Spending Through California's Tax Code

California Budget & Policy Center
Independent Analysis. Shared Prosperity.

AUGUST 2016

California spends a large amount of state revenues through tax breaks, also called "tax expenditures." Personal income and corporate income tax expenditures combined are projected to amount to around $48 billion in forgone revenues in 2016-17 (the state fiscal year that started on July 1, 2016), or an amount equivalent to nearly 40 percent of the 2016-17 General Fund budget. Unlike program spending, tax breaks generally are not up for debate every year, and instead just quietly continue from year to year and are largely deliberated upon outside of the usual budget cycle – if they are debated at all. Some of the largest tax expenditures – for example, the Mortgage Interest Deduction and the Research and Development Credit – help households and businesses that don't need the help, or need it much less, while California significantly constrains the amount of aid given to individuals and families who do need the help. Because of this skewness in who tax expenditures benefit more, tax breaks contribute to unfairness in California's tax system. Furthermore, it may be more effective to pursue the state's policy goals through spending directly on programs rather than through the tax code. California could improve its use of tax expenditures by setting expiration dates, requiring their periodic review, and targeting their benefits to low- and middle-income households.

CONTENTS

California Budget & Policy Center

The California Budget & Policy Center was established in 1995 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The Budget Center engages in independent fiscal and policy analysis and public education with the goal of improving the economic and social well-being of low- and middle-income Californians. Support for the Budget Center comes from foundation grants, subscriptions, and individual contributions. Please visit the Budget Center's website at www.calbudgetcenter.org.

Acknowledgments

William Chen prepared this report.

Introduction

Deliberations on spending on state programs and services are often very visible and publicly debated. However, California also spends large amounts of public dollars through tax breaks – also called "tax expenditures." Unlike program spending, most tax breaks are not up for debate every year, and instead just quietly continue from year to year and are largely deliberated upon outside of the usual budget cycle – if they are debated at all. The Department of Finance (DOF) projects state personal income tax expenditures for 2016-17 (the state fiscal year that began July 1, 2016) will total around $43 billion – greater than one-third of the amount of projected 2016-17 General Fund revenues.[1] The DOF projects that corporate income tax expenditures will amount to another $5 billion in forgone revenues in 2016-17.[2] Total spending on a tax break is often not capped, but instead is given to all who qualify. Some of the largest, most expensive tax expenditures are (1) tax deductions and exclusions that benefit the wealthy much more than they do low- and middle-income households or (2) tax breaks for businesses that serve questionable purposes or are of questionable effectiveness. In this way, California spends enormous amounts of public dollars helping households and businesses that don't need the help, or need it much less, while the state significantly constrains the amount of aid given to individuals and families who do need the help.

In this report, we discuss some of the better known tax expenditures in California for individuals and families and for businesses. Among the issues we consider are: (1) who those tax expenditures benefit and who is left out, in the cases where we have the data to do so; (2) whether the tax expenditures have worthwhile policy goals; and (3) whether they are effective in achieving those goals. We continue by discussing tax expenditures' effect on California's tax system and raise the critical question of whether revenues spent on tax expenditures would be better spent directly on public services. Finally, we conclude with recommendations on how to improve the way California creates, evaluates, and renews tax expenditures.

Background

Tax expenditures include, but are not limited to, "exemptions, deductions, exclusions, credits, deferrals, and preferential tax rates."[3] Most of the tax expenditures discussed in this report are credits, deductions, or exclusions. Tax expenditures reduce the amount of tax revenue collected relative to the state's basic tax structure, thus reducing the amount of revenue the government has available to spend on other priorities – the same way direct spending on one program means that funding is not available for another program.[4] But there is a key difference: repealing a tax expenditure in California requires a two-thirds vote in both houses of the Legislature, while reducing or eliminating program spending only requires a simple majority.

Sales Tax Expenditures

Along with other spending through the tax code, California provides tax expenditures for sales and use tax. Sales tax expenditures come in the form of exemptions or exclusions from sales tax, such as the exemptions of food, prescription medicines, and certain kinds of business equipment from sales tax. Further, while the DOF and the Legislative Analyst's Office (LAO) do not consider the exclusion of services from sales tax to be a tax expenditure, others could, and it "likely would be much larger than any other state tax expenditure."[5] We do not have access to data on the distribution of the benefits of sales tax exemptions, but they represent a substantial public expenditure that should be reviewed and enacted with deliberation.[6]

Like other public services and systems, tax expenditures can have policy goals. For example, with the goal of encouraging homeownership, the Mortgage Interest Deduction allows taxpayers to reduce their taxable income, and hence their tax liability, by the amount of qualifying mortgage interest expenses they paid during the year. However, whether or not a particular tax expenditure is *effective* in achieving its policy goals is a question that should be considered before enactment, and reevaluated periodically, just as policymakers do with direct program spending.

Many households all along the income distribution benefit from tax expenditures, including the two largest tax expenditures in California, without necessarily having to actively claim them when filing taxes (See box "Many Households Benefit From Personal Income Tax Expenditures Without Having to Actively Claim Them"). However, state spending on tax expenditures that primarily benefit the wealthy and tax expenditures for businesses dwarfs state spending on tax expenditures targeted to low- and middle-income households (Figure 1).

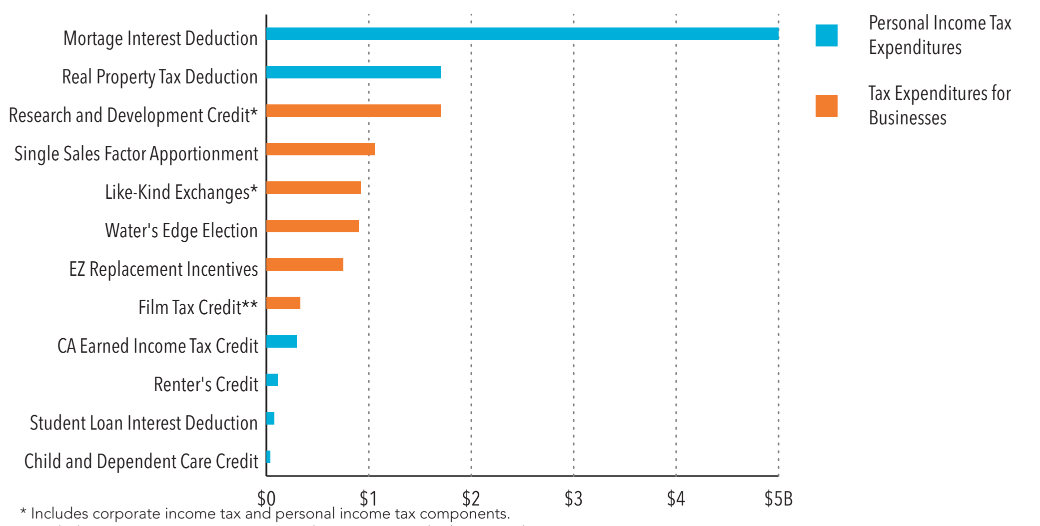
Credits

Tax credits provide a direct reduction in tax liability and can be refundable or nonrefundable. If a credit is refundable and reduces a taxpayer's tax liability below $0, the taxpayer receives the negative balance back in the form of a tax refund payment from the government. With a nonrefundable credit, a taxpayer whose tax liability goes below $0 simply owes no taxes – the negative balance is lost. Nonrefundable credits provide little to no benefit to lower-income households who have little to no tax liability. Similarly, if a business owes no tax, it cannot benefit from a nonrefundable credit.[7]

FIGURE 1

Tax Breaks Primarily Benefiting the Wealthy and Businesses Dwarf Those Targeted to Households of Less Means

Projected 2016-17 Revenue Loss by Tax Expenditure, in Billions



* Includes corporate income tax and personal income tax components.
** Includes corporate income tax, personal income tax, and sales tax exclusion components.
Note: Enterprize Zone (EZ) Replacement Incentives and Film Tax Credit reflect legislated caps rather than projected expenditures.
Source: Department of Finance, Franchise Tax Board, Legislative Analyst's Office, and California State Assembly floor analysis

California Budget & Policy Center
Independent Analysis. Shared Prosperity.

Deductions and Exclusions

Some of the largest, most expensive tax expenditures are deductions and exclusions which benefit primarily wealthier households – and furthermore provide greater benefits the more income a household earns. Deductions and exclusions lower a household's taxes by reducing taxable income, and the higher a household's tax bracket is, the greater the benefit that households receive for each dollar of income no longer taxed. For example, a California taxpayer in the very-high-income 12.3 percent bracket receives a benefit of 12.3 cents for every dollar deducted from their taxable income, while a taxpayer in the 8 percent bracket would only receive 8 cents for every dollar deducted from their taxable income.

The way this tax break is designed is "upside down" – higher-income households receive greater benefits but are less likely to need either financial assistance or additional incentive to engage in the kind of behavior that tax expenditures generally aim to promote, like buying a home or saving for college or retirement.

Furthermore, in order to claim many deductions, a taxpayer has to itemize deductions – meaning that the taxpayer chooses to forego the set value of the standard deduction and instead file for specific deductions, item by item, that he or she will take. Itemizing deductions is only worthwhile if a household's combined deductions reduces its tax liability by more than the value of the standard deduction, and wealthier households tend to have more and larger expenses that they are able to deduct, such as larger homes – and potentially second homes – in more expensive neighborhoods. More than 95 percent of tax filers nationwide with income over $200,000 itemized deductions, compared with just 13 percent of filers with annual income of $50,000 or less, according to a 2014 report from the Corporation for Enterprise Development.[8] Finally, more than 80 percent of the federal tax benefits of itemized deductions nationwide went to households in the top 20 percent of incomes in 2011, while the *bottom* 20 percent received almost nothing at all from them, according to an analysis by the Tax Policy Center.[9]

Deferrals

Deferrals delay recognition of income, lowering taxable income for the period that the deferral is taken. For example, tax-deferred retirement savings plans like 401(k)s defer taxes owed on income saved and earned within those accounts until the taxpayer ultimately withdraws this income. It is also possible for recognition of income to be deferred indefinitely, leaving income that a taxpayer has already received untaxed indefinitely. Like-Kind Exchanges, discussed in this report, are another example of a deferral.

Elections

Tax elections give taxpayers a choice among different tax treatments. For example, the Water's Edge Election, discussed in this report, gives corporations a choice of how to determine the proportion of their worldwide income that can be attributed to California for the purpose of taxation. Given a choice, taxpayers would be expected take the tax treatment that results in lower taxes. However, which option happens to be most advantageous for a taxpayer can change depending on circumstances. Thus, tax elections end up reducing revenues relative to what revenues would be without a choice on tax treatment.

Personal Income Tax Expenditures

Large "Upside Down" Tax Expenditures Aimed at Homeowners

Two homeownership-related tax deductions, the Mortgage Interest Deduction and the Real Property Tax Deduction, provide several billions of dollars in tax breaks to households with incomes over $100,000, who are the top 20 percent of California earners.[10]

The Mortgage Interest Deduction allows households to reduce their taxable incomes by the value of

Many Households Benefit From Personal Income Tax Expenditures Without Having to Actively Claim Them

There are some tax expenditures that households do not have to actively claim on their returns in order to benefit. Benefits that employers pay for or contribute to, like health insurance and retirement plans, represent things that employees would otherwise need to spend their own income on – they are part of an overall compensation package. However, these benefits are excluded from taxable income calculations, resulting in lower taxable income. The two largest income tax expenditures in California are exclusions from taxable income of benefits related to employment:

- The Employer Contributions to Accident and Health Plans Exclusion is the largest income tax expenditure in California, with projected forgone revenue of $6.4 billion in 2016-17, according to estimates from the Franchise Tax Board (FTB). Employer contributions to provide accident and health insurance are excluded from employees' taxable income.
- The Employer Contributions to Pension Plans Exclusion is a close second for largest income tax expenditure with projected forgone revenue of $6.1 billion in 2016-17, according to estimates from the FTB. Employer contributions to qualified retirement plans up to annual limits are excluded from employees' taxable income.

The FTB does not provide distributional analysis of who benefits from these exclusions along the income scale. This is because the FTB does not have data on income that taxpayers are not required to report and thus are not able to estimate the revenue effects. The structure of these tax expenditures clearly favors those with higher levels of benefits and higher marginal tax rates. Households with full-time workers with fringe benefits gain more from these exclusions than do those in part-time jobs without benefits.

qualified mortgage interest expenses paid on up to $1 million in debt.[11] Of the total $3.8 billion in reduced tax revenue from this deduction in 2012, $2.8 billion (74.4 percent) went to households with incomes of $100,000 or over (Figure 2). At the same time, these households represented just 43.9 percent of households claiming the deduction. According to the Franchise Tax Board (FTB), in 2010, if the Mortgage Interest Deduction had been eliminated, "we could have lowered [personal income tax] rates by approximately 9 percent across the board and still raised the same amount of revenue."[12]

The Real Property Tax Deduction allows households to reduce their taxable income by the amount of tax they paid to local, state, or foreign governments on real property, such as land and buildings. Of the total $1.5 billion in forgone 2012 tax revenue from the Real Property Tax Deduction, $1.2 billion (77.8 percent) went to households with income of at least $100,000 (Figure 3). These households represented just 43.8 percent of households claiming the deduction.

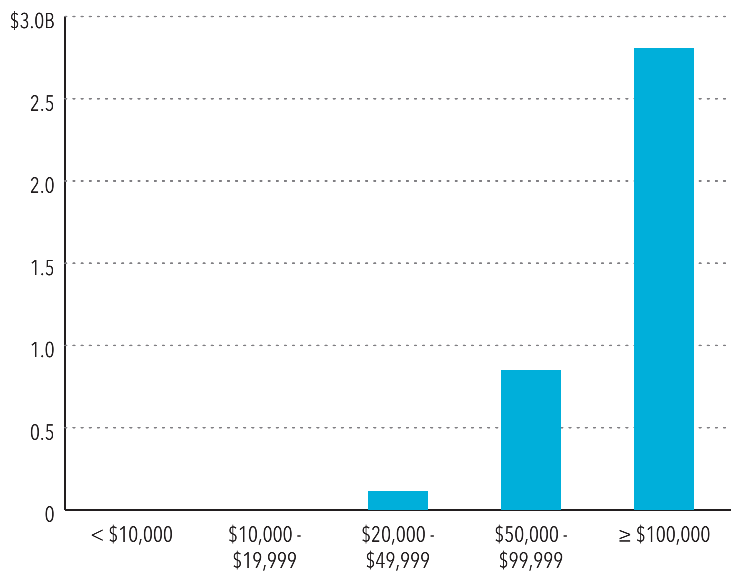
The value of these homeownership-related deductions also serves to increase the price of property because sellers and buyers know that the ultimate cost of a property to its owner is effectively lower due to the ability to take the tax deductions.[13] In other words, if these deductions are meant to subsidize homeownership, they are not very effective since the value of the deductions has been "capitalized" into the price of a property, and the buyer is no better off.

The fact that the value of the deductions is factored into prices also means that they actually contribute to the high cost of housing in California. While those who are well-off enough to be able to purchase a home and pay a mortgage receive the large offsetting

FIGURE 2

Mortgage Interest Deduction Primarily Benefits the Wealthiest Households

Total State Tax Benefit Received by Adjusted Gross Income Group, 2012, in Billions



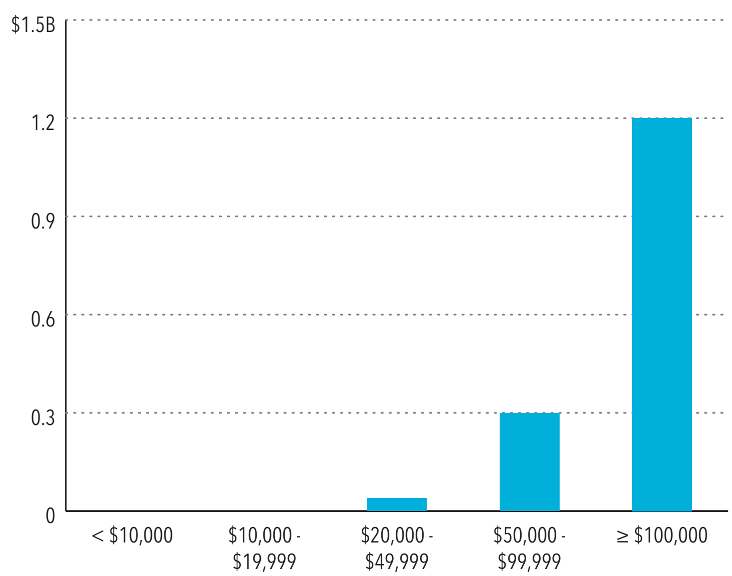
Source: Franchise Tax Board

California Budget & Policy Center
Independent Analysis. Shared Prosperity.

FIGURE 3

Real Property Tax Deduction Primarily Benefits the Wealthiest Households

Total State Tax Benefit Received by Adjusted Gross Income Group, 2012, in Billions



Source: Franchise Tax Board

California Budget & Policy Center
Independent Analysis. Shared Prosperity.

benefits of the Mortgage Interest and Real Property Tax deductions, higher prices make it harder for families with less income and wealth to purchase a home.

The FTB notes that if the goal of the Mortgage Interest Deduction is to increase homeownership, then it might make more sense to give a large credit to *new* homeowners rather than "the current deduction that is most valuable to taxpayers who already own homes, but are moving to much bigger and more expensive ones."[14]

Targeted – but Relatively Small – Tax Expenditures for Households More in Need

Tax expenditure options exist that are better targeted at Californians who need help with the costs of living and trying to build toward a better life, such as the Student Loan Interest Deduction, the Renter's Credit, California's Child and Dependent Care Credit, and the California Earned Income Tax Credit (CalEITC). All four of these tax expenditures have income ceilings and phase out the tax benefit as a household's income level approaches the ceiling or, in the case of the Renter's Credit, simply cut off the benefit above the ceiling. These mechanisms help to target the benefits of tax expenditures toward the households most in need of help.

Student Loan Interest Deduction

The Student Loan Interest Deduction allows households to reduce their taxable income by the amount of qualified student loan interest they paid during the tax year, up to a maximum of $2,500. This deduction benefits middle-income households the most. Households with income between $20,000 and $100,000 comprised 70.6 percent of claimants and received 72.1 percent of the total amount spent on this deduction in 2012. (Figure 4 shows the dollar distribution of benefits.) The deduction phases out above certain levels of income, ensuring that the benefit stays targeted toward those with greater need.[15] Total spending via the Student Loan Interest Deduction in 2012 was $54.8 million.

Unlike the Mortgage Interest and Real Property Tax deductions, the Student Loan Interest Deduction does not require itemization in order to claim it, which helps lower- and middle-income households to benefit from it. However, FTB data show that this deduction does not reach many of the poorest households – those with incomes under $20,000 represent just 14.3 percent of claimants – possibly because individuals in these households are less likely to have attended college. The Student Loan Interest Deduction also represents a very small amount of spending compared to other tax expenditures like the homeownership-related tax deductions discussed above.

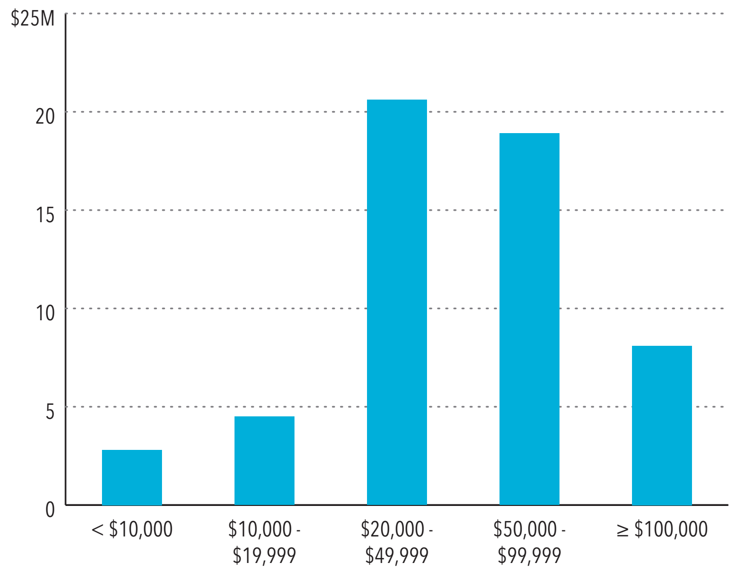
Supports for Higher Education Illustrate Different Avenues of State Spending

Spending via the tax code is one way to help California residents attend college. The state also helps low- and middle-income students to afford college through direct spending on the Cal Grant and Middle Class Scholarship programs. The 2016-17 budget assumes total spending on the Cal Grant program will be $2 billion and the program is anticipated to serve a total of about 348,000 students, based on California Student Aid Commission estimates.[16] The 2016-17 budget provides $74 million for the Middle Class Scholarship program, which is estimated to have made around 53,000 awards in 2015-16.[17] The difference between the Student Loan Interest Deduction and the Cal Grant program highlights a key contrast in how we treat allocations of government revenues – one is called government spending (Cal Grant) while the other is cast as a tax cut, even though both have the same overall effect of allocating revenues.

FIGURE 4

Student Loan Interest Deduction Primarily Benefits Middle-Income Households

Total State Tax Benefit Received by Adjusted Gross Income Group, 2012, in Millions



Source: Franchise Tax Board

Renter's Credit and Child and Dependent Care Credit

The Renter's Credit and the Child and Dependent Care Credit also primarily benefit middle-income households. As tax credits, they provide a direct reduction in tax liability (in contrast with deductions, which reduce tax liability by lowering taxable income). However, both credits provide little to no benefit to lower-income households because they are nonrefundable credits, and low-income households often do not owe income taxes. This means that if a credit reduces a household's tax liability below $0, the household simply owes no taxes. Were the credit refundable, the household could receive the negative balance back in the form of a tax refund. Further, the amount of money spent through the Renter's Credit and the Child and Dependent Care Credit (about $106 million and $34 million in 2012, respectively) is miniscule compared to the multibillions provided to the top 20 percent through the Mortgage Interest and Real Property Tax deductions.

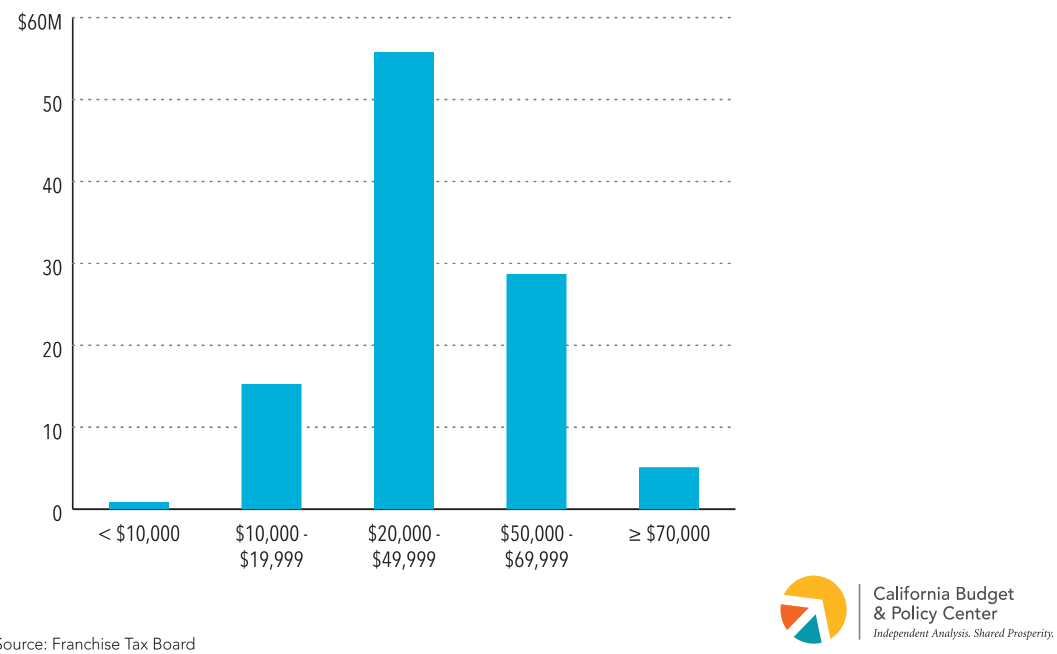
The Renter's Credit provides a $60 reduction in tax liability to individuals ($120 to married couples filing jointly) who were residents of California for the whole year and paid rent on a residence in California for at least half the year. Of households receiving the Renter's Credit, nearly one-quarter (23.6 percent) had incomes below $20,000, and these households received 15.3 percent of the total amount spent on the credit in 2012 ($105.8 million). (Figure 5 shows the dollar distribution of benefits.) As noted above, the Renter's Credit is nonrefundable. In order to claim the credit, taxpayers must have California adjusted gross income (AGI) below $38,259 for individuals and $76,518 for married couples filing jointly.

California's Child and Dependent Care Credit is equal to a percentage of the federal credit it is modeled after and provides a tax credit for child and

FIGURE 5

Renter's Credit Primarily Benefits Middle-Income Households

Total State Tax Benefit Received by Adjusted Gross Income Group, 2012, in Millions



Source: Franchise Tax Board

dependent care expenses for working families.[18] Of the households receiving the credit, 84.4 percent had incomes between $50,000 and $100,000, and they received 89.1 percent of the benefits. (Figure 6 shows the dollar distribution of benefits.) California's Child and Dependent Care Credit is a very small total sum of tax spending at $34.3 million. The credit reaches a relatively narrow band of the income distribution. One reason why is that the credit is not available to households with federal AGI above $100,000. The other critical reason is that the credit is nonrefundable, as discussed above. Just 0.2 percent of households receiving the Child and Dependent Care Credit in 2012 had income below $20,000, and they received 0.1 percent of the total amount spent on this credit. Furthermore, because child care is so expensive, it could still be out of reach for low- and even middle-income families even if the credit were refundable.

California Earned Income Tax Credit

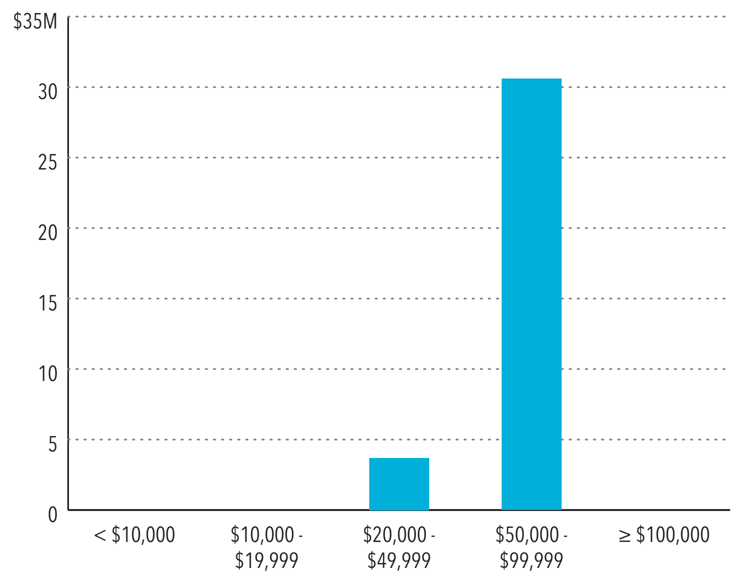
California enacted its first-ever state Earned Income Tax Credit (called the CalEITC) in 2015. This refundable credit helps low-income workers' wages go further by giving them a tax credit that scales up initially as their earnings increase, before gradually phasing out. The CalEITC is targeted to very low-income workers: the credit is only available to households with annual earnings below about $7,000 to $14,000, depending on family size, for the 2015 tax year.[19]

The CalEITC is also notable in that policymakers must specify in each year's state budget how large a credit to provide. Specifically, they must set the state credit at a particular percentage of the federal EITC. This percentage, called the "adjustment factor," determines the size of the credit. If policymakers do not specify the adjustment factor in the budget, then

FIGURE 6

Child and Dependent Care Credit Benefits Middle-Income Households

Total State Tax Benefit Received by Adjusted Gross Income Group, 2012, in Millions



Source: Franchise Tax Board

California Budget & Policy Center
Independent Analysis. Shared Prosperity.

no state EITC will be provided that year. In effect, policymakers must decide to fund the state EITC every year – like a direct spending program. The 2016-17 budget set the state EITC adjustment factor at 85 percent and expects $295 million to be spent on the state EITC in 2016-17.[20]

Tax Breaks for Businesses

Contrary to the popular conception of the private sector as being independent, financially self-sufficient businesses – particularly larger corporations and those that span beyond the borders of California – benefit from state spending via tax expenditures. Each of the four largest corporate income tax expenditures are projected to reduce state revenues by at least $900 million or more in 2016-17. None of these four tax expenditures has a cap on annual spending or an expiration date. Furthermore, they serve purposes of dubious value or are of questionable effectiveness in achieving their purpose, and yet continue from year to year without scrutiny from policymakers.

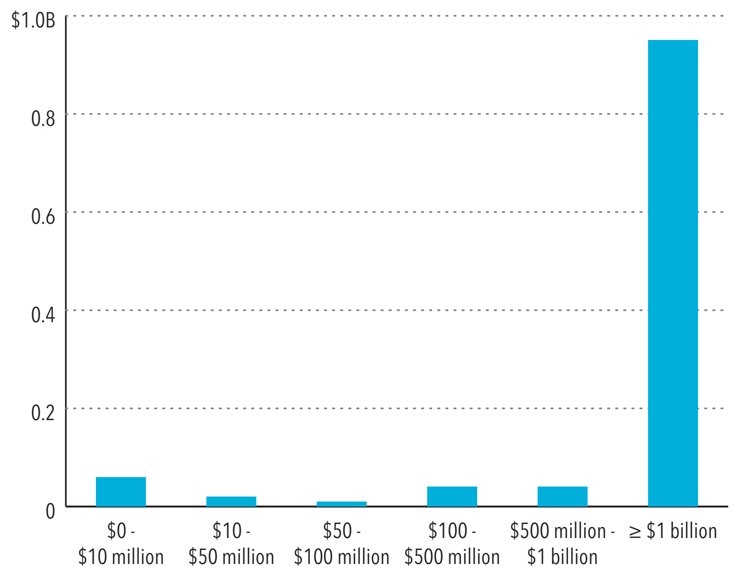
Research and Development (R&D) Credit

The R&D Credit is California's largest business tax expenditure at a projected $1.7 billion in 2016-17.[21] Businesses receive a tax credit for a portion of increased research expenditures relative to a four-year base period.[22] The great majority – 84.7 percent – of total spending on this credit went to businesses with gross revenue of more than $1 billion in 2012.[23] (Figure 7 shows the dollar distribution of benefits.) This credit is meant to (1) encourage businesses to conduct the "optimal" amount of R&D for society, and in particular (2) to do so in California instead of other states.[24] Since there is also a larger federal R&D credit that is available to taxpayers in all states,

FIGURE 7

Research and Development Credit Primarily Benefits the Largest Corporations

2012 State Tax Benefit Used by Gross Revenue, in Billions



Note: If a business generates a larger research and development credit than it can use in a year, that business can "bank" the unused credit value for use in future years.
Source: California State Auditor

California Budget & Policy Center
Independent Analysis. Shared Prosperity.

the extra tax credit the state provides is meant to try to attract businesses to conduct R&D activity in California.

However, the credit is of dubious effectiveness and value. The FTB notes that the credit could only be considered successful if R&D activity is taking place in California that would not happen without the credit, but that this is unknown. The State Auditor echoed this point about lack of evidence of the credit's effectiveness and raised the need for better evaluation, saying they "were unable to determine the R&D credit's effectiveness because no state entity oversees or regularly evaluates it."[25] In fact, the State Auditor pointed out that Washington state allowed its own R&D credit to expire after a study ordered by the state Legislature concluded that "it is clear that the cost of these preferences greatly exceeds the estimated benefits."[26]

As further indication of the lack of incentive provided by California's R&D credit, much more in this credit is generated each year than is used – essentially, businesses can "bank" their unused credits for future use. The unused carryforward balance of R&D credits grew by an estimated $3 billion in 2014 to a new total of $19.2 billion, as $1.3 billion in the credit was used versus $4.3 billion generated, according to the latest figures from the FTB.[27] This balance represents a large and growing future liability to the state.

The LAO gave testimony to the Assembly Revenue and Taxation Committee in 2011 in which it referred back to its 2003 report on tax expenditures and reiterated the recommendation that the Legislature reduce or phase out the credit. The LAO "noted that direct research-related spending (such as through the University of California) may well be a more cost-effective means of subsidizing R&D."[28]

Single Sales Factor Apportionment

Corporations with income derived from both inside and outside of California are not taxed on their whole incomes, but rather apportion their income among the states in which they operate, with California taxing just the portion attributed to California. Since 2013, California has used what is called mandatory "Single Sales Factor Apportionment," which means that the share of a corporation's income apportioned to California is based solely on the percentage of their sales in California. Single Sales Factor Apportionment is projected to cost the state nearly $1.1 billion in lost revenue in 2016-17.[29]

Both the FTB and DOF consider the move from "Three-Factor Apportionment," which the state used before 1993, to the current Single Sales Factor Apportionment to be a tax expenditure.[30] (See box "Giving Corporations the Choice of Lower Taxes" for further discussion of the evolution of income apportionment tax expenditures in California.) Under Three-Factor Apportionment, corporations divide their income according to the percentage of their nationwide property that is in a state, nationwide sales made to residents of a state, and nationwide payroll paid to residents of a state. The three factors are weighted equally in calculating what percent of their income should be apportioned to California.[31] Thus, Three-Factor Apportionment takes into account production activity (property and payroll) and sales activity, both of which are necessary in producing a company's profits. By contrast, Single Sales Factor Apportionment allows corporations to game the system by strategically locating their production factors and targeting sales in certain states.[32]

Water's Edge Election

The Water's Edge Election allows multinational corporations to choose whether or not to exclude earnings or losses derived from foreign parts of their business in calculating the proportion of income taxable in California. Methods for determining the California share of all the international components of a business in computing income include "worldwide combined reporting," and "domestic" or "water's edge combined reporting," which looks at California's share of, for the most part, only United States activity.

Giving Corporations the Choice of Lower Taxes

From 1993 through the end of 2010, corporations were still required to use Three-Factor Apportionment, but with the *sales* factor double-weighted for most corporations. For 2011 and 2012, corporations could choose whether they used Three-Factor Apportionment with double-weighted sales *or* Single Sales Factor Apportionment – meaning that *only* the percentage of sales in a state was considered. This policy change was an attempt to make it more attractive to locate more property and payroll in the state, because those factors were weighted less than sales (or not at all) in determining income tax due.[33] Moving to heavier-weighted sales factor apportionment creates winners and losers. Manufacturing companies that have more property and payroll in-state while largely selling out of state reap tax benefits, but those that sell more to consumers in California with less physical presence in-state end up owing more in taxes. Furthermore, if a company currently has no property or payroll in California but sells products in California – and thus has no "nexus," or "physical presence" – it will have less incentive to start employing people or running facilities in-state because having no nexus in the state allows a company to avoid corporate income tax. Once it does have nexus, all of its sales to California will create corporate income tax liability.

The ability to choose how to apportion income gave corporations an unreasonable way to reduce how much of their income is subject to taxes, representing a tax expenditure with no justification. To improve on this, California voters passed Proposition 39 in 2012, which made Single Sales Factor Apportionment mandatory for most corporations. However, Single Sales Factor Apportionment is still a tax expenditure relative to Three-Factor Apportionment.

As with California income apportionment discussed in the box "Giving Corporations the Choice of Lower Taxes," the ability to choose lower-tax methodology makes the Water's Edge Election a tax expenditure. The Water's Edge Election is projected to cost California about $900 million in lost revenue in 2016-17.[34]

Prior to 1986, this option did not exist. However, as opposition from multinational corporations and international governments grew against the state's policy of mandatory worldwide combined reporting, California passed a law in 1986 implementing the Water's Edge Election.[35] This ability to choose how to calculate their taxes allows corporations to strategically reduce their taxable income, resulting in less tax collected than would be under a mandatory worldwide or mandatory domestic combined reporting scheme. For example, if the foreign parts of a multinational corporation had net losses in a tax year, then including them in the calculation of income for the year would make the end result lower – resulting in lower taxable income in the US (and hence California). On the other hand, if the foreign components had *positive* net income in a tax year, then including them in the calculation of income for the year would make the end result higher–resulting in higher taxable income in the US (and hence California). Given the option, we would expect a corporation to choose whichever method results in lower taxes owed.

Like-Kind Exchanges

Normally, selling or exchanging property at a profit results in a capital gain subject to tax. Like-Kind Exchanges allow taxpayers to defer capital gains (or losses) when they exchange a business or investment property for a similar ("like-kind") property.[36] Like-Kind Exchanges are projected to cost California about $920 million in lost revenue in 2016-17.[37] This rule does not apply to inventory, stocks, bonds, notes, other securities, or to property for personal use (like homes and cars).

The deferred capital gain is recognized if the new asset is sold or exchanged in a subsequent taxable transaction. However, if the new asset is later exchanged in a Like-Kind Exchange, capital gains can be deferred indefinitely.[38] Furthermore, if the owner of the property passes it on to an heir instead of selling it, the capital gain will *never* be recognized and taxed because the base value from which appreciated value is calculated starts with the value at the time the heir receives it.[39]

Although Like-Kind Exchanges were originally meant to exempt small, informal barter transactions from tax and reporting requirements, today individuals and businesses wishing to conduct a Like-Kind Exchange typically avail themselves of a "nationwide industry of commercial intermediaries specializing in the transactions" – in other words, transactions that are not small, informal barter.[40] This tax benefit has not evolved to keep up with the modern economy, and is now being abused to avoid taxes primarily on commercial and investment real estate transactions, which are the "major focus" of the law.[41] As former US Treasury Secretary Andrew Mellon argued decades ago when stocks and bonds were still eligible for Like-Kind Exchanges, "This result is manifestly unfair and destructive of the revenues."[42]

Tax Giveaways to Try to Make Them Stay

There are also smaller business tax expenditures that California makes via commissions rather than being automatically given to all who qualify. The Film Tax Credit and California Competes Tax Credit are structured to limit state expenditures via capped annual allocations of dollars and legislated expiration dates. Still, it is unclear how effective these tax credits are in achieving the economic goals they were enacted with.

Film Tax Credit

The Film Tax Credit is awarded by the California Film Commission (CFC) and is meant to attract and retain motion picture production in California. The CFC can award up to $330 million per fiscal year before July 1, 2020, and the credit can be claimed against corporate income, personal income, or qualified sales and use taxes. Unallocated credits in one year can be allocated in future years. California is among

37 states with some form of film incentive program. California expanded its own film tax credit in 2014 to better compete with film incentive programs in other states. However, the number of states with film incentive programs is actually down from 44 in 2009, and according to the National Conference of State Legislatures, "Overall, states are increasing evaluation and oversight of film incentive programs."[43]

In line with this trend toward greater oversight and evaluation, the changes made to California's film tax credit in 2014 included a new "jobs ratio" formula and other criteria for the credit.[44] Further, there are now penalty provisions that allow the CFC to reduce the amount of credit allowed if the jobs ratio turns out to be lower than originally specified.

For the Film Tax Credit to be considered successful, it must be inducing film production that would not have otherwise happened in California. Unfortunately, as FTB notes, it is not known how much film production would happen in California absent the credit. The State Auditor notes that the CFC's survey of applicants who did not receive the credit found that from fiscal years 2010-11 through 2014-15 (under the previous version of the credit, which had a smaller $100 million maximum annual allocation), nearly one-third still filmed in California.[45] It is likely that to some extent the Film Tax Credit is simply a windfall benefit to filmmakers who would produce in California with or without the credit.

California Competes Tax Credit

The California Competes Tax Credit is an income tax credit meant to attract businesses to move to or expand in California. The credit is part of a package of tax incentives that replaced the Enterprise Zone tax incentives beginning in 2014. Businesses must apply for the credit, with agreements negotiated by the Governor's Office of Business and Economic Development (GO-Biz) and approved by the California Competes Tax Credit Committee, which consists of the State Treasurer, Director of the Department of Finance, Director of GO-Biz, and one appointee each by the Speaker of the Assembly and Senate Committee on Rules. Proposals are evaluated based on criteria including the number of jobs to be created or retained, a minimum level of compensation and period of time the jobs will be retained, the unemployment and poverty rates in the business development area, and how long the awardee commits to staying in California. These factors are set in a written agreement between GO-Biz and the business, and credits may be recaptured by the state if a business fails to meet the terms of the agreement.[46] The California Competes Tax Credit currently has an allocation of $200 million per fiscal year through 2017-18, plus unallocated credits from previous periods.

These performance standards for being awarded and continuing to receive the California Competes Tax Credit should help ensure that the credit succeeds in maintaining and increasing economic activity and employment in California. Certainly the criteria and review required are a step up from the Enterprise Zone hiring credits, which were an uncapped tax benefit that businesses could claim by replacing workers and reporting "new" employees on their tax return rather than applying to a commission.[47] However, a key remaining question is whether or not the credit simply provides a windfall for businesses that would have come to or stayed in the state regardless of whether they received the credit. As the California Competes Tax Credit is implemented and data from awardees becomes available, GO-Biz or another state agency such as the LAO should be required to report on whether the credit actually increases job creation and retention in the state, and policymakers should be required to study the credit before deciding to extend the credit beyond its current expiration date.

Income Tax Expenditures Contribute to California's Regressive Tax System

California's state and local tax system is regressive over most of the income scale. California families with incomes in the lowest fifth of the distribution on average pay the greatest share of their incomes in state and local taxes, according to analysis by the Institute on Taxation and Economic Policy.[48] At the same time, each income quintile pays a lower share of its income on average than the quintile below it, except the top 5 percent of families. The bottom fifth of California's nonelderly families spend an estimated 10.5 percent of their incomes on state and local taxes (Figure 8).[49] In comparison, the wealthiest 1 percent of families spend an estimated 8.7 percent of their incomes on state and local taxes.

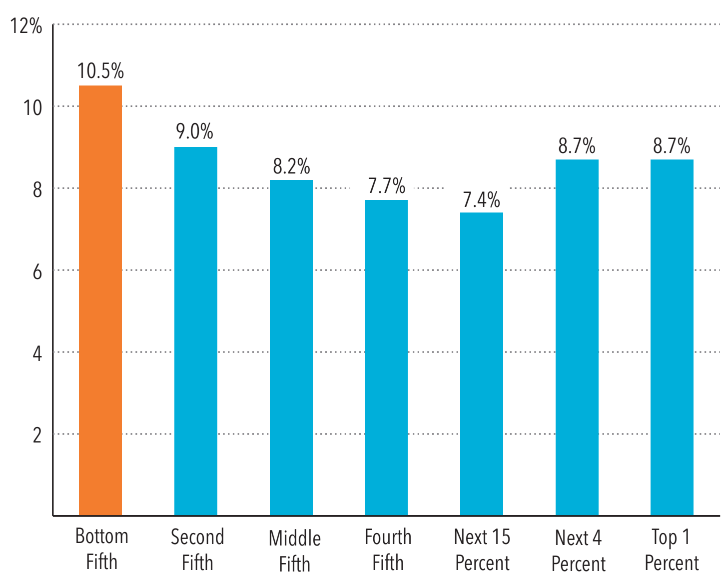
While California's tax system is often characterized as progressive – due to the state personal income tax rates that increase with higher incomes – when factoring in sales and property taxes, as well as tax expenditures, the distribution of who pays California taxes actually looks quite different. In fact, California's tax system runs counter to the principle of equity, which calls for individuals and families to contribute to public services based on their ability to pay. Part of why California's overall tax system is regressive is the fact that tax expenditures are skewed to the benefit of richer households, who least need the break.[50]

It is also important to keep in mind that tax revenues fund public services and systems. Choosing to spend public dollars via tax expenditures means choosing *not* to spend those dollars on other programs.

FIGURE 8

California's Lowest-Income Families Pay the Largest Share of Their Incomes in State and Local Taxes

Average Percentage of Family Income Paid in State and Local Taxes



Note: Data are for nonelderly taxpayers only and include the impact of Proposition 30 temporary tax rates and the offset for federal deductibility of state and local taxes.
Source: Institute on Taxation and Economic Policy

California Budget & Policy Center
Independent Analysis. Shared Prosperity.

It is critical to recognize that there was a choice made once in enacting the tax expenditure and an ongoing choice made not to review, modify, or repeal existing ones. When the state gives tax dollars back to corporations without a clear justification for how that spending benefits the public, or to help wealthy families buy or bid up a bigger or second home, those are all dollars that the state no longer has available to put to other, potentially more effective uses.

The state could reform tax expenditures to better target individuals and families who need the help more, or use the forgone revenue instead to proactively invest in programs that broaden economic opportunity and security such as:

- The state's higher education system – the California State University (CSU) and University of California (UC) – where state spending per student remains below pre-recession levels, despite recent increases.[51]
- The state's support for affordable housing production and preservation, with the need for rental homes affordable to extremely low-income Californians outstripping availability by more than 1 million homes.[52]
- The state's welfare-to-work program (CalWORKs), whose maximum monthly family grant level does not even cover the cost of affordable housing in California.[53]
- The state's child care and development system, which still provides fewer subsidized "slots" than before the recession.

How to Improve Tax Expenditures

Spending public dollars through tax expenditures is not bad in and of itself – some, like the EITC, may both have worthwhile policy goals and be effective at achieving them – but California spends a lot of forgone revenues on poorly targeted tax breaks that continue to operate year to year without ongoing policy evaluation and review. This often means that spending that benefits wealthier households and businesses receives less scrutiny than spending for the poor, much of which is overtly visible in the annual state budget.

Policymakers could improve tax expenditures in the following ways.

Better Oversight

Setting expiration dates on tax expenditures and requiring policymakers to act on extending them would build in periodic review and ongoing oversight of this less-seen avenue of public spending. In their review, policymakers should:

- Consider whether certain tax expenditures are achieving their policy goals and whether those goals are still worth pursuing.[54]
- Consider whether that money would be better spent through direct subsidies or program spending. For example, as mentioned above, the LAO has suggested funding research via direct spending through the UC system rather than the R&D credit.

Policymakers could consider requiring all tax expenditures to be subject to the annual budget appropriation process.[55] This would create a process by which tax expenditures receive periodic review and are weighted more appropriately against other expenditures. As Governor Brown stated in October 2015, "tax credits, like new spending on programs, need to be considered comprehensively as part of the budget deliberations."[56]

Better Targeting

Policymakers could target tax expenditures to low- and middle-income households – households that need help. For example:

- Some tax expenditures, like the Student Loan Interest Deduction, and the Renter's, Child and Dependent Care, and Earned Income Tax credits, have income caps and phase out their benefits as household income approaches the cap. Currently open-ended deductions like the Mortgage Interest and Real Property Tax deductions could also phase out with higher income so that the state is not unnecessarily spending money on households that do not need financial aid.

Alternatively, policymakers could keep the tax benefit open to all incomes levels, but make it balanced in how it benefits households up and down the income scale.[57] For instance:

- Credits can be set at specific amounts, and if made refundable, help even those with incomes too low to owe income taxes. State policymakers in 2011 eliminated the refundable portion of California's Child and Dependent Care Credit, greatly reducing its benefit for low-income families seeking to offset the high costs of child or dependent care. Restoring this credit's refundability would improve its ability to reach those who really need the help.

The Governor and Legislature took a good first step in improving tax expenditure accountability in 2014 by enacting Senate Bill 1335 (Leno, Chapter 845 of 2014), which requires legislation for new personal income and corporate income tax credits to include specified goals, as well as detailed performance indicators and data collection requirements to measure whether new tax credits are meeting their goals. Unfortunately, this requirement on new tax expenditures is easily avoided by simply stating in the bill language that the provision does not apply. Also, SB 1335 only applies to new tax *credits*, and not to other kinds of tax expenditures, such as deductions, exclusions, elections, deferrals, and preferential rates. Furthermore, existing tax expenditures are allowed to continue as they were, without stated goals, metrics, or review if none were previously legislated. All tax expenditure types, both existing and future, should have specified goals, performance indicators, data collection requirements, periodic review, and expiration dates attached.

Given the significant allocation of state revenue to tax expenditures, better oversight and regular review are needed. As it stands, state tax expenditures benefiting primarily wealthy households and businesses dwarf those targeted to low- and middle-income households. These are forgone revenues that could be used for other priorities, so policymakers should be sure that California is spending those dollars wisely.

ADDITIONAL RESOURCES

Franchise Tax Board, *California Income Tax Expenditures, Report for 2012 Tax Year Data.* https://www.ftb.ca.gov/Archive/AboutFTB/reports/TER/Tax_Expenditure_Report_2012.pdf

Department of Finance, *Tax Expenditure Report 2015-16.* http://dof.ca.gov/Forecasting/Economics/Tax_Expenditure_Reports/documents/2015-16_TE_Report_revised_01_15.pdf

ENDNOTES

1 This figure represents the sum of tax expenditures of $5 million or more. Department of Finance, *Tax Expenditure Report 2015-16*, p. 6.

2 This figure represents the sum of tax expenditures of $5 million or more. Department of Finance, *Tax Expenditure Report 2015-16*, p. 7.

3 Institute on Taxation and Economic Policy, *Tax Expenditures: Spending by Another Name* (October 2011), p. 1.

4 Note that what counts as a tax expenditure is subject to debate because "there is no single rule for determining what constitutes an element of the basic tax structure," as the DOF puts it in *Tax Expenditure Report 2015-16* (p. 2). An example of an ambiguous case is the exemption of services from the sales tax, mentioned in the box on page 2.

5 The DOF notes that because California's "basic definition" of sales tax does not include services, they do not consider the exclusion of most services from sales taxes to be a tax expenditure. See Department of Finance, *Tax Expenditure Report 2015-16*, p. 1. Quote is from Jason Sisney et al., *California State Tax Expenditures Total Around $55 Billion* (Legislative Analyst's Office: February 19, 2015).

6 It would be very difficult to track the personal details of the buyer behind every transaction subject to the sales tax. The LAO reported the estimated 2014-15 General Fund tax expenditure was about $5.6 billion for the exemption of certain food products and water from the sales tax; $3 billion for gas, electricity, and water; $1.9 billion for prescription medicines; and $1 billion for livestock, feed, and other farm inputs. Jason Sisney, et al., *California State Tax Expenditures Total Around $55 Billion* (Legislative Analyst's Office: February 19, 2015).

7 Some nonrefundable tax credits are "transferable," which means that any unused portion can be sold to another business. This allows a business that receives a nonrefundable tax credit allocation to benefit by more than the amount of their tax liability by selling the credit to another business. California's film tax credit for independent films is transferable. For more on transferable tax credits, see Josh Goodman, *Tax Breaks for Sale: Transferable Tax Credits Explained* (The Pew Charitable Trusts: December 14, 2012).

8 Ezra Levin, Jeremie Greer, and Ida Rademacher, *From Upside Down to Right-Side Up* (Corporation for Enterprise Development: September 2014), p. 17.

9 Eric Toder and Daniel Baneman, *Distributional Effects of Individual Income Tax Expenditures: An Update* (Urban-Brookings Tax Policy Center: February 2, 2012), p. 15.

10 According to the FTB, in 2012 (the year for the FTB's latest historical data on tax expenditures) the lower bound for the top 20 percent of adjusted gross income in California was $90,019. See Franchise Tax Board, *Revenue Estimating Exhibits* (April 15, 2016), Exhibit A-10, p. 1 of 4.

11 State income tax expenditures broadly fall into two categories: (1) those that fully or partially conform to federal law and (2) those that exist only in state law. Conformity refers to the extent to which state tax law mirrors federal tax law. For example, California tax law conforms to federal tax law with regard to the Mortgage Interest Deduction. In this case, this means that the provisions of federal law that allow homeowners to deduct their mortgage interest expenses from their federal taxable income also apply in determining California taxable income. In contrast, there is no federal counterpart to California's Renter's Credit.

12 Franchise Tax Board, *California Income Tax Expenditures: Compendium of Individual Provisions, Report for 2012 Tax Year Data*, p. 19.

13 Franchise Tax Board, *California Income Tax Expenditures: Compendium of Individual Provisions, Report for 2012 Tax Year Data*, p. 63.

14 Franchise Tax Board, *California Income Tax Expenditures: Compendium of Individual Provisions, Report for 2012 Tax Year Data*, p. 21.

15 For the 2015 tax year, the phase-out occurred between "modified adjusted gross income" (generally adjusted gross income before subtracting the Student Loan Interest Deduction) of $65,000 and $80,000 for individuals and between $130,000 and $160,000 for married couples filing jointly.

16 Legislative Analyst's Office, *EdBudget Tables* (July 14, 2016), pp. 35-36.

17 Legislative Analyst's Office, *EdBudget Tables* (July 14, 2016), p. 37.

18 For more information on the Child and Dependent Care Credit, see Justin Garosi, *Options for Modifying the State Child Care Tax Credit* (Legislative Analyst's Office: April 7, 2016).

19 California Budget & Policy Center, *First Look: The 2015-16 State Budget* (June 29, 2015), p. 2.

20 California Budget & Policy Center, *First Look: The 2016-17 State Budget* (July 6, 2016), p. 3.

21 Department of Finance, *Tax Expenditure Report 2015-16*, p. 7.

22 Both incorporated and unincorporated businesses can claim the R&D credit, so the tax expenditure affects both personal income tax (PIT) and corporate income tax revenues. However, the PIT component of the R&D credit is much smaller than the corporate income tax component – in 2012, the PIT component was about 7.9% of total spending on the R&D credit.

23 California State Auditor, *Corporate Income Tax Expenditures: The State's Regular Evaluation of Corporate Income Tax Expenditures Would Improve Their Efficiency and Effectiveness, Report 2015-127* (April 2016), p. 19.

24 Because R&D activity often benefits people other than the person doing the R&D, left to their own devices, businesses will tend to do less R&D than would be ideal for society as a whole.

25 California State Auditor, *Corporate Income Tax Expenditures: The State's Regular Evaluation of Corporate Income Tax Expenditures Would Improve Their Efficiency and Effectiveness, Report 2015-127* (April 2016), p. 18.

26 Joint Legislative Audit & Review Committee, *2012 Tax Preference Performance Reviews*, Report Summary (February 20, 2013), p. 15.

27 Franchise Tax Board, *Revenue Estimating Exhibits* (April 28, 2016), Exhibit B-3, p. 3 of 5.

28 Legislative Analyst's Office, *Current State of R&D Tax Credits* (December 5, 2011).

29 Department of Finance, *Tax Expenditure Report 2015-16*, p. 7.

30 Franchise Tax Board, *California Income Tax Expenditures: Compendium of Individual Provisions, Report for 2012 Tax Year Data*, p. 70.

31 Department of Finance, *Tax Expenditure Report 2015-16*, p. 32.

32 Institute on Taxation and Economic Policy, *Corporate Income Tax Apportionment and the "Single Sales Factor,"* (August 2012), p. 3.

33 Institute on Taxation and Economic Policy, *Corporate Income Tax Apportionment and the "Single Sales Factor,"* (August 2012), pp. 2-3.

34 Department of Finance, *Tax Expenditure Report 2015-16*, p. 7.

35 California State Auditor, *Corporate Income Tax Expenditures: The State's Regular Evaluation of Corporate Income Tax Expenditures Would Improve Their Efficiency and Effectiveness, Report 2015-127* (April 2016), p. 23.

36 Incorporated and unincorporated businesses – as well as individuals and families if they have investment property – can take advantage of Like-Kind Exchanges, so this tax expenditure affects personal income tax receipts as well.

37 This projection includes personal income tax revenue lost. Department of Finance, *Tax Expenditure Report 2015-16*, p. 7.

38 Chuck Marr, Chye-Ching Huang, and Joel Friedman, *Tax Expenditure Reform: An Essential Ingredient of Needed Deficit Reduction* (Center on Budget and Policy Priorities: February 28, 2013).

39 This is called "Basis Step-Up" on inherited property and is one of the largest personal income tax expenditures. The DOF projects $2.7 billion in lost revenue in 2016-17 due to Basis Step-Up. Department of Finance, *Tax Expenditure Report 2015-16*, p. 5.

40 Calvin H. Johnson, *Impose Capital Gains Tax on Like-Kind Exchanges*, Tax Notes (October 27, 2008), p. 476.

41 Calvin H. Johnson, *Impose Capital Gains Tax on Like-Kind Exchanges*, Tax Notes (October 27, 2008), p. 475.

42 Calvin H. Johnson, *Impose Capital Gains Tax on Like-Kind Exchanges*, Tax Notes (October 27, 2008), p. 478.

43 National Conference of State Legislatures, *State Film Production Incentives & Programs* (April 12, 2016), p. 2.

44 The "jobs ratio" is the amount of qualified wages paid to qualified individuals divided by the amount of tax credit. Revenue and Taxation Code, Section 17053.95(b).

45 California State Auditor, *Corporate Income Tax Expenditures: The State's Regular Evaluation of Corporate Income Tax Expenditures Would Improve Their Efficiency and Effectiveness, Report 2015-127* (April 2016), p. 30.

46 Revenue and Taxation Code, Section 17059.2(a).

47 In 2013, the LAO found that Enterprise Zone programs, of which the hiring tax credit was the most expensive, (1) were "[g]enerally not shown to be effective," (2) likely simply shifted some of the jobs created in one area away from another part of the state, and (3) likely had limited impact on statewide employment. Legislative Analyst's Office, *California's Enterprise Zone Programs* (May 9, 2013). For more on the former Enterprise Zone program, see Kristin Schumacher, *Dollar for Dollar: California's Enterprise Zone Program Falls Short* (California Budget & Policy Center: June 2013).

48 For more on this, see William Chen, *Who Pays Taxes in California?* (California Budget & Policy Center: April 2015).

49 Institute on Taxation and Economic Policy (ITEP) Microsimulation Tax Model. These data apply current tax rates, including the temporary tax rate changes under Proposition 30, to 2012 income levels. Estimates also account for the federal deductibility of state and local taxes. For more information, see *ITEP Tax Model Methodology*: http://www.itep.org/about/itep_tax_model_full.php.

50 The tax expenditures discussed in this issue brief are not comprehensive. See FTB's and DOF's tax expenditure reports for more information on California tax expenditures. The Mortgage Interest and Real Property Tax deductions are not the only large tax expenditures primarily benefiting wealthier households. Because of data limitations, it is not possible to see the precise distribution of tax benefits by income level for many tax expenditures, but based on the design of the tax expenditure, one can still obtain a general idea of the benefit distribution, like with the employer benefits exclusions discussed above. Another example would be the Exclusion of Capital Gains on Sale of a Principal Residence, which allows individuals to exclude the first $250,000 of capital gains on the sale of an individual's principal residence ($500,000 for married couples filing jointly). The more expensive the home sold, the larger the potential capital gain, and the higher a household's income and tax bracket, the greater the benefit from reducing taxable income.

51 For previous discussion of state disinvestment in higher education, see Phaelen Parker, *From State to Student: How State Disinvestment Has Shifted Higher Education Costs to Students and Families* (California Budget & Policy Center: May 6, 2014).

52 Extremely low-income households have incomes at or below 30 percent of the area median income. Andrew Auran, et al., *The Gap: The Affordable Housing Gap Analysis 2016* (National Low Income Housing Coalition: 2016), Appendix A: State Comparisons.

53 Alissa Anderson, *CalWORKs Grants Fall Short as Rents Continue to Rise* (California Budget & Policy Center: March 2016).

54 FTB and DOF publish useful annual reports on California tax expenditures, including descriptions of each expenditure, their policy goals, and in FTB's case some discussion of what to consider in judging their effectiveness. See the publications cited at the end of this report under "Additional Resources."

55 Currently, among California's tax expenditures, only the state EITC is subject to the annual appropriation process.

56 Governor Edmund G. Brown, Jr., veto message on nine tax credit related bills (Office of the Governor: October 10, 2015).

57 These approaches can be combined, as with the CalEITC, which is a refundable credit that phases in before eventually phasing out as income rises.