

Joint Hearing of the Assembly

Committee on Revenue and Taxation Committee on Natural Resources Committee on Utilities and Commerce

Proposition 39: "Tax Treatment for Multistate Businesses. Clean Energy and Energy Efficiency Funding. Initiative Statute."

Thursday, September 27, 2012

10:30 a.m. – 12:30 p.m.

State Capitol, Room 437

Briefing Paper

- I. Overview.** Proposition 39, which will appear on the November 2012 statewide ballot, would repeal existing law allowing multistate businesses to choose a formula for calculating their California income or franchise tax liability and, instead, would require those businesses, starting in 2013, to utilize the "single sales factor" (SSF) method of determining their taxable income. Proposition 39 is estimated to raise \$1 billion in fiscal year (FY) 2013-14 – the first full FY after implementation – growing over time. For a five-year period, from FY 2013-14 through FY 2017-18, approximately half of those revenues - \$500 million to \$550 million annually - would be deposited into a newly established Clean Energy Job Creation Fund, and would be dedicated to energy efficiency and alternative energy projects. The remaining revenues would be deposited in the State's General Fund and, according to the Legislative Analyst's Office (LAO), a significant portion of those revenues would likely be spent on public schools and community colleges.

Proposition 39 also creates a Citizens Oversight Board, composed of nine members appointed by the State Treasurer, the State Controller, and the Attorney General, whose expertise may contribute to the effective execution of energy projects. The Citizens Oversight Board is intended to ensure that funds are used appropriately, and to evaluate the cost effectiveness of projects.

- II. Proposition 39: Stated Purpose.** Proposition 39 would enact the "California Clean Energy Jobs Act" (Act). The stated objectives of the Act include the creation of clean energy jobs in California, improvement of the energy efficiency of schools, as well as public, commercial and residential buildings, and the expansion of existing energy efficiency and clean energy

programs. Retrofitting schools and public facilities to be more energy efficient, job training in the clean energy sector, and nourishing public-private partnerships to promote job creation and clean energy expansion are examples of possible projects. Proposition 39 states that California's current tax code discourages corporations from locating jobs in this state and highlights the fact that, according to the LAO, 40,000 new jobs would be created, if California were to adopt the SSF approach.

III. Key Facts About California's Corporation Tax System. Under California law, multistate and multinational businesses must apportion their income among the jurisdictions in which they do business. California may only tax a portion of the income earned by businesses that operate in other states (or nations), in addition to California. That amount is determined by an apportionment formula. Prior to January 1, 1993, California used a "three-factor" formula that was based on the proportion of a company's sales, payroll, and property located in California. For example, if one-third of a company's sales, one-third of its payroll, and one-third of its property were located in California, then one-third of its total business income would be subject to California tax under the Corporation Tax Law. This "three-factor" formula was derived from the Uniform Division of Income for Tax Purposes Act (UDITPA), a model statute developed by the National Conference on Uniform State Laws in 1957. California adopted UDITPA and its apportionment formula in 1966 (AB 11, Petris).

Effective January 1, 1993, California adopted a revised formula in which the sales factor is double-weighted (i.e., is given twice the importance of the other two factors). (SB 1176, Kopp). For example, if a company has 75% of its property and payroll in California, but only 10% of its sales in this state, then 53.3% of its income would be subject to California tax under an equal weighting of the three factors. The double-weighted sales factor formula, however, would reduce the apportionment percentage to 42.5%. Double-weighting of the sales factor, however, does not apply to businesses that derive more than 50% of their gross receipts from agricultural, extractive (e.g., oil and gas producers), or banking or other financial activities. Those companies must still use the equally weighted three-factor formula to apportion their worldwide income.

In 2009, a component of the FY 2009-10 budget package gave multistate and multinational corporations an additional option for apportioning their business income to California [AB x3 15 (Krekorian), Chapter 10, Statutes of 2009, and SB x3 15 (Calderon), Chapter 17, Statutes of 2009]. Specifically, this legislation authorized multistate businesses to apportion their business income to California using only their percentage of sales in California, as an alternative to using the traditional four-factor apportionment methodology described above. Thus, starting with the 2011 taxable year, corporations are now allowed to make an annual election between using the SSF and a four-factor formula. Businesses that derive more than 50% of their gross receipts from agriculture, extractive business, savings and loans, or banking and financial activities are still limited to a single-weighted sales factor and are required to use the same three-factor apportionment formula.

IV. The Elective SSF Formula. For a long time, businesses with substantial employment and property in California that primarily sell their products nationally or internationally argued that the three- or four-factor apportionment methods penalized them for expanding in

California. They pointed out that any increase in their payroll and/or property in California would result in an increase of their tax liability in California under the three- or four- factor apportionment formulas. Conversely, any decrease in their California property and/or payroll factors, without any change to their sales factor, would result in a reduction of their California tax liability. Many California high-tech and biotech companies made the argument that the three-factor formula rewarded businesses for expanding outside the state.

The enactment of the SSF provision was welcomed by companies that have significant payroll and facilities in California, but make the bulk of their sales outside the state because the election of the SSF apportionment formula would, most likely, reduce their California taxes. Companies doing business only in California were not affected by this change because they do not apportion their business income; in other words, all of the business income is considered to be derived from California. On the other hand, companies that have few employees or facilities in California, but make substantial sales here, may pay more tax under the SSF apportionment formula. To alleviate the tax burden on those companies and to avoid creating "winners and losers," the Legislature included a provision that allows taxpayers to make an annual election between the SSF formula and a double-weighted formula for the apportionment of their business income to California. As a result, taxpayers that have a relatively high amount of sales in California, most likely, will elect the four-factor formula as long as they have property and payroll in California and elsewhere.

- V. **An Overview of the SSF Apportionment Regime in Other States.** In the last few years, several states have changed their apportionment formulas to a SSF regime, eliminating the property and payroll factors entirely. In addition to California, 24 states have implemented, or are in the process of phasing-in, the SSF apportionment formula. However, most states will only allow manufacturers or other identified industries to use the SSF formula, or require taxpayers to invest in the state (*e.g.*, Kansas) or to file an annual information report with the tax agency (*e.g.*, Maryland) in order to utilize the SSF formula. Finally, according to staff at the Franchise Tax Board (FTB), Missouri and California are the only states that allow corporations to elect between the SSF and a traditional three-factor apportionment formula *on an annual basis*.
- VI. **Is Elective SSF Justified on Policy Grounds?** Under the current elective system, businesses will naturally choose, *on an annual basis*, whichever method reduces their tax liability. An elective SSF formula is a tax expenditure that contains no requirement to invest or to create jobs in the state, no accountability measures, no paper trail for the state to review, and no records about outcomes at any specific company or industry. Furthermore, an elective SSF regime provides fertile soil for creative tax planning, especially in light of other recent legislation that allows corporate taxpayers to "carry-forward" net operating losses to 20 years with a phased-in two-year carryback and to share business tax credits with the members of a combined reporting group. For example, for a company with sales outside of California, but property and payroll located in the state, electing the SSF apportionment formula should, generally, result in a reduction of the California apportionment factor and, consequently, California taxable income. However, if the same company, in a particular year, generates losses instead of profits, it would elect the double-weighted formula in order to apportion a greater amount of losses to California for purposes of offsetting its California

tax liabilities in the future or claiming a refund for the last two taxable years. In other words, an elective SSF method provides multistate and multinational corporate taxpayers with an opportunity, i.e. an "election," to choose how much tax they like to pay to the state in a particular tax year. This election is one of a kind. The only other election allowed to corporate taxpayers is an election between two reporting methods: worldwide combined reporting and a reporting on a "water's-edge" basis. However, the "water's-edge" election is binding for a seven-year period.

When the three-factor apportionment formula was first developed between 1955 and 1957 and later adopted by various states, it was considered the only reasonable and fair system to ensure that multinational companies are not taxed unduly by the states in which they do business. At the same time, if adopted by all the states, the three-factor formula would, arguably, guarantee that 100% of corporate income is taxed. In contrast, if all states were to enact legislation to allow an *elective* SSF formula, corporations would elect the SSF formula in states where they have relatively large portions of their payroll and property, while choosing the alternative formula in states where they have a relatively large portion of their sales. As a result, the total amount of income apportioned to all states will be less than the amount of income the corporation earned nationally. (FTB, *California Income Tax Expenditures*, Report, December 2009, p. 28).

California's elective SSF regime represents an attempt to accomplish a public policy objective – alleviate the tax burden on out-of-state companies - that would be more efficiently addressed through direct outlay of state funds or through more targeted tax incentives that include certain accountability measures.

- VII. Mandatory SSF Approach and the LAO Recommendations.** In its publication, "Reconsidering the Elective Single Sales Factor" published in May 2010, the LAO recommended that the Legislature require sales factor-only apportionment. 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 net operating losses to apply against future tax liabilities. The LAO states that mandatory SSF raises needed revenue 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 vis-à-vis out-of-state competitors.
- VIII. Similar Legislation.** There have been various attempts to impose a mandatory SSF regime since the Legislature approved an elective apportionment formula in February 2009. In January 2011, Governor Brown proposed removing the ability of firms to choose an apportionment formula. In July 2011, SB 116 (de León) proposed a mandatory SSF, coupled with an education credit and a partial sales and use tax exemption. In September 2011, AB1X 40 (Fuentes and Fletcher) was amended to implement a mandatory SSF combined with a partial sales and use tax exemption for certain manufacturers and a reduction in various tax rates. SB 116 was later amended to include provisions identical to those in AB 1X 40. Both AB1X 40 and SB 116 died in the Senate.

In January 2012, Governor Brown again proposed that the state adopt a mandatory SSF, not as part of the budget, and suggested he would create a jobs program to spend the money raised. In January 2012, the Speaker of the Assembly, John A. Pérez, introduced AB 1500, which proposed to repeal the annual election and impose a mandatory SSF apportionment formula on multistate businesses. AB 1500 proposed to use all of the revenues derived from those changes for a newly established Middle Class Scholarship Fund. AB 1500 passed the Assembly on August 8, 2012, but failed on the Senate Floor on the last day of the legislative session.

- IX. Initiative vs. Legislative Process.** The annual election of an apportionment formula was a result of considerable negotiation and compromise in the 2008 and 2009 budget agreements. The Legislature considered several similar proposals relating to the SSF apportionment in the past, but rendered its judgment by enacting the provision allowing an annual election. While the passage of Proposition 39 would provide a much-needed increase in revenue for the state and would put California in conformity with other large states, it would also eliminate part of the 2009 budget agreement. Once again, a proposition has highlighted the natural tension between the initiative and legislative processes and is reviving the debate about direct democracy.
- X. Dedicated Funding.** Proposition 39 dedicates \$550 million, or 50% of the annual increase in revenues from the SSF, whichever is less, annually for five years to fund projects that create energy efficiency and clean energy jobs in California, upon appropriation by the Legislature. As noted above, the proposition also creates a Citizen Oversight Board to review expenditures made from this funding allocation and publishes an accounting of the fund. The funding may include:
- a) Energy efficiency and clean energy installations at public schools, universities and colleges, and other public buildings;
 - b) Job training and workforce development on clean energy and energy efficiency programs; and,
 - c) Financing and technical assistance to fund Property Assessed Clean Energy (PACE) programs.

Attached is a summary of major clean energy and energy efficiency programs currently in place in California. A number of existing programs provide funding for activities similar to that those described in the proposition.