goods in California might decide to shift more property and payroll into the state, since these factors would no longer count toward their tax. On the other hand, firms whose business models make it difficult for them to benefit from single sales factor apportionment – such as multistate manufacturers of hard-to-ship products that locate multiple facilities in close proximity to their customer bases in different regions – might be discouraged from locating in California. Even so, firms that face higher tax liabilities under single sales factor apportionment might still want to maintain a presence in California's large consumer market.

There is no definitive evidence to support predictions of dramatic job growth or job loss if Proposition 39 passes. In recent years, many states have increased the weight on sales in their apportionment formulas in an attempt to induce firms to maintain or relocate facilities and employees in the state. However, there is no consensus regarding the impact of these policies on states' economies. Supporters of mandatory single sales factor point to research that links single sales factor apportionment to job growth and site location decisions, especially in sectors – like manufacturing – that produce for national and international markets.[17] Other studies question the magnitude and economic importance of these findings.[18] In addition, studies on the economic impact of apportionment formulas usually consider changes from one mandatory formula to another, and the findings of such studies are not directly applicable to a change from California's current optional system to mandatory single sales factor apportionment. Finally, more modest findings in recent studies may reflect the fact that many states have now adopted single sales factor apportionment, diminishing the economic impact of the change.[19]

Corporate Tax Breaks Are Not Likely To Boost Economic Growth Enough To Make Up for Lost Revenues

Some proponents of corporate tax cuts contend that reducing taxes will spur enough economic growth to result in a net

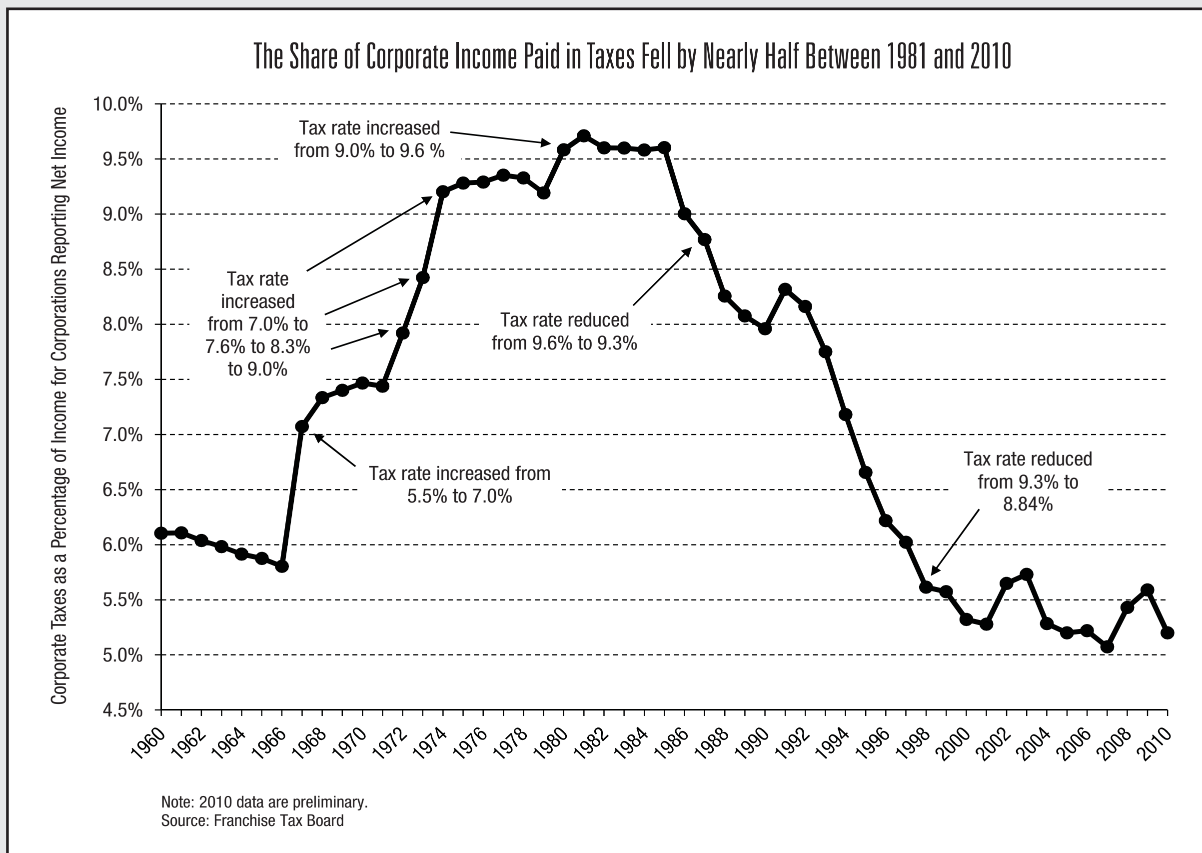
increase in state revenues. However, the historical record demonstrates that even large tax cuts have failed to generate the substantial level of economic growth that would be necessary to produce such a dramatic result.[20] It is unrealistic to expect that the current apportionment tax break will affect the state's economic growth enough to counterbalance the approximately $1 billion in state revenues lost each year.[21] Already, optional single sales factor and other recent corporate tax breaks have contributed to large budget shortfalls and, in turn, deep spending cuts (see box, "Corporate Tax Payments Have Fallen as a Share of Profits and of State Revenues"). Failure to adequately fund vital public programs and systems has far-reaching effects on the state's economy and business climate that are likely to outweigh any economic benefits from corporate tax breaks.

For example:

- State spending reductions disproportionately impact low- and middle-income Californians such as teachers, child care providers, and in-home care workers, who spend most of their incomes locally. Therefore, one less dollar spent by the state means one less dollar circulating in the state's economy, since that dollar otherwise would have gone to local grocers, shopkeepers, and landlords.
- Spending cuts can contribute to public sector job losses. Between June 2011 and June 2012, California lost 31,200 state and local government jobs, which includes jobs in public education as well as jobs with cities and counties.

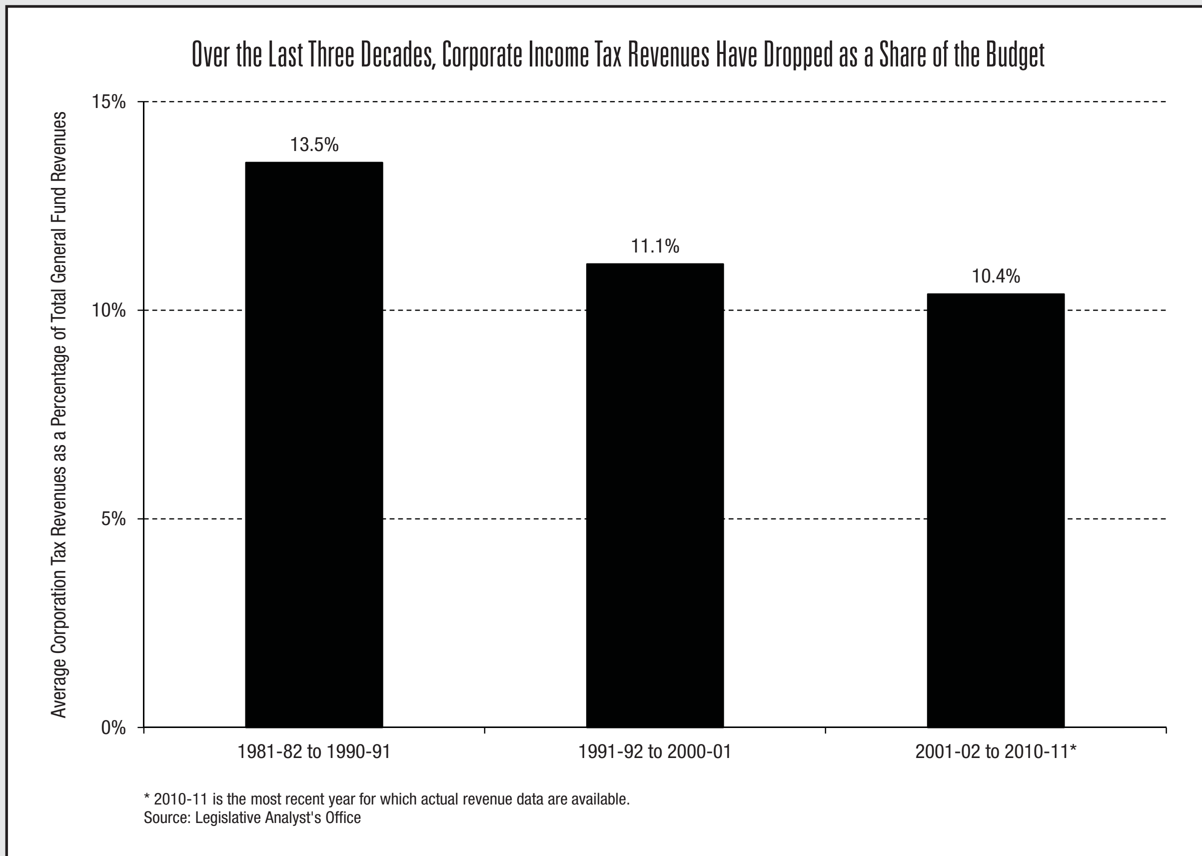
Corporate Tax Payments Have Fallen as a Share of Profits and of State Revenues

Corporate profits have grown significantly in recent decades, but California corporate income tax revenues have not kept pace with this growth. Because of a combination of legislated policy changes and aggressive tax planning on the part of corporations, the share of corporate income paid in taxes fell by nearly half over the last three decades.[22] In the past decade alone, the profits of corporations doing business in California more than quintupled, while their corporate tax liability increased by far less – 72.3 percent. In contrast, over the same period, personal income taxpayers' incomes increased by about one-fourth, while their personal income tax liability increased by a somewhat higher 42.0 percent.[23]



Note: 2010 data are preliminary.
Source: Franchise Tax Board

The share of General Fund revenues provided by corporate income taxes has also declined, dropping from an average of 13.5 percent in the 1980s to an average of 10.4 percent in the 2000s. In contrast, over the same period, personal income tax revenues increased as a portion of General Fund revenues – from an average of 41.2 percent to an average of 51.3 percent.[24]



In short, California is relying more on the personal income tax as a source of revenue and is relying less on the corporate income tax. Proposition 39, by eliminating a $1 billion annual tax break for multistate firms, would restore some of the corporate income tax revenues lost from the General Fund in recent years. This change would help ensure that corporations contribute an appropriate share of the funding for public programs and services from which they benefit.

These job losses partly offset modest gains in private sector job growth, slowing the state's recovery from the recent recession.[25]

- Diminished public investment negatively affects the state's economy in the long run. Companies largely base their decisions about where to locate on factors related to sufficient public funding, including a skilled workforce and access to high-quality transportation networks and other public infrastructure.[26] These factors can reduce businesses' costs or boost employers' productivity far more than tax breaks can. Deep spending cuts like the ones California has experienced in recent years chip away at the state's ability to invest in high-quality public services, which diminishes the quality of life for Californians – and could make California a less attractive place to do business.

What Policy Issues Does Proposition 39 Raise?

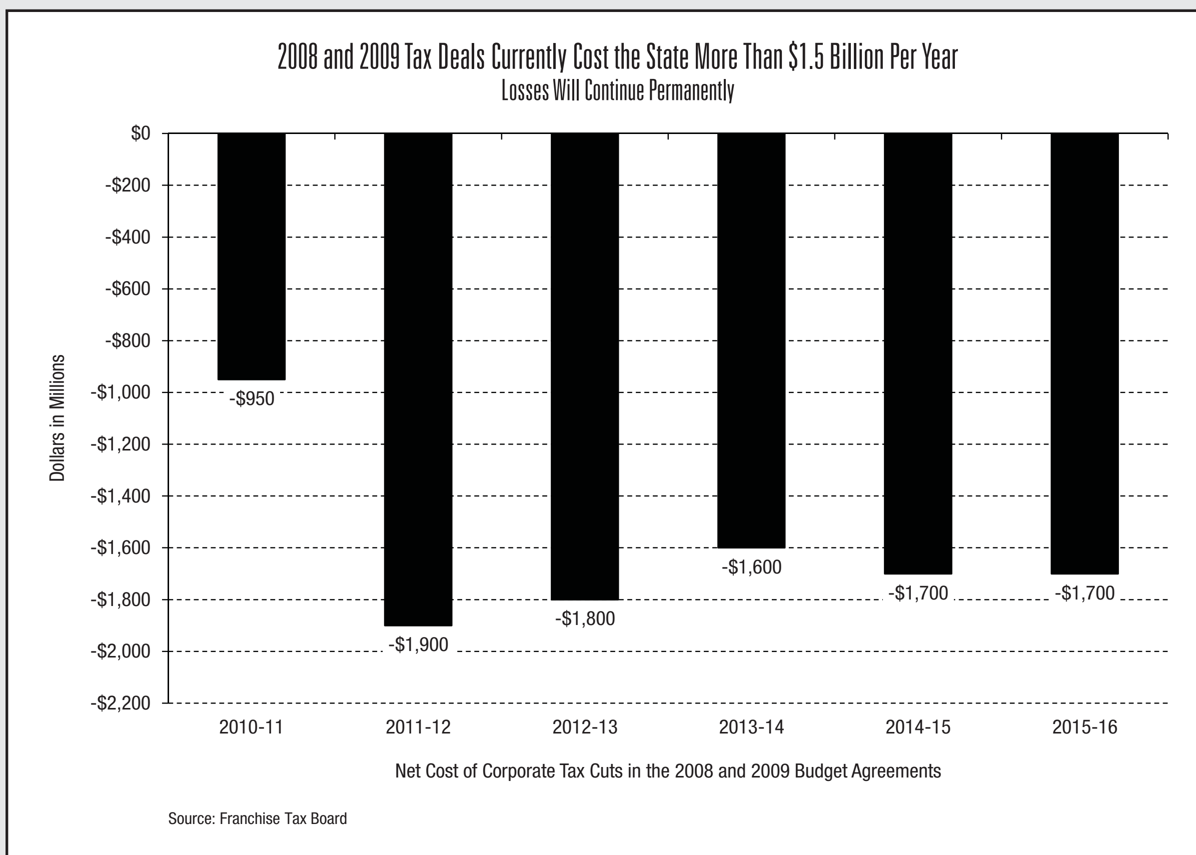
California Does Not Achieve a Specific Policy Goal by Letting Corporations Choose How They Are Taxed

States choose different apportionment formulas in part because they seek to accomplish different goals with their

Corporations Received Large Tax Breaks During the Recession

State General Fund revenues – the dollars that support California's public schools, colleges and universities, and health and human services programs – are lower today as a share of the economy than in all but two of the past 40 years.[27] While the drop in state revenues is partly due to declining incomes during the recession, a series of large, permanent tax cuts in recent years also contributed to California's budget shortfalls.[28]

During the depths of the recession, the September 2008 and February 2009 budget agreements enacted corporate tax cuts that currently cost the state more than $1.5 billion each year, with losses continuing permanently.[29] More than half of the lost revenue – over 60 percent – is due to the adoption of optional single sales factor apportionment.[30] No public hearings were held, and no public testimony was provided, on either the September 2008 or the February 2009 tax changes.



In addition to the single sales factor option, the 2008 and 2009 corporate tax deals authorized tax credit sharing, which lets corporations transfer tax credits among a combined reporting group, or "family," of related corporations. The tax deals also gave corporations the ability to claim net operating loss (NOL) carrybacks. This change allows firms to "carry back" losses and use them as a deduction in order to claim refunds against prior years' taxes.[31] Businesses are likely to claim NOL carrybacks in bad budget years based on profits earned and taxes paid during previous good economic times. Thus, this change could exacerbate California's budget problems by further reducing tax receipts in years when revenues are already low.

The choice between two apportionment formulas can result in even larger benefits for corporations when combined with NOL carrybacks or tax credit sharing. For example, a corporation for which the double-weighted sales factor formula results in a higher tax liability can choose that formula in order to maximize the loss it declares in a bad year, then carry that loss back to a profitable year in order to claim a deduction. In contrast, during a profitable year, the same corporation can choose the single sales factor formula to minimize the amount of its profits subject to tax.

Substantial corporate tax cuts have contributed to the budget gaps California has faced in recent years. Last fall, the LAO projected that 2012-13 "baseline" revenues – the amount anticipated in the absence of a tax increase – would be nearly $47 billion below the 2012-13 level that had been forecast in 2007, just before the national recession began. Insufficient revenues to fund California's public programs and systems have led to deep cuts to vital services, leaving California ill-equipped to respond to exceptionally high unemployment and stagnating incomes in the wake of the Great Recession.

corporate income taxes. Some observers argue that the equally weighted three-factor formula represents the principle that firms should pay taxes roughly in proportion to their presence in the state and their use of state services such as transportation and energy infrastructure and a trained workforce.[32] On the other hand, states that heavily weight the sales factor or adopt single sales factor apportionment often hope to provide an incentive for firms to locate and hire in the state, accepting that some multistate firms will have tax liabilities that do not precisely reflect their use of state services.

California's current system of allowing corporations to choose between single sales factor and double-weighted sales factor benefits certain multistate corporations with no clear logic. It neither offers an incentive for firms to expand employment and capital investment in California nor fully reflects these corporations' use of state services. Instead, it arbitrarily favors some firms over others, benefiting corporations with disproportionately high or low California sales – relative to property and payroll – that can reap large tax savings simply by switching apportionment formulas from year to year.[33] By minimizing taxes on profits and maximizing deductions on losses, these firms will pay lower taxes than multistate firms with more balanced property, payroll, and sales – or firms that operate solely in California.[34] Proposition 39, on the other hand, would offer incentives for multistate corporations to locate a higher proportion of property and payroll in the state and, moreover, would eliminate the ability of a small number of mostly large corporations to lower their taxes by using the apportionment option.

The Current Apportionment System Conflicts With a Basic Principle of Tax Fairness

The current apportionment system conflicts with a generally accepted principle of tax fairness: that the tax system should treat taxpayers in similar economic situations the same way. This principle is important for at least two reasons. First, it influences taxpayers' perceptions of the fairness of the tax system, and such perceptions affect the level of tax compliance. Additionally, many economists argue that tax laws that provide special treatment to certain industries or activities lead to inefficiency because they encourage businesses to focus on the tax consequences of their decisions rather than respond to market demand. Proposition 39, by mandating single sales factor, would eliminate an arbitrary benefit for a small number of mostly large corporations. It would treat most corporations doing business in California the same way by requiring that they use the same apportionment formula.

Should Voters Set Tax Policy at the Ballot Box?

Proposition 39 would alter California's corporate income tax apportionment system and would dedicate a share of the revenues raised to specified uses. Critics argue that the initiative process limits voters to an up-or-down choice in isolation from other potential options. Indeed, there are other policy options for addressing the flaws of California's corporate income tax apportionment system. These include restoring the pre-2011 mandatory double-weighted sales factor formula or continuing to allow corporations to choose between the two apportionment formulas but limiting how often they can switch back and forth.[35] However, the two-thirds vote requirement for legislative approval of tax increases makes it difficult for policymakers to alter the corporate income tax apportionment system to raise new revenues. Bills attempting to end optional single sales factor have been introduced in recent years but have not achieved the necessary two-thirds vote. Placing the issue before voters is an alternative to the challenge of passing revenue-raising legislation.

Proposition 39 Includes a Tax Break for Cable Companies

Proposition 39 would allow cable companies that spend $250 million or more on certain business expenditures in the state to exclude 50 percent of their California sales from being assigned to California in apportionment, lowering their tax liability compared to what it would be otherwise. In general, without this provision, many cable companies might face higher tax liabilities under Proposition 39 due to the required single sales factor apportionment formula, and also because of a change in the definition of in-state sales for firms producing "intangible goods." Under Proposition 39, sellers of intangible goods such as services, telecommunications, and licenses to operate software would be

required to report sales for tax purposes based on actual sales in the state, without consideration of whether the original costs of developing the product or service were spent in-state.[36] This change would likely raise the percentage of sales occurring in California for many firms selling intangible goods, resulting in a higher tax liability for these firms.

Corporations in other industries, including software, might be affected by the change in the definition of in-state sales as well and are not offered a tax break like the one offered to cable companies. An analysis of a previous bill containing the same provision by the state Senate Governance and Finance Committee raised the point that "[g]enerally, tax systems should apply the same rules to all taxpayers," and suggested that it may be worthwhile to "consider why a separate set of rules should apply to cable companies."[37]

What Do Proponents Argue?

Proponents of Proposition 39 include Thomas Steyer, founder and co-senior managing member of Farallon Capital Management; Alan Bankman, professor of tax law at Stanford Law School; and the California League of Conservation Voters. Proponents of the measure assert that the corporate tax apportionment option in effect since 2011 "allows out-of-state corporations to manipulate our tax system every single year, and avoid paying their fair share to California."[38] They refer to multistate corporations' ability to choose between double-weighted and single sales factor apportionment as a "billion dollar tax loophole" that lets "out-of-state corporations ... pay less tax to California if they have *fewer* employees here."[39] Proponents state that Proposition 39 "levels the playing field, ensuring that multistate companies play by the same rules as California employers."[40] Additionally, those in favor of Proposition 39 contend that "[u]sing proven energy efficiency measures like improving insulation, replacing leaky windows and roofs and adding small-scale solar panel installations will reduce state energy costs – freeing up dollars for essential services."[41]

What Do Opponents Argue?

Opponents of Proposition 39, including the California Manufacturers & Technology Association and the California Taxpayer Protection Committee, contend that proponents have inaccurately characterized the current apportionment system as a loophole, since some version of a three-factor apportionment formula – which Proposition 39 would eliminate as an option – has "been in effect for decades."[42] Opponents also state that it is inappropriate to call firms that would be negatively affected by the tax change "out-of-state" firms, since they may still have property and payroll in the state even though their share of sales is higher.[43] Opponents claim that Proposition 39 is "ballot box budgeting at its worst" and will result in "[h]igher taxes, fewer jobs, more bureaucracy and waste ... and no taxpayer protections against conflicts of interest."[44]

Conclusion

Proposition 39 would eliminate multistate corporations' ability to choose between two methods for calculating the share of their income that is subject to California's corporate income tax. The measure would revoke a sizeable tax break that achieves no clear policy goal, but arbitrarily lowers taxes for a relatively small number of multistate firms. This change would result in an estimated $1 billion in additional revenues each year beginning in 2013-14, up to $550 million of which would be used from 2013-14 through 2017-18 to fund energy efficiency and clean energy initiatives. Because Proposition 39 would raise revenues for the state's General Fund, it would likely increase the amount of the state's minimum funding guarantee for K-12 schools and community colleges. The measure would take a step toward restoring corporate income tax revenues to their pre-2011 trajectory and would help prevent deeper cuts to important public systems and programs.

Hope Richardson prepared this Budget Brief *with assistance from Alissa Anderson, Connor Cole, and Scott Graves. The California Budget Project (CBP) neither supports nor opposes Proposition 39. This* Budget Brief *is designed to help voters reach an informed decision based on the merits of the issues. The 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, subscriptions, and individual contributions. Please visit the CBP's website at www.cbp.org.*

ENDNOTES

[1] This estimate is based on corporate income tax returns from 2009, the most recent year for which complete data are available. Franchise Tax Board, *2010 Annual Report: Statistical Appendix Tables,* Table C-2.

[2] Throughout this *Budget Brief,* the term "multistate" refers to a firm that operates both in California and in other states or countries.

[3] AB15x3 (Krekorian), enacted in February 2009, gives corporations the option to base their corporate income tax calculations solely on the share of their sales that occur within California, using the single sales factor apportionment formula. This change took effect January 1, 2011.

[4] Legislative Analyst's Office, "Proposition 39. Tax Treatment for Multistate Businesses. Clean Energy and Energy Efficiency Funding. Initiative Statute. Analysis by the Legislative Analyst," in Secretary of State's Office, *California General Election Tuesday, November 6, 2012: Official Voter Information Guide,* p. 70.

[5] An apportioning business must use the equally weighted three-factor formula if it derives more than 50 percent of its gross business receipts from agriculture, extraction (including oil), savings and loan activity, or financial services.

[6] In 2009, multistate, apportioning corporations comprised 9.2 percent of corporations in California, but they accounted for 86.4 percent of state net income reported for tax purposes. Franchise Tax Board, *2010 Annual Report: Statistical Appendix Tables,* Table C-2.

[7] Here and in Figure 1, estimates of the distribution of the impact of mandatory single sales factor are based on Franchise Tax Board (FTB) data modeling the effects of Proposition 39 had it been in effect in 2010 (the latest year for which relevant data are available). The FTB estimates that approximately 13,000 firms would have used double-weighted sales factor apportionment in 2010 if the option to choose between two formulas had been in effect that year.

[8] Specifically, the Constitution allows states to (1) tax corporations when they have sufficient "nexus" within the state, meaning that a connection exists between the state and the corporation's income-generating activities, and (2) tax the portion of a corporation's income that has a "rational relationship" to the "intrastate values of the enterprise," meaning that apportionment must fairly reflect the corporation's activities in the state. This review draws heavily on material presented in Richard D. Pomp, *State and Local Taxation,* 6th ed., Vol. 2 (2009), pp. 10-1 to 10-52.

[9] For a summary of California's history with UDITPA, see California Court of Appeal, First Appellate District, *Gillette Company et al. v. Franchise Tax Board,* A130803 (2012), pp. 2-6.

[10] Legislative Analyst's Office, *Reconsidering the Optional Single Sales Factor* (May 26, 2010), p. 9.

[11] Net income can be a positive or a negative number. A business that paid taxes in a prior year, but then incurred a loss, might wish to allocate a greater share of its losses to California to increase the size of the NOL "carryback" deduction that it could claim in order to maximize its refund of taxes paid in a prior year.

[12] Legislative Analyst's Office, *Reconsidering the Optional Single Sales Factor* (May 26, 2010), p. 3.

[13] Legislative Analyst's Office, *Reconsidering the Optional Single Sales Factor* (May 26, 2010), p. 3.

[14] According to the Senate Governance and Finance Committee, "The property factor generally includes all tangible property owned or rented during the taxable year. The payroll factor includes all forms of compensation paid to employees. The sales factor includes all gross receipts from the sale of tangible and intangible property." Senate Governance and Finance Committee, *Analysis of SB 116* (July 11, 2011), pp. 14-15.

[15] The state is constitutionally required to provide a minimum level of funding for K-12 education and community colleges guaranteed by Proposition 98, an initiative passed by voters in 1988. For an overview of Proposition 98, see California Budget Project, *School Finance in California and the Proposition 98 Guarantee* (April 2006).

[16] Legislative Analyst's Office, "Proposition 39. Tax Treatment for Multistate Businesses. Clean Energy and Energy Efficiency Funding. Initiative Statute. Analysis by the Legislative Analyst," in Secretary of State's Office, *California General Election Tuesday, November 6, 2012: Official Voter Information Guide,* p. 70.

[17] See, for example, Austan Goolsbee and Edward L. Maydew, "Coveting Thy Neighbor's Manufacturing: The Dilemma of State Income Apportionment," *Journal of Public Economics* 75 (January 2000), pp. 125-143, and William G. Hamm and Avinash K. Verma, "If California Adopted the Single-Factor (Sales) Apportionment Formula, What Would Be the Impact?" *State Tax Notes* 24 (June 10, 2002).

[18] See, for example, Michael Mazerov, *The "Single Sales Factor" Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?* (Center on Budget and Policy Priorities: Revised September 2005) and Sanjay Gupta and Mary Ann Hofmann, "The Effect of State Apportionment and Tax Incentives on New Capital Expenditures," *The Journal of the American Taxation Association* 25 (2003), pp. 1-25.

[19] Michael Mazerov, *The "Single Sales Factor" Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?* (Center on Budget and Policy Priorities: Revised September 2005), p. 9.

[20] For example, states that enacted large tax cuts between 1994 and 2001 – reducing revenues by at least 7 percent – performed worse on key economic indicators than other states: They subsequently experienced weaker growth in jobs and personal income and larger increases in the unemployment rate, on average, than states that did not enact large tax cuts. In the absence of strong economic growth, it is highly unlikely that states eventually recouped the revenues they lost as a result of providing the cuts. In fact, as state economies weakened during the economic downturn that began in 2001, the states that had provided large tax cuts had lower budget reserves and faced larger budget shortfalls, on average, than other states. Nicholas Johnson and Brian Filipowich, *Tax Cuts and Continued Consequences: States That Cut Taxes the Most During the 1990s Still Lag Behind* (Center on Budget and Policy Priorities: December 19, 2006).

[21] A simple example shows that it is unreasonable to expect tax cuts to pay for themselves. If a state has 100,000 businesses with profits of $500,000 each that are taxed at a rate of 10 percent, the state would receive $5 billion in revenues, based on $50 billion in total profits. If the state cut corporate taxes in half – a massive reduction – revenues would fall to $2.5 billion. In order to recover the $2.5 billion in revenue losses, the total profits of all businesses in the state would have to double to $100 billion – an implausible scenario. For further discussion of this topic, see California Budget Project, *No Free Lunch: Tax Cuts Widen Budget Gaps* (July 2010).

[22] According to Franchise Tax Board data, corporate taxes as a percentage of income (for corporations reporting net income) fell from 9.7 percent to 5.2 percent between 1981 and 2010.

[23] According to Franchise Tax Board data, total state net income of corporations increased by 448.5 percent between 2001 and 2010; state corporate tax liability increased by 72.3 percent. Total adjusted gross income of California personal income taxpayers increased by 24.4 percent, while California personal income tax liability increased by 42.0 percent.

[24] Legislative Analyst's Office. Sales taxes, a portion of which are paid by businesses, also declined as a share of General Fund revenues during the period.

[25] California Budget Project, *Waiting for Recovery* (September 2012), p. 3.

[26] Michael Mazerov, *The "Single Sales Factor" Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?* (Center on Budget and Policy Priorities: Revised September 2005), p. 4.

[27] Even if voters approve Proposition 30 – which would bring in an estimated $6 billion in annual revenues through 2016-17, on average – General Fund revenues would still be lower as a share of the economy in 2012-13 than they were in the mid-1970s. For more information on Proposition 30, see California Budget Project, *What Would Proposition 30 Mean for California?* (September 2012).

[28] Tax cuts approved since 1993 will cost the state more than $13 billion in 2012-13, according to state data.

[29] Lawmakers temporarily boosted corporate tax revenues during 2008-09 and 2009-10 in order to help close state budget shortfalls. Specifically, the September 2008 legislation temporarily suspended businesses' ability to claim net operating loss (NOL) deductions in 2008 and 2009 – resulting in a temporary tax increase – but allowed businesses to carry forward losses incurred in those years for an additional two years. Moreover, optional single sales factor apportionment – the single largest corporate tax cut included in the 2008 and 2009 legislation – did not take effect until 2011. Consequently, the corporate tax changes enacted in 2008 and 2009 resulted in a temporary net state revenue gain of approximately $850 million in 2008-09 and $360 million in 2009-10.

[30] According to Franchise Tax Board estimates and projections for 2011-12 through 2015-16, optional single sales factor apportionment will account for approximately $5.4 billion out of a five-year total of $8.7 billion in state revenue losses due to the 2008 and 2009 corporate tax deals. In addition to optional single sales factor, AB15x3 also included several large temporary tax reductions benefiting business, including a tax credit for motion picture production activities and a tax credit for businesses that expand employment. The September 2008 legislation, AB 1452 (Committee on Budget), introduced NOL carrybacks and extended the carryforward period for loss deductions.

[31] California historically has allowed businesses to "carry forward" losses to future years, thereby reducing the amount of income subject to tax. The September 2008 legislation allows businesses to carry *back* half of any loss incurred in 2011, 75 percent of any loss incurred in 2012, and 100 percent of any loss incurred beginning in 2013. This legislation also extended the length of time businesses can carry losses forward and use NOL deductions from 10 years to 20 years.

[32] Michael Mazerov, *The "Single Sales Factor" Formula for State Corporate Taxes: A Boon to Economic Development or a Costly Giveaway?* (Center on Budget and Policy Priorities: Revised September 2005), p. 55.

[33] Legislative Analyst's Office, *Reconsidering the Optional Single Sales Factor* (May 26, 2010), p. 9.

[34] Legislative Analyst's Office, *Reconsidering the Optional Single Sales Factor* (May 26, 2010), p. 10.

[35] If Proposition 39 is approved and mandatory single sales factor goes into effect, the state's annual revenues likely would still be lower in future years than they would have been under the mandatory double-weighted sales factor formula that all apportioning firms used prior to 2011. A 2010 report by the Legislative Analyst's Office estimated the difference between mandatory single sales and mandatory double-weighted sales at $50 million to $100 million annually (that report was based on Franchise Tax Board projections using 2006 data). Legislative Analyst's Office, *Reconsidering the Optional Single Sales Factor* (May 26, 2010), p. 10.

[36] Currently, corporations producing intangible goods calculate the value of their California sales differently depending upon which apportionment formula they choose. Firms that choose the double-weighted sales formula use a "costs of performance" method, where sales of intangible goods in California are only counted as California sales if a greater proportion of the costs of originally producing the goods were spent in-state. Firms that choose single sales factor apportionment, however, must count sales of intangible goods as occurring in California to the extent that the goods are ultimately used in California, an accounting method known as "the market rule." Proposition 39 would require the market rule for calculation of in-state sales of intangible goods, which could increase the tax liability of some cable companies and other companies producing intangible goods.

[37] Senate Governance and Finance Committee, *Analysis of SB 116* (July 11, 2011), pp. 14-15.

[38] "Argument in Favor of Proposition 39," in Secretary of State's Office, *California General Election Tuesday November 6, 2012: Official Voter Information Guide,* p. 72.

[39] Emphasis in original. "Argument in Favor of Proposition 39," in Secretary of State's Office, *California General Election Tuesday November 6, 2012: Official Voter Information Guide,* p. 72.

[40] "Argument in Favor of Proposition 39," in Secretary of State's Office, *California General Election Tuesday November 6, 2012: Official Voter Information Guide,* p. 72.

[41] "Argument in Favor of Proposition 39," in Secretary of State's Office, *California General Election Tuesday November 6, 2012: Official Voter Information Guide,* p. 72.

[42] "Rebuttal to Argument in Favor of Proposition 39," in Secretary of State's Office, *California General Election Tuesday November 6, 2012: Official Voter Information Guide,* p. 72.

[43] California Manufacturers and Technology Association, "CMTA Opposes Proposition 39," August 10, 2012, downloaded from http://www.cmta.net on October 15, 2012.

[44] "Rebuttal to Argument in Favor of Proposition 39," in Secretary of State's Office, *California General Election Tuesday November 6, 2012: Official Voter Information Guide,* p. 72.