

## **Proposition 24: Repeals recent Legislation That Would Allow Businesses to Carry Back Losses, Share Tax Credits, and Use a Sales-Based Income Calculation to Lower Taxable Income.**

Proposition 24, on the November 2010 General Election ballot, repeals legislation that implemented tax changes from the last two State Budget agreements: AB 1452 (Committee on Budget, 2008) and ABx3 15 (Krekorian, 2009)/SBx3 15 (Calderon, 2009). The two measures represented the most significant changes in the history of California corporation tax since its inception, and were enacted as part of a series of bills that implemented the State Budget and made several other changes to other parts of law that reflected agreement among legislative leaders and Governor Arnold Schwarzenegger.

Specifically, Proposition 24 repeals AB 1452's provisions that allow individual and corporate taxpayers to carryback net operating losses and share tax credits within the unitary group. The initiative also eliminates the provision to extend carryforwards to 20 years, reinstating the prior law's ten-year period. Additionally, this proposition repeals elective single sales factor apportionment provided by the Krekorian/Calderon bills. Proposition 24 does not affect four changes to the Corporation Tax Law also made by those bills regarding the sourcing of intangible sales, changes to nexus standards, the definition of gross receipts, and changes to throwback rules.

### **Net Operating Losses**

A net operating loss (NOL) is incurred when a business taxpayer has negative taxable income in a taxable year. In the past, for state tax purposes, taxpayers could deduct income for the next ten taxable years by a percentage of the past NOL, until the Legislature allowed 100% NOL deductions for the 2004 taxable year and thereafter as part of a measure that suspended taxpayers from applying NOLs in the 2002 and 2003 taxable years (AB 2065, Oropeza, 2002). Until 2008, taxpayers could only apply NOLs as a deduction against income realized in future taxable years, called a "carry forward." However, in addition to extending carry forwards from ten to 20 years, the Legislature authorized NOL "carrybacks" beginning in the 2011 taxable year, where taxpayers take losses from the current year and use them as a deduction against past income, receiving a refund for previous taxes paid (AB 1452, Committee on Budget, 2008). AB 1452 provided for two-year NOL carrybacks according to the following restrictions:

- For NOLs generated in the 2011 taxable year, taxpayers may carry back 50% of the loss to the 2009 and 2010 taxable years.
- For NOLs generated in the 2012 taxable year, taxpayers may carry back 75% of the loss to the 2010 and 2011 taxable years.
- For NOLs generated in the 2013 taxable year and thereafter, taxpayers may carry back 100% of the loss to the 2011 taxable year and thereafter.

Under federal law, nearly every taxpayer is allowed to carry back an NOL from a trade or business to apply as a deduction against income in prior taxable years.

Generally, NOLs can be carried back to the two years preceding the loss year and then forward to the 20 years following the loss year. Recently, the federal carryback period was extended from two to five years for specified losses. The basic rationale for allowing losses to be carried back flows from recognition that businesses are established with the goal of making a profit over a business cycle rather than in any particular year. Economic theory demonstrates that a suitably long carryback period for NOL deductions helps to smooth out income and taxes paid over a business cycle, thereby allowing a business to make efficient decisions regarding financing and investment. A 2009 Congressional Research Service (CRS) Report entitled *Net Operating Losses: Proposed Extension of Carryback Period* indicates that the majority of the tax burden falls on risky investments. As a way of easing this burden, NOLs are allowed to be carried back, effectively creating a partnership between the taxpayer and the government. This allows the government to share both the return on investment (tax revenue) and the risk of investment (revenue loss). A refund, as a means of sharing investment risk, provides a firm with cash flow, which helps pay for business expenses during tough economic times. The ability to carry back an NOL is particularly important for businesses that have historically generated taxable income, but may currently be experiencing losses. Additionally, an NOL carryback may provide for a cheap source of funds in an economy with restrictive credit.

A recent Assembly Revenue and Taxation analysis points out that while there is strong justification for a carryback provision as a method of averaging business income over time and as a way of reducing investment risk, there is disagreement over its ability to stimulate the economy. In terms of economic stimulus, it is important to understand the differences between the state and federal governments. The federal government, unlike the state government, is able to stimulate the economy because of its ability to run deficits by issuing Treasury notes and bills. Because of this, the federal government is able to provide for an NOL carryback deduction by issuing debt to offset the cost. The state must fund a carryback deduction by eliminating government spending or increasing revenues. The ability to run deficits allows the federal government to maintain or increase spending, whereas the state government simply reallocates spending or taxes. Therefore, the stimulating effect that a carryback provision would have at the federal level does not apply at the state level, unless carrybacks have economic effects superior to the foregone spending, or more than offset the effect of increasing a tax.

Business benefits from state programs, infrastructure, protection of property and other activities that facilitate the operation of business, and therefore, should compensate the government for services rendered. Allowing NOLs to be carried forward and backwards may be good tax policy, but should unprofitable businesses be able to enjoy the services without compensating the state for, at least a portion of, those services? The sharp drop in state tax revenue has made it difficult for California to fund the programs and services needed for the operation of businesses. Therefore, it may be impossible for the state to maintain basic government services while providing refunds to businesses.

Carrybacks also transform taxes into contingency payments. A firm that uses carrybacks may cancel past tax payments if it incurs losses in future years, resulting in a tax refund out of current revenues. Government must then scramble to fund public services in the current year with less revenue. This mismatch is exacerbated during poor economic times, when taxpayers are generally more likely to incur losses, public services costs increase, and general revenues decline.

Proposition 24 repeals the use of NOL carrybacks for both personal income tax and corporation taxpayers and reinstates NOL carryforwards to ten years.

## **Tax Credit Assignment**

California provides various tax credits designed to provide incentives for taxpayers that incur certain expenses, such as child adoption, or to influence behavior, including business practices and decisions, such as research and development credits and Geographically Targeted Economic Development Area credits. The Legislature typically enacts such tax incentives to encourage taxpayers to do something but for the tax credit, they would otherwise not do.

Under existing law, a taxpayer may make an irrevocable election to assign a corporation tax credit to an affiliated corporation within its unitary group in any taxable year on or after July 1, 2008, subject to specified requirements, to reduce tax for a taxable year beginning on or after January 1, 2010 (AB 1452, Committee on Budget, 2008). Federal law does not permit the assignment of tax credits among taxpayers.

This proposition repeals Revenue & Taxation Code section 23663, eliminating the ability of taxpayers to share credits. However, some of these credits have been transferred already and affiliated firms would be able to use the tax credits they have received.

## **Sales Factor-Only Apportionment**

Existing law determines the portion of a multistate or multinational corporation's net income taxable by California using "formulary apportionment," under which three apportionment factors are computed: a property factor (the amount of property the corporation has in California divided by its total nation-wide or world-wide property); a payroll factor (California payroll divided by total payroll); and a sales factor (California sales divided by total sales). The actual amount of income apportioned to California using this formula is computed by adding the payroll factor, the property factor and twice the sales factor, then dividing that sum by four (the so-called "double-weighted sales factor"). The formula serves to calculate a corporation's tax due in an amount that approximates its demand on public services, assuming that taxpayers derive profits from the effective marshalling of labor and capital in the presence of a market. The formula comes from the Universal Division of Tax Purposes Act (UDITPA), a model statute developed by the National Conference on Uniform State Laws in 1957. California adopted UDITPA and the apportionment formula in 1966 (AB 11, Petris), and double weighted the sales factor in 1993 (SB 1176, Kopp). In California, all multistate businesses must apportion income according to the double-weighted sales factor, except for trades or businesses that derive more than 50% of its gross receipts from agriculture, extractive business, savings and loans, or banks and financial activities.

Notwithstanding the above, beginning in the 2011 taxable year, taxpayers may make an annual, irrevocable election to determine its California apportionment by using either the existing double-weighted sales factor or by using only the sales factor, effective in the 2011 tax year (ABx3 15 Krekorian, SBx3 15 Calderon). In February 2009,

California joined Missouri as the only state in the nation to allow firms to annually elect to apportion income according to the traditional three-factor, double-weighted formula, or solely using the sales factor. Elective single sales factor ensures that almost all firms are winners; they can simply choose the formula that works best for them, although some firms will pay more than before because of the other four corporate tax law changes embedded in the implementing legislation.

A Legislative Analyst's Office (LAO) publication, "Reconsidering the Elective Single Sales Factor", published in May 2010, recommends that the Legislature require sales factor-only apportionment beginning in 2013 and not sooner due to the budget shortfall. The LAO states that optional formulas benefit firms without a clear rationale, and allow taxpayers to switch formulas annually to either minimize tax or generate significant NOLs to apply against future tax liabilities. The LAO also states that mandatory single sales factor promotes job growth to some extent and puts California into conformity with other large states that currently use mandatory single sales, thereby preventing California firms from being put at a disadvantage to its out-of-state competitors. Opponents to sales factor-only apportionment have countered that changing to mandatory single sales would not just penalize out-of-state firms; the change would negatively affect some California based firms with specialized products that sell primarily to other California based firms, producing a sales factor which exceeds its property and payroll factors, resulting in an increase in tax.

Proposition 24 eliminates the option of taxpayers to elect sales-factor only apportionment of corporate business income. Instead, multistate businesses must continue to determine their California taxable income based on the current "formulary apportionment" method.

### **Fiscal Effect:**

According to LAO, when fully implemented in 2012-13, Proposition 24 would increase state General Fund revenues by an estimated \$1.3 billion each year. There would be smaller increases in 2010-11 and 2011-12.

### **Supporters of Proposition 24**

Proposition 24, known as the "Tax Fairness Act", is sponsored by the California Teachers Association and supported by a broad coalition of community, consumer, taxpayer and labor unions. In their filing with the Secretary of State, proponents of Proposition 24 set forth twelve findings and declarations for their initiative, originally known as the "Repeal Corporate Tax Loopholes Act". Arguments in favor of Proposition 24 can also be found at the "Yes on Proposition 24" website ([www.yesprop24.org](http://www.yesprop24.org)) and in the Official Voter Information Guide issued by the Secretary of State for California's 2010 Statewide General Election. Statements in favor of Proposition 24 include the following:

The State of California is in the midst of the worst financial crisis since the Great Depression. To cope with the fiscal crisis, in 2008 and 2009 the Legislature and Governor raised taxes paid by the people of the State: the personal income tax, the state sales tax, and vehicle license fees. Yet at the same time they passed three special

corporate tax breaks that give large corporations nearly \$1.3 billion a year in state revenues.

No public hearings were held and no public notice was given before these corporate tax breaks were passed by the Legislature and signed into law by the Governor. Corporations get these tax breaks without any requirements to create new jobs or to stop shipping current jobs overseas.

These tax breaks unfairly benefit less than two percent of California's businesses and they are the state's wealthiest multi-state and multi-national corporations. 87 percent of one of the tax breaks goes to .03 percent of the California's corporations with gross incomes of more than \$1 billion. Six multi-state corporations would be average tax cuts of \$23.5 million each. 98 percent of California's businesses, especially small businesses, would get virtually no benefit from the tax breaks.

If these loopholes are not closed before they go into effect in 2011, they will cut corporate taxes in California by nearly 15 percent and not create or save a single new job in California.

At the same time it created these corporate loopholes, the Legislature and Governor enacted \$30 billion in cuts to the state budget – decimating funding for public schools and colleges, eliminating health care services to our neediest citizens, closing state parks, furloughing state workers, and wreaking havoc on our state's citizens.

Public schools are bearing the brunt of these cuts. Over the last two years, the state has cut more than \$17 billion from the K-12 school system. Schools have laid off more than 20,000 classroom teachers and education support staff. Elementary class sizes have grown from 20 students to more than 30 kids in each class. Middle and high school class sizes of 40 are common, with some as large as 60.

Since 1981, the share of corporate income paid in taxes has fallen by nearly half – even before these special tax breaks. California taxpayers are paying more, while big corporations are paying less.

We should not be cutting vital programs and raising taxes on low-income and middle-class Californians while enacting tax loopholes for big corporations. In these tough economic times, everyone should pay their fair share.

## **Opposition to Proposition 24**

“No on 24 – Stop the Jobs Tax” is a coalition of taxpayers, employers and biotechnology associations opposed to Proposition 24; arguments on their website ([www.stopprop24.com](http://www.stopprop24.com)) and in the 2010 Official Voter Information Guide published by the Secretary of State claim the proposition is a giant step backward on California's road to recovery. Their statements include the following:

States across the country have updated tax laws to attract and grow businesses and jobs. California finally did the same, but Proposition 24 on the November ballot would repeal those updates. Proposition 24 penalizes job growth and encourages businesses to expand into other states – taking good jobs and tax revenue with them.

With the recent state tax update, multi-state companies can have their state income tax based on their in-state sales. But the Jobs Tax Initiative would take us back to an outdated formula that increases their income taxes every time they create a new job here, which an economic study reveals would cost California 144,000 jobs.

Proponents falsely claim it only hits big corporations, but State Franchise Tax Board records show Proposition 24 could impact 120,000 businesses.

More than half of the state's private sector jobs are created by small businesses. Last year, small business bankruptcies in California rose 81%. To help them survive the recession, federal tax laws were recently updated to allow small businesses to carry back net operating losses five years. The recent state tax update allows businesses two years. Prop.24 takes away that lifeline altogether. It would force more small businesses to close shop, causing even more layoffs.

Proponents failed to include language to guarantee proper expenditure of the tax increase, leaving it up to the same politicians who misspent us into debt. Worse, Proposition 24 would dramatically slow down our economic recovery, leaving fewer long-term revenues for classrooms, public safety, services for seniors and others.

The state's corporate income tax rate remains unchanged. It will still be among the highest in the nation and the highest in the west. And if the Jobs Tax Initiative passes, we count on California still coming in close to rock bottom on almost every national ranking of business tax climates. The Tax Foundation ranks us 48<sup>th</sup> on their *State Business Tax Climate Index* and the Small Business & Entrepreneurship Council ranks us 49<sup>th</sup> with one of the nation's worst climates for small business and entrepreneurship on their *Small Business Survival Index*. Almost every state in the country is more hospitable to business, and jobs, than California. The recent tax updates would help keep businesses here and grow more jobs here. By repealing them, Prop 24 promises the opposite.”

## **Comments:**

### **A. Madison and Jefferson, Redux.**

While the passage of Proposition 24 would provide a much needed increase in revenue for the state, and eliminates tax benefits of questionable effect on employment, the tax benefits the initiative seeks to repeal were a result of considerable negotiation and compromise in the 2008 and 2009 budget agreements. As with any significant tax issue, opponents and proponents of the tax benefits argued vigorously regarding its merits; enactment either turned California's corporate tax system into a national laughing stock, or ensure enhanced future employment for Californians and profitability for firms that choose to locate here. The Legislature considered several proposals to enact many of these provisions in the past, assessed these arguments for many years, and rendered its judgment by enacting the measures. While these tax benefits were enacted as part of a carefully crafted legislative compromise, the initiative allows voters to eliminate one part of that agreement, once again reviving the debate regarding longer than the history of our

nation whether elected representatives should address the issues of the day or voters should set priorities directly.

## **B. Death and Taxes**

California's corporate tax has changed radically in only a few years after years of relative quiet. After few modifications since adopting UDITPA in 1966, including double-weighting the sales factor and allowing a water's edge election, the Legislature granted NOL carrybacks in 2008, and elective sales factor-only apportionment in 2009, benefits which Proposition 24 would eliminate. While many of the benefits have not yet taken effect, firms allocating finite investments cannot adequately assess rates of return when tax policy is unresolved, and many have relied upon the certainty of the 2008 and 2009 budget agreements in making investments and other business decisions. Firms generally prefer certainty above all else because business decisions have more predictable results in an unchanged policy environment. Enacting Proposition 24 would cause additional uncertainty by changing current law's course.

## **C. Sure, But Will It Work?**

Proposition 24 challenges the conventional, yet largely unproven, economic wisdom that reducing state business taxes increases employment. By canceling the tax benefits, enacting the initiative would cause taxpayers to pay more tax, resulting in higher revenues to the state that would ostensibly be used to fund public services, and a reduction in wealth in the private sector. Proponents and opponents of the initiative have an empirical if not theological disagreement about the economic effect of tax reductions or increased public spending on employment, and likely regarding the economic benefits that each would produce. A key question for the Committee is whether evidence exists that enacting these tax benefits at a state level causes employment growth. Additionally, given that the tax benefits have been enacted, though not yet tangible, for 16 months, have firms made tangible plans to employ more Californians because of the tax benefits that the initiative seeks to repeal? Are capital expenditures, hiring practices, investments in research and development different because of these tax incentives? What firms have announced plans to invest in California, and were these tax benefits a key factor in that choice? Would enacting Proposition 24 cause these firms to change behavior? Is this discussion largely missing the point because the Great Recession changed business decisions far more than the relatively small impact of changes in state taxes?

## **D. For the Children**

Opponents of Proposition 24 argue that not a single dollar recovered by eliminating the tax benefits is guaranteed to be spent on education. However, according to the LAO's July 14, 2010 analysis, if voters approve Proposition 24, quite a bit of the revenues it will provide will go to education. LAO states that "Proposition 98 (passed by the voters in 1988) determines the minimum amount of state and local funding for K-12 schools and community colleges each year. Under the formulas of Proposition 98, a significant part of Proposition 24's revenue increases would be allocated to schools and

community colleges. The remaining revenues would be available to the Legislature and the Governor for any purpose.” However, supporters of Proposition 24 state that small businesses (and ultimately individuals) will not be negatively affected by this initiative, opponents refute this claim by stating that the FTB’s website lists tax statistics including the number of taxpayers that had NOLs for the 2007 at approximately 120,000, although whether a firm has an NOL doesn’t determine whether or not it meets any or all of tax law’s definitions of “small business.”

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